THE AFRICAN CAPACITY BUILDING FOUNDATION | FONDATION POUR LE RENFORCEMENT DES CAPACITES EN AFRIQUE

ZEPARU Zimbabwe Economic Policy Analysis and Research Unit


# AN ASSESSMENT OF FINANCIAL MARKET DISTORTIONS IN ZIMBABWE

THE AFRICAN CAPACITY BUILDING FOUNDATION | FONDATION POUR LE RENFORCEMENT DES CAPACITÉS EN AFRIQUE

Zimbabwe Economic Policy Analysis and Research Unit

ZEPARU

# An Assessment of Financial Market Distortions in Zimbabwe

Gibson Chigumira, Sanderson Abel, Wellington Matsika & Ivy Gurure[1]

**ISBN: 978-1-77906-374-8**

[1]Research team comprised of: Gibson Chigumira, ZEPARU Executive Director and Team Leader; Sanderson Abel, Consultant; Wellington Matsika, ZEPARU Research Fellow; Ivy Gurure, Research Assistant.

# TABLE OF CONTENTS

## LIST OF FIGURES



## LIST OF TABLES

## Acronyms and Abbreviations

| | |
|---|---|
| DIMAF | Distressed Industry and Marginalised Areas Fund |
| GDP | Gross domestic product |
| MFI | Microfinance institutions |
| MNOs | Mobile Network Operators |
| POSB | Post Office Savings Bank |
| RBZ | Reserve Bank of Zimbabwe |
| RTGS | Real-Time Gross Settlement System |
| SECZM | Securities exchange commission of Zimbabwe |
| TBs | Treasury Bills |
| TFP | Total factor productivity |
| WTO | World Trade Organisation |
| ZAMCO | Zimbabwe Asset Management Company |
| ZETREF | Zimbabwe Economic and Trade Revival Fund |

## Acknowledgements

The study team would like to acknowledge the following: African Capacity Building Foundation (ACBF) for funding the study and all the participants who provided information during the inception workshop, key informant interviews and the validation workshop. The views in this study report are those of the authors and do not necessarily reflect the views of Zimbabwe Economic Policy Analysis and Research Unit (ZEPARU) or those of the funder of the study – ACBF.

## Executive summary

The main objective of the study is to assess the market distortions in the Zimbabwean financial markets. The specific objectives are to: (i) identify the distortions in the financial market; (ii) analyze the causes of financial market distortions; and (iii) proffer recommendations on how the distortions can be addressed.

The study identified the following distortions: (a) adverse selection and moral hazard emanating from the absence of comprehensive credit infrastructure; (b) missing markets depriving the economy of specialist services which are now being offered by commercial banks that lack the relevant expertise; (c) missing robust credit guarantee system affecting lending to SMEs; (d) unplanned private placement of TBs against the international best practice of the tender system; (e) absence of Lender of Last resort facility depriving the market of a benchmark rate for setting interest rates; (f) direct influence of the central bank in setting of Lending rates; (g) foreign exchange priority list which has distorted the foreign exchange markets, (h) central bank financing facilities constitute directed lending and fixed interest rates; (i) uneven regulatory framework for mobile money and banking services; (j) The lifting off of bad loans through ZAMCO disguised the real non-performing loan levels obtaining in the banking sector, resulting in the understating the real level of credit risk, hence distorting the pricing of loans in the sector; (k) Introduction of bond notes which has distorted the payment system and created parallel pricing systems; (l) Growth in non-interest income in banking sector and (m) growth in RTGS balance which has created inflationary pressures in the economy.

The study recommends the following: (i) curbing excessive government borrowing from the banking sector through sticking to the statutory maximum borrowing of 20%; (ii) establishing a government borrowing plan to avoid expensive reactive borrowing; (iii) adopt transparent issuing of TBs through the competitive auction system; (iv) minimize TB rollovers to avoid significant systemic settlement risk to the banking sector; (v) ensuring that the central bank

stick to its core mandate and reduce its involvement quasi fiscal activities that distort the market; (vi) avoiding direct control of interest rate by the central bank; (vii) liberalizing foreign currency allocation through allowing banks to actively allocate foreign exchange and expediting the establishment of the Foreign Currency Management Committee (FCMC); (viii) liberalizing or demonetizing the bond note exchange rate; (iX) consolidating government securities through buying back securities with same maturity but different interest rates and re-sell them at similar rates while also floating benchmark bonds at 2/3 years, 5 years, 7 years and 10 years in order to establish a yield curve in the market that will facilitate the pricing of financial instruments; (x) harmonizing legislation for MNOs, banks and insurance companies to create a level playing field; and (xi) incentivizing the establishment of missing institutions and markets that provide specialist financial products.

## 1.1Introduction

The financial services sector play an important role in the economy through mobilizing resources and allocating them to investors, monitoring performance of corporates, managing risk and facilitating trade through reducing transaction costs. Financial markets play a central role in economic development acting as a link between surplus units and deficit units in the economy. Among other key functions played by the financial markets are facilitation of price discovery in the market, provision of liquidity and reduction of transaction costs on the market. An efficient financial market ensures that participants do not have to spend time sourcing information as it is readily available in financial markets.

The ability of financial markets to bear risk is central to economic welfare and stability. Growth and economic wellbeing is inhibited if financial markets are unable to transfer resources efficiently from the suppliers of liquidity to entrepreneurs. However, this proper functioning of global financial markets has been distorted by levels of volatility considerably in excess of those implied by fundamentals. Markets have undergone dramatic crashes and they display speculative bubbles with market prices far removed from their equilibrium values.
There is no single agreed definition for financial market distortions. Financial frictions, whatever their origins may be, distort the allocation of funds to projects, causing some less productive projects to be funded while more productive projects are not. Financial distortions can be policy or regulatory induced or arise from market failures. Policy or regulation induced distortions could arise from interest rate ceilings, directed credit lending and any other interventions meant to direct the operations of the financial markets but cause financial market frictions.

The sources of distortions are myriad ranging from government interventions, collateral constraints, informational asymmetries or search frictions. Many different kinds of events, actions, policies, or beliefs can bring about a market distortion. These include asymmetric information or uncertainty among market participants, any policy or

action that restricts information critical to the market, illiquidity of the market (lack of buyers, sellers, product, or money),mass non-rational behavior by market participants, price supports or subsidies, failure of government to provide a stable currency, failure of government to protect property rights, failure of government to regulate non-competitive market behavior, and natural factors that impede competition between firms, such as occurs in real estate. Financial Market distortions are not only a source of vulnerability for the economy but they are a hindrance to growth.

A competitive financial system in any country is critical since banks are effective entities for financial intermediation, channeling savings into investments so as to foster higher economic growth (Buchs and Mathisen 2005). The competitiveness of banks is also important for the stability of financial systems. A higher degree of competition and efficiency in the banking system also contributes to greater financial stability, product innovation and lends access by households and firms to financial services; this in turn improves the prospects for economic growth (Antwi and Antwi 2013; Yildirim and Philippatos 2007). This argument is not valid in the case of state-dominated monopolistic, inefficient and fragile banking systems in many low-income countries and has been criticized as the major hindrance to economic development (Hauner and Peiris 2005).

A properly functioning financial market is characterized as a market where: consumers choose from various products and services and make tradeoffs between factors such as access and availability of financial products and services; type/attributes of financial products and services, quality, price/interest rates, and convenience/transaction costs. Prices/interest rates provide information about the affordability of or return on investment in the financial products and services. These characteristics of a properly functioning financial market would result in the maximization of societal benefits. Under such circumstances, the market should exhibit the following principles:

i. Consumer options - consumers need viable options from which they can choose and make trade-offs between factors such as price, type of financial product/service quality of financial product/service and convenience . They also need convenient and timious information about available products and services.
ii. Cost-based pricing - prices (what consumers pay for financial products and services) must reflect marginal costs (what it costs to produce the product or service).
iii. Economic neutrality - public policies (investments, taxes, subsidies, regulations, etc.) should not favor one financial product, services or group of users of financial services, unless specifically justified.

The financial market in Zimbabwe like in the rest of the world is characterized by a number of distortions. The existence of these financial market distortions is a cause for concern given their implications on the functioning of the economy. Financial market distortions cause unproductive projects to be implemented at the expense of more productive projects. Because of this, the return to the marginal units of funding is relatively higher in more distorted economies. For example, the upheaval in the markets which manifested itself last year largely as a surge in stock market prices and a dislocation in the foreign exchange market which has spilled into the real goods market in the form of multi-tier pricing, must be tackled head on if the country is to put the economy on a sustainable path to recovery. The economy also experienced a rapid decline in real asset valuations in the property markets, contraction of private sector credit and the resurgence of inflation as a result of the distortions.

## 1.2. Objective of the study

The main objective of the study is to assess the market distortions in the Zimbabwean financial markets. The specific objectives are to:

- Identify the distortions in the financial market;
- Analyze the causes of financial market distortions; and
- Proffer recommendations on how the distortions can be addressed.

The study will mainly focus on the banking sector and the microfinance sector. The banking sector is the dominant sector in the financial services sector ahead of the insurance sector and the stock market. The microfinance sector will be studied because of its important role in providing financial services to the marginalized groups such informal sector players and the rural populace. Focus will be on those distortions which generate negative impacts on the financial market. To accomplish the objective of the study the researchers undertook an inception workshop, key informant interviews with some stakeholders and received written submissions from some institutions. Interviews were done in Harare, Bulawayo, Gweru and Masvingo. The subjects of interviews were drawn from business management organisations, and financial market players. A validation workshop was held in which those who were interviewed and other financial sector players who were not interviewed were invited to validate the research findings.

## 1.3. Background to financial distortions in Zimbabwe

### 1.3.1 Period of heavy financial controls in Zimbabwe

The financial sector in Zimbabwe has undergone transformation since independence in 1980.The period between 1980 and 1990 was characterized by heavy state controls in the financial sector. These included state fixed lending and deposit interest rates, liquid asset ratios, credit ceilings which channeled resources to specified sectors, unequal reserve requirements for different financial institutions, fixed exchange rate, portfolio restrictions on financial institutions which created a market for government paper, foreign exchange allocation procedures, selective credit programs, compulsory investment requirements, preferential tax treatment, and legal limitations on the kinds of activities and sources of revenue for different financial institutions. The financial market was also oligopolistic in nature, characterized by few large institutions; most of them of foreign origin. The central bank set targets for commercial banks for lending to the marginalized groups such as SMEs and newly established enterprises owned by blacks.

### 1.3.2 An abortive financial markets liberalization programme in Zimbabwe

Over the period 1991 to 2000, the government partially liberalized the financial market through: decontrolling of lending and deposit rates, removal of credit controls, opening up for new entries of financial institutions, relaxation of portfolio restrictions, relaxation of foreign exchange controls to allow banks greater freedom in the control and use of foreign currency, removal of restriction on the use of surplus funds, removal of interest rate caps on surplus funds, introduction of foreign currency accounts, abandonment of the two-tier exchange rate system, move towards a more market determined exchange rate, and opening up of the stock market to allow for foreign participation. However, some interest rates (e.g. minimum deposit rates for POSB, building societies' rates on savings and owner-occupied residential mortgages) were not decontrolled.

During the period when the financial market was liberalized, new financial market institutions were created resulting in an increase in the number of finance houses, building societies, merchant banks, and venture capital companies. However, currently there are institutions that used to exist in the Zimbabwean financial market that no longer exist today such as discount houses, finance houses, and venture capital companies (Figure 1). Their disappearance implies that there are services that are no longer provided at the level of expertise that these institutions provided.

## Figure 1: Registered financial market players


*Source: MoF, RBZ, IPEC and SECZ, November 2018*

### 1.3.3 Return to financial repression in Zimbabwe

However, starting in 2013, the government re-introduced most of these controls that were experienced over the period 1980 to 1990.In 2013 the Reserve Bank of Zimbabwe signed a Memorandum of Understanding (MOU) with the banking sector on an agreed framework for reducing service charges and interest rates. Since then lending interest rates are controlled through a MOU with banking institutions, directed lending facilities for marginalized groups have been introduced, targets have been set for banks to lend towards marginalized groups, and foreign exchange allocation controls. However, statutory reserve requirements for banking institutions were abolished with effect from 28 July 2010, to contain risks in the banking system and to release more resources for lending by banks, at lower and affordable interest rates.

The government of Zimbabwe has been directly and indirectly involved in the financial market offering different facilities. These include, the Zimbabwe Economic and Trade Revival Fund (ZETREF) with Afreximbank and the Distressed Industry and Marginalised Areas Fund (DIMAF) which aimed at mobilising funds to address working capital challenges faced by distressed and marginalized companies? These facilities did not live up to expectation. In 2017 the government through the Reserve Bank of Zimbabwe introduced 11 funding facilities valued at $268.592 million to promote production, financial inclusion and sustainable development. These are discussed in detail in section 3.

## 2. Literature review and case studies

Markets may fail to reach competitive outcomes for many reasons, including market failures, anti-competitive behavior by firms, and restrictive government policies. In the case of market failures and anti-competitive behavior by firms, appropriate government policy may be used to partially or wholly eliminate damage to welfare. However, these policies have the potential to do more harm than good if they are not carefully implemented. The government can also implement policies that can be classified as reactions to market failures but which also reduce welfare. When policy changes the way in which players in a market interact with each other, reducing welfare, the policy can be said to be a negative market distortion regardless of the reason for implementing the policy.

The financial sector is at the heart of a well-functioning economy. Several researchers have studied the linkages between financial development and economic growth and found bi-directional causality between financial sector development and economic growth. Goldsmith (1969) provided an empirical study documenting the existence of a link between finance and economic growth. Rajan and Zingales (1998), using firm-level data confirms that countries with better functioning financial systems and industries that are heavy users of external finance grow faster than industries that are not. Levine

(2005) also confirms the existence of a strong positive link between the functioning of the financial system and growth. The above studies therefore point to the fact that financial development leads to economic growth

The government and monetary authorities might intervene into the financial market trying to correct market failure, however these interventions might introduce distortions. Guariglia and Poncet (2005) found that traditionally used indicators of financial development and China-specific indicators measuring the level of state intervention in finance are generally negatively associated with growth and its sources, while indicators measuring the degree of market driven financing in the economy tend to promote GDP and total factor productivity (TFP) growth, as well as capital accumulation. Therefore, little or no government intervention is advocated for.

In his analysis of financially repressed developing economies, Shaw (1973) argues that distortions of financial prices including interest rates and foreign-exchange rates reduces the real rate of growth and the real size of the financial system relative to non -financial magnitudes. "In all cases financial repression has stopped or gravely retarded the development process" (Shaw, 1973: 3-4).

However, Allen et al. (2005) in their study found China as a counterexample to the findings of the finance-growth literature, in spite of a malfunctioning financial system. China had one of the fastest growing economies. The Chinese case therefore suggests that not all financial distortions represent an impediment to growth.

Engel (2013) argues that there is a rationale for targeting the exchange rate despite the "myth" that many economists share that freely floating exchange rates will enhance overall economic efficiency and lead to better allocations. He argues that this is not necessarily true in a world of slow adjustment of nominal wages and prices. When exchange rates fluctuate, they influence relative prices and wages across countries because nominal wages and prices don't adjust as fast as exchange rates move. Even in efficient foreign

exchange markets, the fluctuations of exchange rates do not lead to efficient movements in international wages and prices. He concludes that controlling exchange rates might be a legitimate activity, given the distortion of sticky wages and prices. Nevertheless, a fixed exchange rate may be equally detrimental to economic growth. Therefore a middle-of-the-road approach such as a flexible managed exchange rate float can actually achieve positive results. A good example of such an arrangement in the Southern Africa region is Botswana. The Botswana Pula is a managed float and it has performed fairly well. If it was allowed to float it would appreciate very strongly due to a healthy international foreign currency reserve position which would damage or decimate the little manufacturing sector there is in the country.

Ostry et al. (2011) found that countries with capital controls rebounded more quickly from the financial crisis than those that did not have controls. They examined the change in economic growth from 2004–07 and 2008–09 and found that countries with capital controls did better. This finding holds even when capital controls were instrumented with a binary variable that measures whether a country had a BIT (bilateral investment treaty) with the US – countries with BITs tended to have fewer capital controls.

Chinn and Ito (2006) found that allowing capital inflows speeds the development of local financial markets, especially local equity markets. But there is a threshold effect – this works only in countries that score highly in measures of bureaucratic quality and law and order. Therefore, what governments and monetary authorities need to worry about is bureaucratic quality and law and order for open capital markets to allow the development of financial markets.

In their study on the effectiveness of public guarantees on bank bonds, Grande et al (2011) argue that public guarantees have been associated with major economic disruption and recessions. In many developed countries guarantees that were granted in 2008-09 to distressed banks created severe distortions. The cost of issuing guaranteed bonds reflected by more than 50 per cent the guarantor's

creditworthiness rather than the issuer's. This implied that banks with lower profitability and weaker balance sheet positions but enjoying guarantees from highly rated sovereigns were able to raise funds at a much lower cost than sounder and better-rated banks. This distortion in the pricing of bank bonds had two main negative effects. First, was the absence of a level playing field which was detrimental to competition and led to a misallocation of resources that lowered the banking system's productivity. Secondly, the measures created expectations of further intervention, thus influencing and distorting banks business strategies and encouraging excessive risk-taking (i.e. moral hazard). Therefore, in this case preserving a level playing field and containing moral hazard are crucial principles in steering the financial system towards a new environment with better incentives.

## 3. Market Distortions in the Banking and Microfinance Sector in Zimbabwe

The economic and political environment in Zimbabwe over the past two decades has been very harsh and uncharacteristic of a normal economy. The period was characterized by the decline in real GDP by 8.1% from US$15.7 in 1998 to an estimate of US$14.5billion in 2017. The current account balance averaged -4.7% of GDP over the period and international reserves have been lower than one month of import cover. Hyperinflation topped an official record rate of 281 million percent in July 2008, leading to the demonetization of the Zimbabwe dollar and an adoption of the multicurrency system in 2009 which has reduced the role of monetary policy in the economy. Following the land redistribution programme in the year 2000, international relations between Zimbabwe and the USA and European countries deteriorated resulting in the suspension of some financial and development cooperation programmes. In 2003 Zimbabwe's IMF voting and other related rights were suspended. Hence some of the distortions discussed here have been a result of the abnormal economic environment.

## 3.1 Adverse Selection and Moral Hazard

The financial market is affected by the challenge of adverse selection and moral hazard emanating from the absence of critical market infrastructure. For example, between 2009 and 2015 there was no credit infrastructure (e.g. credit bureaux) in the country which the microfinance institutions and banks could rely on. Post 2016, the credit infrastructure has been instituted but has not taken into consideration some credit suppliers hence is not yet providing full information pertaining to the credit worth of the clients approaching the banks or microfinance institutions. In this case the potential for a resurgence of non-performing loans (NPL) in the economy is likely to increase because financial institutions are basing their assessment on incomplete information which excludes payments such as rentals, water bills, electricity bills and insurance premiums.

**Box 1: Why credit reference systems matter**

Transparent credit information is a prerequisite for sound risk management and financial stability. Credit reporting institutions, such as credit bureaus, support financial stability and credit market efficiency and stability in two important ways. First, banks and nonbank financial institutions (NBFIs) draw on credit reporting systems to screen borrowers and monitor the risk profile of existing loan portfolios. Second, regulators rely on credit information to understand the interconnected credit risks faced by systemically important borrowers and financial institutions and to conduct essential oversight functions. Such efforts reduce default risk and improve the efficiency of financial intermediation. In a competitive credit market, these efforts ultimately benefit consumers through lower interest rates.

Effective credit reporting systems can mitigate a number of market failures that are common in financial markets around the world, and most severely apparent in less developed economies. The availability of high-quality credit information, for example, reduces problems of adverse selection and asymmetric information between borrowers and lenders. This reduces default risk and improves the allocation of new credit. Information sharing can also promote a responsible "credit culture" by discouraging excessive debt and rewarding responsible borrowing and repayment.

Perhaps most important, credit reporting allows borrowers to build a credit history and to use this "reputational collateral" to access formal credit outside established lending relationships. This is especially beneficial for small enterprises and new borrowers with limited access to physical collateral. Stylized evidence from the recent financial crisis also suggests that positive credit information helped to safeguard the financial access of creditworthy borrowers that would have otherwise been cut off from institutional credit.

Source: http://www.worldbank.org/en/publication/gfdr/background/key-terms-explained#3

### 3.2 Missing markets

The financial sector in Zimbabwe has lost a number of institutions since the sector was financially liberalized. The financial market then was composed of commercial banks, building societies, discount houses, leasing houses, development finance houses and venture capital among other specialist financing houses. At the moment the financial sector is broadly composed of commercial banks and building societies hence depriving the economy of specialist financing houses. The effect of the absence of these specialist financing houses is that players in the economy are reliant on commercial banks who don't have the relevant skills to assess certain type of projects. This implies that these projects are assessed using conventional credit assessment instead of being viewed with the specialist lenses that there are supposed to be subjected to. Notable among these challenges is the lack of financing of Greenfield projects. Most of the banks are used to financing Brownfield investment projects hence the rejection of the Greenfield investment because they don't have any history under which they can be assessed. In the presence of venture capital such projects could get favorable assessment because there will be systems that have the capacity to assess them unlike the current situation.

### 3.3 Missing Institutions

The absence of a robust credit guarantee system is also affecting small to medium enterprises despite the sector being viable and productive. Traditional banking approach is averse to lending to this sector because of the high risk associated with SMEs. Under normal circumstances the government intervenes or allows some institutions to underwrite the perceived risk through guarantees for the SMEs so that they get funding from the banks. The situation is worsened by the collateral-based lending in the country when the other countries are moving towards relationship lending. Changing the current situation from the collateral-based lending towards relationship lending coupled with a robust credit guarantee scheme would help unlock

resources to support the SMEs and other organizations requiring finance from banks and microfinance institutions.

The Zimbabwe country being an agro based economy, financing of the agricultural sector is currently hindered by the absence of an effective order system that cuts across all crops. Tobacco being a good example where the benefits of an effective stop order system is functional. With tobacco all suppliers of raw materials to the farmer are given a priority ahead of the payment to the farmer. In the case of other crops there is serious distortions which arise because the payment mechanism favor the farmer at the expense of the supplier of the materials. Legislation framework should clearly define the payment mechanisms for the various crops in order to ensure the funders are protected from unscrupulous farmers who don't want to repay as well as criminalizing the side market of agricultural produce.

### 3.5 Technological gap

The slow uptake of technology mostly in the microfinance sector and to some extent in the banking sector is hindering the growth of the financial services sector and provision of financial services hence acting as a hindrance. The world is moving towards the branchless banking where clients are not supposed to approach banks whenever they want to access credit. With most productive sector time being lost as one approaches the bank, there is need for adoption by the microfinance of electronic mechanisms where the clients can make their loan application. Internet access has since improved seriously in the country hence MFIs and Banks should take advantage of this phenomenon to improve their service offering to clients. In South Africa, people are able to apply for insurance, credit etc. through mobile phones hence that is the route the country needs to be taking with the regulator putting in place regulations controlling this platform to avoid institutions being duped. In addition, in Zimbabwe there is low financial product innovation designed for marginalized groups such as SMEs. In East Africa, for example, loan

and insurance products are guaranteed by group members and collateralized by warehouse receipts and green groups which are common means of lending to the marginalized groups.

### 3.6 Ad-hoc issuance of financial market instruments

The issuance of financial instruments on the market by the Government has been more distortionary in the financial services sector. The government has relied more on the private placement of Treasury Bills compared to the use of the international best practice of using the tender system. Under this situation the banks which are the ultimate funders are caught by surprise when asked to fund the issuance while under normal circumstances banks know in advance during the tender processes.

The government ceased to auction TBs in 2008. In 2012 the government attempted to re-introduce the auction system for issuing TBs for the dual purpose of raising US$300 million for government and to activate the money market. However, the re-introduction was unsuccessful (see Table 2). Government sought to raise about US$300 million. Bidders were restricted to one bid per auction. The minimum bid amount was US$100 000.00. The tenor was 91 days for all auctions as the bid amounts were below the offered amount, bid rates were considered high, participation was low, and almost all the bids were rejected. The reasons for the unsuccessful auction of TBs included low participation by banks, participation limited to banks only, TBs were not perceived as low risk instruments because of government's weak revenue generating capacity, under-capitalization of the RBZ, inability to print money, lack of clarity on the intended use of the borrowed money, TBs lacked the buy-back feature, unfavourable TB allotment rate formula, limited usefulness of the TBs without lender of last resort window, and fear of continuous roll-over of TBs at maturity.

**Table 1: Unsuccessful Re-Introduction of Government Treasury Bills in 2012**

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

*Source: Reserve Bank of Zimbabwe*

Another issue associated with the issuance of the TBs is the issuance of the instruments with the same features but with different rates. This is quite distortionary because instruments with similar maturity profiles should have similar coupon rates. Under this situation to bring the two rates in line means someone has to suffer huge losses if you are to discount / sell at a higher rate than the issue rate especially the longer the holding period. This scenario is only beneficial to someone holding an instrument issued at a higher rate and then rediscount at a lower rate. The bulk of the issues are at the lower rate. At best the client has to offload at the original rate of issuance. This brings the question of how does one mark to market such instruments or determine the market value of such instruments. One of the main distortion on the market is the absence of yield curve in the market. This implies that there is no basis for pricing of financial instruments.

The Government borrowing reflects a lack borrowing plan. The market has since realized that the government borrowing is done on an Ad-hoc basis. This does not give the market the opportunity to plan ahead before the government enters the market. This type of borrowing by the government places providers of liquidity in a fix as they will not freely set the desired parameters. This is further worsened when itis done privately as it might suggest desperation on the part of the borrower and naturally the surplus unit will take advantage of the situation. This then further distorts the situation on the market as the signals are ad hoc when in fact there should be systematic to allow

market players to make preparations to support government borrowing with provision of liquidity as and when required. This is at the heart of lack of a yield curve on the market.

### 3.7 Absence of Lender of Last resort

Dollarization led to the loss of the Lender of Last Resort (LLR) facility by the Central Bank. This then deprives the market of a benchmark rate for setting interest rates. Coupled with the absence of an interbank market, secondary trading of instruments is largely bilateral to the extent that a genuine seller will be forced to sell to one particular institution because all the others are unwilling to do so and they get hit since there are no available options. In this case that is the reason why the central bank has to play a critical role in the re-development of a vibrant secondary market by being an active player in the market to ensure proper pricing of securities and transparency of pricing information.

In a fully dollarized economy it is often argued that the central bank cannot print money and therefore would not be able to stop a financial crisis by injecting liquidity. However, there are alternative ways to the LLR, for example, Argentina arranged a facility with several large banks that allows authorities to get sizable instant credit in case of crisis. Another alternative is to have individual banks secure international connections from which they can get credit lines to avert liquidity challenges.

Nevertheless, the financial system may still perform exceptionally well without a LLR. For instance, Panama does not have a central bank, neither does it have a LLR nor a mechanism to mitigate systemic liquidity shortages, and the absence of these features has contributed to the strength and resilience of the banking system which is ranked seventh in the world for soundness. This is because banks rely on holding high levels of liquidity beyond the prudential requirement as a

[4]Michael Fry (2016).
http://www.thenational.scot/news/14867740.Michael_Fry__Lender_of_last_resort__Let___s_build_a_system_that_doesn___t_need_one___/

Komaromi A, MHadzi-Vaskov M., and Wezel T., (2016) Assessing Liquidity Buffers in the Panamanian Banking Sector. IMF Working Paper WP/16/200.

result of the lack of central bank, LLR and a mechanism for insuring against systemic liquidity shortages. Authorities in Panama have set out a regulation that defines the Legal Liquidity Index (LLI) as a measure of liquidity and sets a 30% minimum requirement on liquid assets as a share of qualifying deposit.

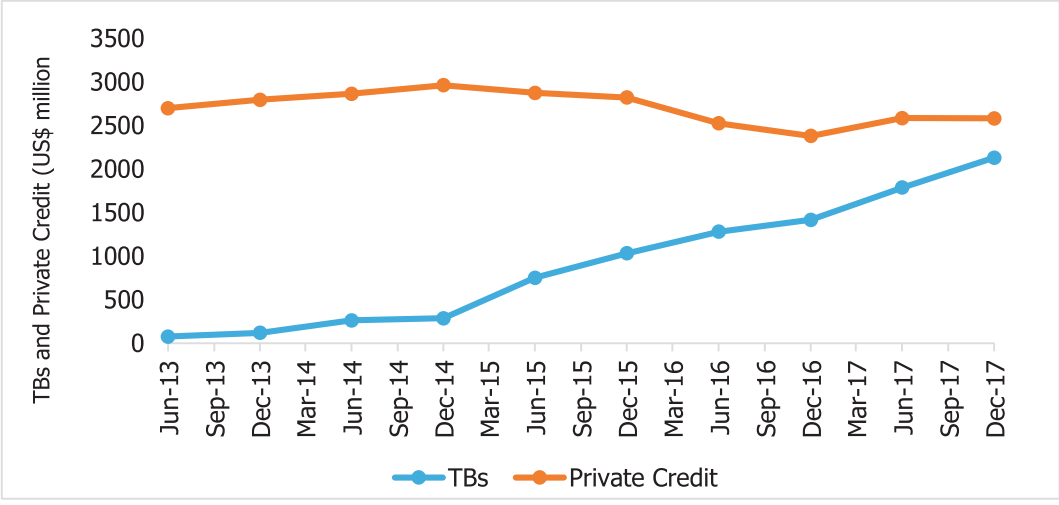
Unlike Panama, Ecuador and El Salvador which are also fully dollarized, both have deposit insurance schemes. Ecuador has a liquidity fund for banks, while El Salvador is in the process of implementing a lender of last resort facility and both countries have central banks which provide the institutional setting for the liquidity facilities.

### 3.8 Setting of Lending rates

Interest rates broadly defined are the price of money. The price in a strictly liberalised environment is supposed be set by the market forces. In the Zimbabwean economy since dollarization, specifically starting in 2013 when the central bank instituted the Memorandum of understanding with banks, there has been a tendency by the central bank to dictate the interest rates not premised on the cost of the funds to the banks. These interest rates have gradually been revised down from 18%, 15% and now 12% for the productive sectors without market-based justification. This is tantamount to financial repression because neither the banks nor market forces are deployed to determine the interest rates.

This has resulted to a significant extent in disintermediation in the market through a reduction in lending by banks as they prefer to channel the resources towards the Treasury Bills. Given the difference between the TBs and lending rates which have been going down since the central bank started intervening in the setting of the interest rates, banks have found a safe haven in TBs which are a relatively less risky investment. The justification for such a move by the banks is that the interest rates are low to cushion them from the risk prevailing in the market hence better to hold relatively less risky assets.

## Figure 2: TBs and Private Credit- Commercial Banks

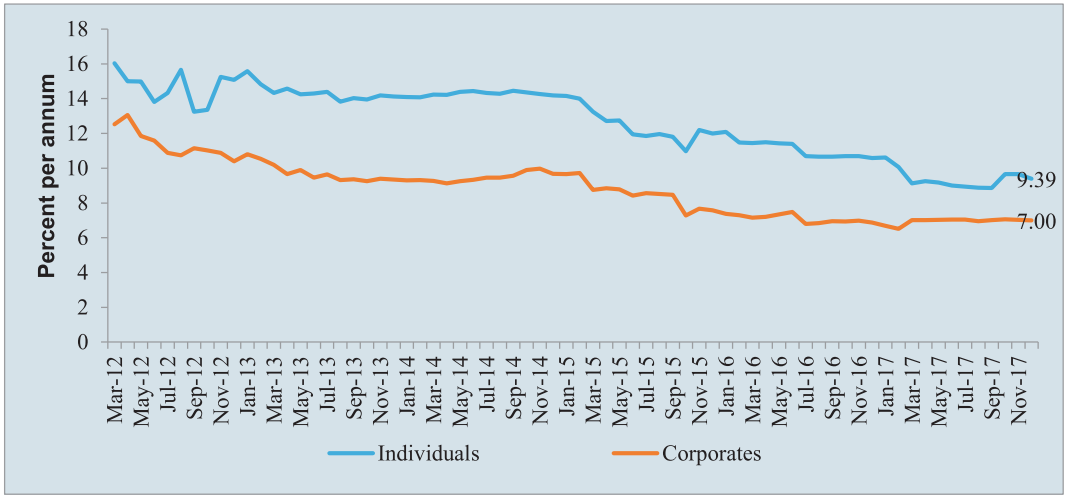



*Source: Reserve Bank of Zimbabwe (RBZ), 2014*

**The net effect of the above include:**

- Reduced lending to the productive sectors which is impacting the growth trajectory of the economy.
- Failure to attract lines of credit and offshore financing since the suppliers of these funds(lines) to banks are sceptical that banks might fail to repay because there are not in control of the pricing of these funds. This means that banks need strong justification to land these funds into the economy which deprives the productive sectors

**Figure 3: Average weighted bank lending rates for corporates and individuals**




*Source: RBZ, 2017*

A further distortion of interest rates is evident on the quoting of the interest rates by commercial banks and microfinance institutions. Commercial banks and building societies are supposed to quote their rates per annum while microfinance institutions are charging monthly rates (you annualise these monthly rates the rate is enormous). Both these interest rates lie under the purview of the central bank which sends different signals to the market. Currently, microfinance institutions are required to charge an effective lending rate of not more than 10% per month inclusive of all administrative charges according to the Reserve Bank of Zimbabwe Circular No:02-2017/BSD to Money lending by Credit-only and Deposit-taking Microfinance Institutions. Compounding of the interest rates by the microfinance institutions makes them higher than those charged by commercial banks. For instance, while commercial bank average lending rates are 7.0% for corporates and 9.4% for individuals as of December 2017, microfinance institutions charge a rate of 10% per month which translates to an annualized percentage rate of 120% per annum. This is way above the cost of funds and goes against the notion that MFIs are supposed to be catalyst of poverty alleviation.

The implication of the interest rate caps has been to distort financial institutions business models. Different banks have different business models reflecting the value proposition of their products, the

segment(s) of their target clients, the communication and distribution channels to reach out to target clients, the relationships established with clients; the key resources and activities needed to provide their products, the key partners, revenue streams and cost structure. Therefore regulating service charges and interest rates distorts the business models of banks. In addition, the regulating of service charges and lending rates distorts the real cost of funds because the caps on service charges and lending rates do not fully absorb the cost of funds. Due to interest rate caps, banks have reduced their lending as they become more and more conservative in extending credit. Banks have also reduced their effort in securing external lines of credit.

**Box 2: Impact of interest rate controls: the case of Kenya**

In September 2014 Kenya introduced the Banking (Amendment) Act 2016 which set bounds on lending and deposit rates. The Act stipulates that lending rates should not be 4% above the central bank base lending rate and deposit rates should be at least 70% of the central bank base lending rate. The impact of these interest rate controls has resulted in the following:

Impact on intermediation and financial inclusion

a) Reduced number of loan accounts as lending is extended to very credit worthy clients
b) Increase in average loan size
c) Reduced lending to small borrowers and larger loans to established firms
d) Increase in personal household loans which are salary based, less risky and administratively less expensive, but presumably highly consumptive than productive
e) Increased investment in government securities which are less risky and commensurate with lower interest rates
f) Increase in bank non-interest income from fees and commissions as a share of total revenue

Impact on the risk to financial stability

a) Erosion of the capital base of small and medium size banks due to reduced earnings
b) Reduced profitability of the banking sector, thus reducing the ability to build the capital base to absorb shorts/losses
c) Shift in the structure of deposits from time deposits to demand deposits, thus affecting the loan maturity mismatch

Impact on the monetary policy

a) Ineffectiveness of monetary policy in influencing credit and investment as reductions in the interest rate reduce credit and increase in interest rate increase credit to the private sector. This is because reduced lending rates lower the range of pricing loans thus reducing loans to more risky borrowers while increasing the central bank base rate increases the range of pricing loans and hence allowing access to loans by high risk borrowers.

Impact on economic performance

a) Reduced economic growth due to reduced lending to micro, small and medium enterprises

*Source: Central Bank of Kenya (2018)*

### 3.9 Distortions in the Foreign Exchange Markets

The shortage of foreign exchange in Zimbabwe has seen the government coming up with mechanisms of allocating the scarce foreign currency through the development of a foreign currency priority list. This list categorises the beneficiaries of the foreign currency into high priority, medium priority and low priority. This categorisation strictly speaking has seen some potential beneficiaries not benefiting since the list was put in place and only those in the high priority such as energy, pharmaceuticals and the like being allocated forex most of the time at the expense of other institutions.

Under normal circumstances forex allocation is supposed to be done through market forces where demand and supply would determine the prices. In the Zimbabwean case the price has been fixed by the government where they have equated USD to the Bond Note. The severity of the distortion of the forex allocation has led to the development of a vibrant parallel forex market where the price of forex is significantly different from what is obtaining in the formal market with the USD trading at a premium ranging from 290 percent to around 400 percent. In the informal market a person is able to access as much forex as he wants at the prevailing market price showing that there are rules prevailing there which sustains this market. The existence of this market is believed to be the one sustaining the majority of the importers who are not on the high priority import list. This then implies the distortion in the forex market is permeating the goods market through imports.

The scarcity of foreign exchange in the local market has seen the country fail to remit dividends, profits and other incomes offshore. This is bringing in some further distortions on the market as this is equal to failure to honour the country's obligations to foreigners. This then signals to potential investors that there will not be able to take recover their investments as and when they want. Similarly, banks are now finding it difficult to attract new finances because there is no guarantee that there will be able to repatriate the repayments to the foreign institutions providing support. Scarcity of the forex has brought

about foreign exchange risk which is detrimental to the functioning of the economy.

### 3.10 Central Bank financing facilities

The country's productive sectors have been receiving a number of central bank supported facilities. These facilities are in the sectors including: tobacco, horticulture, small scale miners, among others. The provision of these facilities by the central bank is a misnomer because the central bank is supposed to stick to its core mandate of price stability and growth. The central bank intervention in the financing brings in distortions in the market as it competes with the commercial banks and microfinance institutions in providing funding to the productive sectors. This might actually lead to financial disintermediation as commercial banks are by passed in the credit allocation. Some of these funds that are lent by the central bank could be used for lender of last resort facility by the central, which is its core mandate.

In case where the central bank provides financing with interest rates below those being offered by the commercial banks then the performance of these banks is compromised. It should be noted that commercial banks have the skills of selecting fundable projects as compared to central banks. This then means central bank provision of the facilities might end up being provided on other considerations outside the proper credit assessment criterion which might include political considerations rather than viability.

**Table 2: Funding facilities**

| | | All inclusive interest interests | | |
|---|---|---|---|---|
| Facility | Facility size (US$ millions) | Banks (max rate per annum, %?) | Micro finance (max rate per month) | On-lending institutions |
| Export finance | 70 | 7.5 | 2 | Banks and MFIs |
| Tobacco finance | 28.592 | 10 | - | TIMB and Agribank |
| Business linkages | 10 | 10 | 2 | Banks and MFIs |
| Horticulture | 10 | 10 | 2 | Banks and MFIs |
| Tourism supply facility | 15 | 10 | 2 | Banks and MFIs |
| Small scale gold facility | 40 | 10 | - | Fidelity Printers and Refinery |
| Cross border traders and SMEs | 15 | 10 | - | Homelink |
| Women empowerment | 15 | 10 | 2 | Banks and MFIs |
| People with disabilities | 5 | 10 | 2 | Banks and MFIs |
| Youth empowerment | 10 | 10 | 2 | Banks and MFIs |
| Higher and tertiary education facility | 50 | 10 | 2 | ZB Bank, POSB, NMB, GetBucks, Eduloan and CBZ |
| Total | 268.592 | | | |

*Source: RBZ*

In some instances the interventions are well intended especially in the light of the knowledge that financial markets on their own can never function in a socially efficient manner. However, these interventions constitute a distortion in the markets and it is imperative to assess whether the benefits that they bring are worthwhile relative to the costs of the distortions. The interest rates on these facilities is well below the maximum prescribed interest rate for the productive sectors.

These RBZ lending facilities for sustainable development and financial inclusion are regarded as a distortion as they constitute directed lending and fixed interest rates. These facilities are disbursed through the banks which have their own facilities with interest rates that differ from those of the disbursing banks, thus competing with the facilities of the disbursing banks. Clients prefer RBZ lending facilities because they have lower interest rates relative to those of banks. Interviews with some stakeholders indicated that some banks are deliberately not disbursing the RBZ facilities in an attempt to compel client to access their lending facilities. Because of lower interest rates that do not reflect the underlying credit risk of a client, banks have become very stringent in disbursing loans from the RBZ facilities. One reason for this is that the disbursing banks are the bearers of the entire credit risk associated with these RBZ facilities. As result disbursement of loans from these funds has been low.

### 3.11 Exogenous shocks as a distortion

Commercial banks have the role of supporting international payments for the country through correspondent banks. The correspondent banks help the banks to effect international payments and received funds from offshore. Commercial banks in Zimbabwe have been witnessing a decline in the number of the correspondent bank relationships as most international banks are de-risking. This then brings in challenges to the local market as the financial flows are distorted and sometimes no longer comes into the country.

### 3.12 Regulatory framework for mobile money

The economy has embraced mobile money and the mobile money is a significant amount out of the total transaction values (28.3% and second highest after RTGS) and volumes (80.7% and is the highest). Lack of a robust regulatory framework to regulate the providers of mobile money and financial services constitute a distortion in the financial market.While the introduction of mobile money and financial services is innovative it the uneven regulatory environment between banks/financial institutions and mobile network operators (MNOs) has created distortions. MNOs provide financial products which are outside the purview of monetary authorities and are supposedly add-on services yet these products have become primary sources of revenues for MNOs. MNOs are not subjected to the same level of regulations that financial institutions are subjected to. This therefore creates loop holes and unfair advantages for MNOs which offering financial products and services without facing the same stringent requirements as banks as stipulated in the Banking Act.

Laxity in regulating the financial products and services operations of MNO creates a dichotomous/fragmented regulatory environment for institutions issuing financial products and services in the country. Like any financial innovations it is important that regulations should be ahead of developments or should be in place when a product is launched to avoid situations like the ones which the global economy experienced leading to the global financial crisis.

## 3.13. ZAMCO

The policy objective for setting up ZAMCO was cleaning of banking institutions' balance sheets through lifting off bad loans which were sold to ZAMCO. While the policy intentions were noble policy effect unintended effect was the introduce other distortions in the financial market. A number of countries in similar situations have established special purpose vehicles (SPVs) such as ZAMCO to deal with the problems of non-performing loans in the banking sector. However, these SPVs promote adverse/moral hazard behavour among banks who can gamble and take up excessive risks in full knowledge that if the loans go bad they will not be allowed to fold by government. This has the same effect as bailing out banks based on the fear of contagion/systemic effects, "the classical too big to fail hypothesis" which ensures that banks are implicitly guaranteed of survival in spite of the bad investment decisions they may have made in accumulating non-performing loans. Furthermore, hiving off bad loans to ZAMCO has the effect of disguised the full extent of non-performing loan levels obtaining in the banking sector. This results in understating the real level of credit risk and hence distorting the pricing of loans in the sector.

## 3.14. Introduction of bond notes

The introduction of bond notes is also one of the perceived financial distortions in the economy. The Reserve Bank of Zimbabwe (RBZ) introduced bond notes in November 2016 as an incentive to exporters. However, this has resulted in the disappearance of the US dollar in circulation, the emergence of parallel pricing structures, and the sale of hard currency at a premium. Banks are forced to absorb distortions created as a result of fixed exchange rate between the bond notes and the United States dollar. Currency is no longer circulating in the banking sector. The public no longer deposit hard currency into the banking system. They sell the hard currency in the parallel market at a premium to get electronic balances that then reflect into the banks.

Tiered pricing mechanisms have developed as a result of bond notes.

While the RBZ maintains that the bond note is valued one-to-one with the United States dollar, the market perceives that the United States dollar has more value than the bond note. As a result, the market now has 4 prices for the same product – one price in the US dollar, the other in bond notes, the other in the RTGS and the other in mobile money.

### 3.15. Growth in non-interest income

Another perceived distortion is that banking institutions are now making profits out of service charges instead of the core activity of providing loans to the productive sectors. In addition, financial market is failing to provide long-term loans yet one of the roles of the financial market is to undertake maturity transformation whereby short-term savings are used to finance long-term investments

### 3.17. Growth in RTGS balance

The growth in RTGS balances has been considered a distortion in the financial market. These RTGS balances do not match with real money balances in the economy. Although RTGS balances and real money balances are not necessarily supposed to match one-to-one, there is supposed to be an acceptable ratio between the two balances. Currently, the ratio between the two balances is way above any acceptable level. This mismatch has resulted in the inflationary pressures in the economy.

## 4. Policy Proposals for addressing distortions

### 4.1. Curbing excessive government borrowing

Since 2013, the government has had a planned deficit which exceeds its statutory maximum borrowing limit of 20% and therefore showing fiscal indiscipline. There is need to align government expenditure to the revenue that is being generated. Government annual borrowing from the central bank is capped at 20% of its revenue from the previous year. In 2016 government revenue fell short of $4billion, meaning its recourse to RBZ overdraft should not have exceeded $800 million in 2017.However, in 2017, the overdraft was $1.2 billion,

$400million more than the limit. Political will is very important in empowering the RBZ to be empowered in order to enforce the 20% fiscal rule. Borrowing above the 20% threshold must not be permitted. Government borrowing above the limit should then be approved by the parliament as stated by section 300 of the constitution. It will be good for the authorities to uphold the 20% limit from 2018 going forward as going beyond the limit has inflationary pressures on the economy. In fact, in a number of countries Government is not permitted to borrow from the central bank as this effectively is printing money which in most cases is inflationary.

### 4.2. Government should have a borrowing plan

There seems to be no planned borrowing by the government. It seems as if government borrowing is reactive rather than pre-planned. This reactive borrowing is discouraged as the government is most likely to borrow money at a higher premium as compared to when it is planned and the auction system is used. We therefore propose that the government adopts a calendar for the issuance of treasury bills. The borrowing calendar will enhance transparency and encourage competitive pricing of treasury bills through the auction bidding system.

### 4.3. Transparent issuing of Treasury Bills

Government has been issuing treasury bills (TBs) to its creditors through the RBZ to cover its financial obligations. When the government wants to borrow, there should be transparency in the floating of the TBs. The government needs to use an open market operations(OMO) auction system where bids are entertained and offers made. The auction system should be used as opposed to private placements as it is transparent and also the government is likely to get cheaper sources of finance through the auction system as opposed to private placements where individual investors get different rates depending on relative negotiating power. The auction system also guarantees a discernible yield gap, assuring all investors of similar returns. Economists, market analysts and investors in money markets monitor the yield curve closely because significant interest rate changes,

affect financing costs and therefore expenditure decisions of businesses across all sectors of the economy.

The government is justified in issuing TBs as a result of the need to bridge the gap between revenue collection and expenditure. However, the issuance of treasury bills is not sustainable in the long run if there is no increase in real production. What is needed are comprehensive reforms that promote production so that the revenue collection base of the government can increase. The issuing of TBs of over $3 billion by the government is believed to have crowded out local players that need to borrow, starving the market of the much-needed capital to reindustrialize. Section 300 (1) of the constitution limits government borrowing to 70% of GDP. Therefore the issuance of TBs should be guided by GDP. However, for debt to be manageable, the 70% threshold is too high. The government should actually set a lower limit than the 70%threshold if the debt is going to be sustainable and manageable.

### 4.4. TB roll overs should be minimised

A rollover is when funds from a mature security are reinvested into a new issue of the same or a similar security maybe to allow the government more time to raise funds. However, rollovers expose the banking sector to significant systemic settlement risk given the likely default by government on maturity of these securities. Rollovers of treasury instruments are expected to negatively impact the liquidity environment going forward. They also reduce the confidence that the public has on the treasury to meet its financial obligations. If confidence in the treasury is to be improved and also to improve liquidity in the economy, rollovers of treasury instruments should be minimized or where possible avoided.

### 4.5. RBZ to stick to its supervisory mandate

The RBZ should stick to its mandate of bank supervision. The central bank should not be involved in quasi fiscal activities. The RBZ has increased the domestic debt by having various facilities such as the cross-border facility, SME facility, the youth empowerment fund

facility, horticulture facility and tourism support facility. These quasi fiscal activities like the SME facility for example though it was set up to support SMEs who previously were limited in terms of sources of finance, creates distortions. Such type of facilities crowd out private sector lending because usually the interest rates will be way too low compared to those offered by banks. Banks will then lose business to the central bank making them less profitable, yet the RBZ should not compete with banks. The central bank should rather create a policy environment and incentive framework that induces bank to mobilize resources and increase lending to the marginalized groups

### 4.6. RBZ should not peg interest rates

Although bank supervision is within its mandate, the RBZ should not peg interest rates. The RBZ has pegged interest rates for the productive sector from 25% per annum in 2015 to 15% per annum in 2016, and 12% per annum effective 1 April 2017 (January 2017 Monetary Policy Statement). Capping of interest rates has made it difficult for commercial banks to access funding because sometimes it would not be profitable for banks to borrow for on-lending when interest rates are fixed. In such cases lenders would first consider countries with unregulated interest rates because then the risk of loss is less than in Zimbabwe where interest rates are pegged by the central bank.

The pegging of interest rates by the central bank exposes banks to the risk of making losses. When interest rates are capped at less than the rate at which the bank would have borrowed the money, then the bank will definitely make a loss. For instance, when the RBZ capped the lending rates at no more than 18%, banks that had borrowed at a rate more than 18% definitely incurred losses. Banks should be left to compete for clients without the intervention of the central bank. Those with low lending rates and better terms will get more clients.

Interest rate pegging has also resulted in a marked slowdown in credit advancement by banks which is continuing to weaken aggregate demand. The country has also been accessing expensive offshore credit lines owing to the high perceived country risk attributed by the perpetual accumulation of external payment arrears by Zimbabwe.

Within this context, banks have been accessing offshore loans at around 10% per annum, a rate which is way above the 365-day London Interbank Offered Rate (LIBOR) of 1.07% per annum(Nyarota,2015).Banks argue that it is better to lend to the government through treasury bills which are risk free. They have also been doing salary-based lending to individuals because salary-based lending is also less risky. Lending to the government and individuals has stifled lending to the productive sector because most companies are considered riskier because of low production or lack of collateral security. The removal of interest rate caps to allow the market to freely price the credit it advances to its clients is likely to increase credit creation as risk will be minimized and adequately compensated.

### 4.7. Liberalise foreign currency allocation

Currently the RBZ is responsible for the allocation of foreign currency according to a priority list. This is a form of distortion because a physical hand should not be seen in foreign currency allocation, market forces should be at play. The treasury departments of commercial banks should be doing their work in linking those with foreign currency to those without. Foreign currency allocation should also be done by the Foreign Currency Management Committee so as to ensure transparency. Currently the Foreign Currency Management Committee is not in existence because it awaits the promulgation of the new Reserve Bank Act. The promulgation of the act needs to be expedited so that foreign currency allocation improves.

### 4.8. Liberalise bond note exchange rate

While the bond note was initially introduced to ease change shortages and as an export incentive, its existence in the market has resulted in different exchange rates. Currently there is USD/bond exchange rate, RTGS/bond exchange rate, and a bond/USD exchange rate. These distortions have resulted in a thriving parallel market such that the USD hardly finds its way to the formal financial system. The differing exchange rates in the parallel market with the USD being the superior currency has resulted in USD shortages in the formal market and it is also being mainly used as a store of value in the

informal market than any of the functions of money. There been calls from the different stakeholders to demonetize bond notes in print, electronic and social media. Government on the other hand has maintained the policy position that there is parity 1:1 between the bond notes and US$. Transactions in the parallel market which is has filtered four tier pricing system of goods and services demonstrates that there are huge distortions caused by the divergence of rates.

Furthermore, the rationing of foreign currency highlights the fact that there is not enough foreign currency in the formal sector to meet demand from would be importers. In this regard there is need to open space for candid and constructive discussions to generate a consensus on the country's currency regime. The issue of how to deal with bond notes will effectively be dealt with in this broader context. The question that has been skated for long but which is fueling speculations and distortions is whether or not Zimbabwe will introduce the its own currency, under what conditions and when. The broader discussion referred to above need to tackle these issues head on inorder to remove the veil of uncertainty and improve confidence in the country's financial system

### 4.9. Consolidation of government securities

Currently the situation prevailing is one whereby treasury bills with the same maturity have different interest rates which results in distortions. TBs that had the same maturity were issued at different rates of 10% and 13% thereby sending mixed signals to the market. According to Nyarota et al (2015), the issuance of treasury bills by the government since adoption of the multicurrency regime has produced an inverted yield curve which does not bode well for the re-acceleration of economic activity. To correct the current situation the government should buy back treasury bills with the same maturity but have different interest rates. Treasury bills with the same maturity should then be floated with the same interest rate to effectively have a yield curve. The Government should consolidate these securities and establish benchmark bonds at 2/3 years, 5 years, 7 years and 10 years in order to establish the yield curve in the market. A yield curve helps investors understand the relationship between bonds of differing time

horizons to maturity. Understanding the yield curve is important to investors because easily comparing yields allows them to understand their return on investment and make investment decisions based upon these future payouts.

### 4.10. Regulatory bodies should be independent of the RBZ

The RBZ should stick to its role as a regulatory body for banks and not overlap into insurance and other sectors. There are instances when the RBZ has overridden other regulatory bodies like Insurance and Pensions Commission (IPEC) and Securities and Exchange Commission of Zimbabwe (SECZ). These are independent regulatory bodies which should enforce compliance in their respective sectors without the intervention of the RBZ. These bodies should also come up with a self-regulatory mechanism for instance the banking sector has the Banking Act. These self-regulatory mechanisms will improve efficiency in the market.

### 4.11. Harmonising legislation for MNOs, Banks and Insurance Companies

Mobile network operators (MNOs) have introduced into the financial market similar products to those that commercial banks could also offer. Banks have also partnered with the insurance sector through bancassurance. The MNOs are regulated by Postal and Telecommunications Regulatory Authority of Zimbabwe (POTRAZ), banks are regulated by the RBZ while the insurance sector is regulated by the Insurance and Pensions Commission (IPEC). MNOs seem to be more innovative while very few banks are developing new products which are in line with technological advancement. It seems most banks are in the survival mode with little or no innovation at all. While there is need for product innovation on the part of banks, there is need for the harmonization of laws and regulations that affect the three sectors for there to be a level playing field.

### 4.12. Missing institutions in the financial markets

Venture capitalists, discount houses and leasing houses disappeared from the market because of the unfavourable economic conditions

currently prevailing in the economy. Discount houses trade in money market securities in the secondary markets. They intervene between the central bank and financial institutions in mobilising funds for investments in securities and take positions depending on the liquidity situation. Venture capitalists provide startup companies and small businesses that are believed to have long-term growth potential. Leasing companies provide a physical asset or service for use by a commercial client or individual for an established period of time (sometimes with provisions to purchase asset at the end of the contract) in return for regular payments, known as financial leasing. These institutions have succumbed to shifting macro-economic trends, and a changing market profile that has wiped out money markets and forced banks to reconfigure their structures. More importantly, deregulation effectively increased competition against these institutions which were protected by their own Acts from competition, resulting in their folding. Macroeconomic fundamentals need to be in place for these financial institutions to come back. For instance, leasing companies would work well in a country with a vibrant manufacturing sector whereby some companies would not want to buy machinery but lease it, or even do a lease to buy arrangement.

## 5. Conclusions and Recommendations

While the government and monetary authorities' intervention in the financial market to correct market failure is welcome, the study concludes that some of the interventions have caused distortions which have negatively impacted on the economy. From the study findings, we therefore recommend the following to correct the distortions.

i. The government should avoid excessive borrowing which should be guided by the rule that it should not borrow more than 20% of the previous year's revenue from the central bank. Excessive government borrowing has been crowding out private sector lending thereby limiting the recovery of our productive sectors.
ii. The government should also avoid ad hoc borrowing as this

reduces its negotiating power. A pre-planned borrowing calendar should be established

iii. Treasury bills should be floated using the open market operations system for there to be transparency and also to allow financial market players to price instruments correctly guided by a yield curve. In this case, the government should consolidated the existing TBs through buying them back and re-introduce benchmark bonds which would help establish a proper yield curve.

iv. The government should work on policies that increase production and stabilize the economy to promote re-emergency of non-bank financial institutions whose services may still be required in the market such as discount houses, leasing companies and venture capital companies which are currently missing in the financial market.

v. The central bank should manage interest rates through utilizing indirect monetary instruments/tools instead of issuing directives which has resulted in the banking sector advancing credit to less risk nonproductive sectors such as salaried individuals as opposed to the productive sector where financing is much needed to revitalize the productive sector. The banking sector has also largely preferred to lend to the government through TBs which are less risky as opposed to lending to the productive sector.

vi. There is need for harmonization of legislation for MNOs, banks and the insurance sector to allow all the players a level playing field.

vii. The calls to liberalize the exchange rate should be dealt with through engaging the citizens in systematic evidence informed national dialogues on the proposed currency reforms to generate a consensus on the way forward and road map for the implementation of these reforms in order to avert the prevailing challenges that have resulted in a four-tier pricing system induced by severe foreign currency shortages and a thriving parallel market.

viii. The RBZ should stick to its role of bank supervision and not be involved in quasi fiscal activities as these have resulted in the central bank competing for customers with banks and also

increased the domestic debt at a time when the economy is struggling

ix. Government should avoid using captive practices in accessing money from the market such as prescribed assets for pension funds.

## 6. Recommendations for further research

The current study concentrated on the two sub sectors of the financial sector the banking and microfinance sectors, whilst leaving out the non-bank financial institutions (NBFIs) given the time limitations and resources available. However, there is scope for further research to cover distortions in the NBFIs which include insurance; pension and the Zimbabwe Stock Exchange and related institutions. The issue of currency reforms and the appropriate foreign exchange regime require more detailed studies that will generate evidence to inform policy process considering that these issues have become emotive and yet they are critical enablers of the economic transformation of the country. These studies would build a body of knowledge that will assist policy makers to make the hard choices that need to be made to remove distortions in the financial sector while ensuring that it grows and effectively plays its intermediary role as well as lubricate the engine of growth.

# REFERENCES


Allen, F., Qian, J and Qian, M. (2005). *"Law, Finance, and Economic Growth in China",* Journal of Financial Economics, 77, 57-116.

Chinn, M. and Hiro, I. 2006. *"What Matters for Financial Development? Capital Controls, Institutions, and Interactions."* Journal of Development Economics 61, 163–192.

Engel, C (2013) *Capital controls: what have we learned?* BIS Papers No 68.

Goldsmith, R. (1969). *Financial Structure and Development,* Yale University Press, New Haven, CT.

Guariglia, A. and Poncet S (2005) Could Financial Distortions Be No Impediment to Economic Growth After All? Evidence from China.School of Economics, University of Nottingham, University Park, Nottingham, NG7 2RD, United Kingdom.

Levine, R. (2005). "Finance and Growth: Theory and Evidence": Handbook of Economic Growth, The Netherlands: Elsevier Science.

Rajan, R.G. and Zingales, L. (1998). "Financial Dependence and Growth." American Economic Review, 88, 559-86.

Shaw, E, S. (1973). Financial Deepening in Economic Development, New York: Oxford University Press,

Ostry, J, D., Mahvash S. Qureshi, A., Ghosh, R and Chamon, M. 2011. "Managing Capital Inflows: The Role of Capital Controls and Prudential Policies." National Bureau of Economic Research, working paper no. 17363.

Grande, G., Levy, A., Panetta, F. and Zaghini, A. (2011) "Public Guarantees on Bank Bonds: Effectiveness and Distortions". OECD Journal: Financial Market Trends – Volume 2011, Issue 2

Zimbabwe Economic Policy Analysis and Research Unit (ZEPARU)
55 Mull Road, Belvedere,
Harare, Zimbabwe
Tel: +263-242-778423 / 785926/7
Fax: +263-242-778415
Email: administration@zeparu.co.zw
Website: www.zeparu.co.zw

EPOCH: 0774 207 147