

**Did Financial Sector Reform
Result in Increased Savings
and Lending for the SMEs
and the Poor.**

Gibson Chigumira
Nicholas Masiyandima

March 2003

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DID FINANCIAL SECTOR REFORM RESULT IN INCREASED SAVINGS AND LENDING FOR THE SMES AND THE POOR?

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March 2003

Abstract

This paper assesses the impact of financial reforms in Zimbabwe on savings and credit availability to small and medium scale enterprises (SMEs) and the poor. We established that the reforms improved domestic savings mobilization due to high deposit rates, the emergence of new financial institutions and products and the general increase in real incomes after the 1990 economic reforms. The study uncovered that inflation and real income were the major determinants of savings during the sample period. High lending rates and the use of conventional lending methodologies by banks restricted access to credit by the SMEs and the poor.

JEL Classification Numbers: E21, O16.

Keywords: Financial sector reform, saving and lending criteria, SMEs, poor.

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Résumé

Ce papier présente une analyse de l'impact des réformes du secteur financier au Zimbabwe sur l'épargne et la disponibilité de crédits pour les petites et moyennes entreprises (PME) et pour les défavorisés. Les résultats montrent que la mobilisation de l'épargne nationale s'est améliorée grâce à l'augmentation des taux d'intérêt, à l'émergence de nouvelles institutions financières et de nouveaux produits et aussi grâce à l'augmentation générale du revenu réel après les réformes de 1990. L'étude montre que l'inflation et le revenu réel sont les principaux déterminants de l'épargne pendant la période d'analyse. Des taux élevés et l'usage de méthodes très traditionnelles dans l'attribution des prêts ont restreint l'accès au crédit par les PME et les défavorisés.

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Executive Summary

Financial sector reform involves the general decontrolling and deregulation of the economy's financial sector in order to enhance savings mobilization, the quantity and quality of investment and economic development (Shaw, 1973 and McKinnon, 1973). This contrasts with financial repression, which involves controls on interest rates, bank lending policies that restrict entry in the financial sector and selective credit policies. Financial sector repression leads to financial dis-intermediation, which may encourage the emergency and growth of informal financial institutions. If accompanied by high inflation financial sector repression in the form of caps on deposit rates will result in negative real deposit rates which discourage saving and ultimately reduce the level of credit extended to the private sector. Thus, credit rationing becomes more pronounced and small-scale and medium scale enterprises together with the poor face stiffer borrowing constraints.

Prior to 1991 the levels of interest rates in Zimbabwe were controlled and direct controls as well as moral suasion determined the distribution of credit. There were also laws and regulations, which restricted entry into the financial sector hence the financial sector was highly segmented. The resultant oligopolistic structure of the banking sector limited inter and intra market competition. The poor performance of savings due to these restrictive policies created serious domestic and foreign resource gaps, which resulted in low credit availability to the private sector and ultimately, low investment and low economic growth. In the late 1970s, for example, the gross national saving rate was above 18% and had fallen to levels below 10% in the 1980s. This reduced credit and investment rates from over 30% and 20% in the 1970s to below 25% and 15% in the 1980s respectively. In the mid 1980s economic growth rates resultantly had started staggering at levels below 2%.

In the controlled regime big corporations could finance their investments and working capital through the use of profit reserves or retained earnings. However, the Small to Medium Enterprises (SMEs) and the poor were hit harder by the shortage of credit. The lending criteria of banks which focused on risk, reputation, profitability, collateral security and the creditworthiness of proposed projects naturally rated the SMEs and the poor low and favoured large corporations which could easily meet these criteria. During the financial repression era SMEs and the poor almost exclusively relied on development financial institutions, which could not provide them with adequate finance because of their unsustainable reliance on Government and or donors for funding.

These problems and the general economic decline necessitated the adoption of the Economic Structural Adjustment Programme (ESAP) in 1991, which included a considerable set of financial sector reform measures to close down the domestic and foreign financial resource gaps. These reform measures included the decontrolling of interest rates, removal of credit controls, the easing of financial sector entry restrictions, the decontrolling of the foreign exchange market and increased de-segmentation of the activities of financial institutions. The monetary authorities also shifted away from the use of direct monetary policy tools towards the use of more market-oriented tools. This was intended to give banks greater lending autonomy in a more competitive environment that would improve the financial intermediation and allocative efficiency.

The financial liberalization programme in Zimbabwe has however relied more on the interest rate-policy to enhance the development of the conventional bank and non-bank financial institutions and the mobilization of savings by these financial institutions. In

contrast the promotion of linkages between the formal and informal financial institutions has been under played in the policy documents that outline the financial sector reform program. This has tended to undermine the fact that, the informal financial institutions and the micro finance institutions have the capacity and are better placed to provide financial services to the micro savers and borrowers. Established banks generally neglect micro savers and borrowers because of their high transaction costs and low credit worthiness rating. Interest rate deregulation designed to affect returns on financial instruments in conventional banks and non-bank financial institutions may therefore not achieve the optimal levels of savings and credit provision to SMEs and the poor, if the potential and experiences of micro-finance institutions (both formal and informal) are not harnessed.

This research paper provides a postmortem of the impact of financial sector reforms in Zimbabwe on domestic financial savings and on credit availability for on-lending to the private sectors. The major focus is on the small to medium enterprises (SMEs) and the poor who have traditionally been denied credit by banks due to high transaction costs and default risks associated with lending to this sub-sector. This study will also provide some suggestions on policy measures that can be adopted in Zimbabwe to enable SMEs and the poor to benefit from the wide-ranging financial sector reforms.

The study is focused on the effect of financial sector reforms on private financial savings and credit availability to SMEs and the poor. Non-financial savings in the form of inventories and other physical assets and government savings are left on the grounds that they are not readily available for investment and on the basis that they are not largely interest rates determined respectively. The research defines the 'poor' as the economically active poor. The paper takes a two-pronged methodology in that secondary data for the period 1977 to 2001 is used to econometrically test the determinants of private savings and credit extended to the private sector. Quantitative and qualitative analyses of primary data gathered from the SMEs, the poor as well as financial institutions are done to supplement the econometric analysis. In the econometric analysis three major relationships are investigated, these include the private savings function (S_t), the total credit function (CR_t) and the private credit function. Below is a summary of the paper's findings.

The study uncovers some evidence that financial sector reforms in Zimbabwe improved domestic private financial savings mobilization. This resulted from positive real deposit rates, increased financial depth in the form of increased entry into the financial sector, increased bank branch networking and the widening of the variety of financial products. The increase in nominal incomes (ability to save) after the commencement of economic reforms in 1990 also raised savings significantly. The impact of high inflation on savings during the sample period was found to be positive given that most savers in a developing country like Zimbabwe are target savers. However, the excessively high and unstable inflation rates starting in the late 1990s forced savers to switch back to physical inflation hedges as opposed to financial savings. This resulted in a fall in the financial savings ratio. In consistency with the reviewed empirical literature the impact of the deposit interest rate on savings was found to be positive but statistically insignificant.

The study also found some evidence that show total domestic credit and private credit increased against savings as a measure of credit availability. The high lending rates tended to reduce this increased financial sector liquidity effect, especially in the late 1990s. The poor and SMEs in Zimbabwe did not benefit much from the increase in total credit arising from financial sector reforms. This has been caused mainly by banks' continued use of their conventional lending methodologies, which focus on collateral security, capacity,

character of borrower, initial capital outlay and business track record, which commonly lack among the SMEs and the poor. Some banks, which had started considering the viability of the projects, have since backtracked to the safe haven of collateral security. The information gap and high lending rates have also contributed towards the SMEs' loan gap.

Given the above findings it has been recommended that interest rates should be strategically managed instead of being left to be determined completely on a *laissez-faire* basis to make sure that they remain within bands, which enhance both savings mobilization and investment. It has also been recommended that restrictive fiscal policy in terms of reduction in government borrowing and expenditure should be implemented. International experience has shown that fiscal discipline is a prerequisite for successful financial liberalization. The rationale behind this assertion is that government budget deficits will be financed invariably by taxing the domestic financial system in one way or another when there is fiscal indiscipline.

The use of tight monetary policy, which raises interest rates to contain inflation, tends to worsen inflation rather than containing it given that most firms in Zimbabwe use the cost-plus pricing strategy. Higher real interest rates may also reduce aggregate demand because of the increased markups associated with interest rate costs thus reducing real wages. In turn, lower aggregate demand reduces investment.

A broad based financial reform programme, which seeks to develop the institutional structures, deepening the financial sector through fostering linkages between the informal financial sector institutions, micro finance institutions and formal financial institutions. This would also encourage broad based savings mobilisation thus increasing the pool of resources that can be on-lent to the private sector including the SMEs and the poor at competitive rates. Informal financial markets also play a key role in determining the timing, direction and magnitude of macroeconomic effects.

Banks are also advised to consider the use of lending methodologies that are appropriate to the micro-borrowers as a way of reaching the SMEs and the poor. Using past performance as a criterion for allocating credit discriminates against new entrants and perpetuates the skewed lending policies, which favour large established corporations. The traditionally neglected SMEs can be nurtured into big future clients for the banks especially where effective competition forces banks to consider the formerly "unbankable" sectors.

1. Introduction

Financial sector reform involves the general decontrolling and deregulation of the economy's financial sector in order to enhance savings mobilization, the quantity and quality of investment and economic development (Shaw, 1973 and McKinnon, 1973). Financial sector reform contrasts financial repression which involves government intervention in the financial sector, implicitly or explicitly, to tax and distort the free working of financial institutions through restrictive controls on interest rates, bank lending, restrictive entry policies in the financial sector and the use of non-market oriented monetary policy tools (The World Bank, 1989, 53-64). Financial repression leads to financial dis-intermediation and reduced credit availability to potential investors including the SMEs in the economy.

The financial sector reforms implemented in Zimbabwe as from 1991 included the decontrolling of interest rates, removal of credit controls, the easing of financial sector entry restrictions, the decontrolling of the foreign exchange market and increased de-segmentation of the activities financial institutions. The monetary authorities also shifted away from the use of direct and reactive monetary policy tools towards the use of more market-oriented tools. This was intended to give banks greater lending autonomy in a more competitive environment that would improve financial intermediation and allocative efficiency.

1.1. Background on Domestic Savings and Credit in Zimbabwe

In the controlled environment of the 1980s and before, monetary policy in Zimbabwe was rather passive and reactive to direct controls on both deposit and lending rates (RBZ, 1995). This was against the background of controls on wages, the exchange rate and the general price level aimed mainly at keeping inflation in check. Direct controls and moral

suasion determined the distribution of bank credit and interest rates levels. This limited the lending discretion of banks. Different required reserve ratios and liquid asset ratios existed for different financial institutions. In addition, there were laws and regulations, which restricted entry into the financial sector hence the financial sector was highly segmented with limited competition. Together with a continuously widening foreign resource gap, this resulted in low domestic financial saving rates, low credit availability, low investment and low economic growth. In the late 1970s the gross national saving rate was above 18%, in 1985 the saving rate had fallen to levels below 10% resulting in real economic growth rate of less than 2%. Credit and investment rates had consequently started to show downward trends falling from over 30% and 20% respectively in the late 1970s to below 25% and 15% in the mid 1980s.

Unlike big corporations, which could finance their investments and working capital through the use of profit reserves in the financially repressed economy, the small to medium enterprises (SMEs) were hit harder by the shortage of credit. The absence of reasonable competition as a result of an oligopolistic financial sector resulted in the natural discrimination of SMEs and the poor. The few financial institutions that existed prior to financial sector reforms mainly looked at risk, reputation, profitability and collateral in their creditworthiness appraisal of projects for, which SMEs are naturally rated lower compared to established corporations. The situation was even worse for the SMEs in the agricultural sector because of the sector's relatively higher risk. In the pre-financial reform era, the major windows of finance for SMEs were the Small Enterprise Development Corporation (SEDCO), the Agricultural Finance Corporation (AFC), the Africa Development Fund (ADF), the Zimbabwe Development Bank (ZDB) and the Venture Capital Company of Zimbabwe (VCCZ). These institutions could not provide adequate finance for SMEs because of their unsustainable reliance on the Government or donors for funding.

The average domestic savings projected in the Economic Structural Adjustment Programme (ESAP), which spanned the period 1991-1995, was 24.5% (see The Government of Zimbabwe, 1991, p. 29). However, the gross domestic savings rate for the period 1991-1995 turned out to be 16.8%, which falls short of the figure projected in the reform document (see Central Statistical Office National Accounts, 1985-1997). The Zimbabwe Programme for Economic and Social Transformation (ZIMPREST, 1996-2000) projected domestic savings to grow by 19.5% over the period (see ZIMPREST, 1998, p. 71). In 1996 and 1997 domestic savings grew by 18.1% and 18.8% respectively. After 1997 there was a dip in domestic savings, which averaged 9% in 1999.

The mobilization of savings was to be achieved mainly through financial sector reforms. These reforms included among other measures the liberalisation of interest rates, increasing competition in the financial sector, developing new money market instruments, deregulating the financial system, and enhancing the regulatory and supervisory frameworks. Thus, rules and regulations, which tended to restrict entry and competition in the financial sector, were relaxed. This enabled banks to have greater autonomy on how to use their deposit liabilities. We noted above that domestic savings fell short of the projected figure for both ESAP and ZIMPREST. This raises questions as to whether financial sector reforms, which had been viewed as the main vehicles for savings mobilisation resulted in an increase in savings and consequently an improvement in credit availability to the poor and small to medium enterprises.

Financial deepening is a noticeable positive feature of financial sector reforms in Zimbabwe. The new financial institutions and products that have emerged since the commencement of financial reforms in 1991 bear evidence to this. The structure of the financial sector has changed dramatically. Currently, there are at least 36 banking

institutions compared to less than 20 before reform. These include 13 commercial banks, 7 discount houses, 5 building societies, 7 merchant banks, 5 finance houses. Apart from the expansion of banks the non-bank financial sector, which, includes insurance companies, developmental financial institutions such as the development bank and venture capital companies as well as unit trusts has expanded considerably.

1.2. Research Problem and Justification of the Study

The debate on whether financial liberalisation (decontrolling of interest rates) lead to higher savings and investment remains shrouded in controversy (see Fry, 1997, Stiglitz 1994). Some governments have expressed some pessimism on the appropriateness and workability of financial reforms. Such, pessimism has manifested itself in policy reversals. In Zimbabwe, financial sector reforms have been implemented faster than other reforms particularly public sector reforms. To our knowledge, there has been no systematic and rigorous study on how financial sector reforms have faired in Zimbabwe. It is the purpose of this study to provide an analysis of the impact of financial liberalisation on savings and access to credit by SMEs and the poor. It is hoped that this study will have a positive contribution on these issues.

In most developing countries including Zimbabwe policies to promote indigenization and the growth of small to medium enterprises have received greater attention in recent years because of the high employment potential of this sector. The commonly held view is that the growth of the small-scale enterprise (SMEs) sector in Zimbabwe has been inhibited by the availability and cost of credit, land and basic utilities, as well as numerous licensing and other regulations (see The Government of Zimbabwe, 1991, p. 19). Economic reforms, particularly financial sector reforms, were expected to stimulate the growth of SMEs and

unleash their employment generation potential as credit became widely available in a liberalised financial sector, which is capable of mobilising large volumes of savings.

However, the reality on the ground may not support the optimistic view held by reforming countries with regard to the growth of SMEs. This justifies an investigation of how SMEs and the poor have been affected by financial sector reforms. It is important to see whether the credit constraints faced by SMES and the poor or their survival strategies changed under the liberalized environment. A study of this nature is expected to generate useful information that may assist policy makers in the formulation of appropriate and more effective policies designed to alleviate the plight of this sub-sector. This includes financial sector policies, which are consistent with promoting the growth of SMEs and alleviating poverty among the poor.

The financial sector liberalization programme in Zimbabwe has mainly focused on the interest rate deregulation and removing of barriers to entry in the banking sector to encourage competition. These measures are aimed at enhancing the development of the conventional bank and non-bank financial institutions and the mobilization of savings by these financial institutions. On the contrary, the promotion of informal financial institutions or linkages between the formal and informal financial institutions have been under played in the policy documents that outline financial reform program¹. Furthermore conventional banks have traditionally neglected the mobilizing savings from small savers in the rural agricultural and non-agricultural sectors as well as the urban poor because of high transaction costs. SMEs and the poor have been denied credit by the same institutions due to perceived high risks and costs of extending credit to this sub-sector.

¹ For details on the financial sector reform measures see the following government policy documents enunciating the reform measures: The Government of Zimbabwe (1991), Policy Matrix, table 1, pp. 4-6 and ZIMPREST (1998), p. 35.

However, the informal financial institutions and the micro finance institutions have the capacity and are better placed to attract savings from small savers in areas generally neglected by established banks because of high transaction costs. These institutions have in the past, extended credit to SMEs and the poor. Interest rate liberalization, generally affects the rate of returns on financial instruments in conventional banks and non-bank financial institutions. Thus financial sector reforms that focus on interest rate liberalization may not achieve the optimal levels of savings and credit provision to SMEs and the poor, if the potential and experiences of micro-finance institutions (both formal and informal) are not harnessed. The promotion of linkages between the formal and informal financial institutions aimed at designing diversified savings instruments that take into account the investment needs of SMEs and the poor may boost savings and credit extension to this traditionally neglected sector.

This may require changes in the legal framework to facilitate contract enforcement and a clear government policy position on the operations of financial institutions. This entails official acknowledgement and recognition by public agencies, the central bank and policy makers of the input and importance of micro-finance institutions (both formal and informal) in savings mobilization. Such recognition may help to boost confidence and give assurances to banks and non-bank financial institutions which may want to put in place their own arrangements for interacting more closely with micro-finance institutions, without being seen to be infringing any government regulatory requirements.

The financial sector reform measures implemented in Zimbabwe so far have not embraced this broad agenda of developing the institutional structure and new instruments to mobilise domestic savings. The focus has mainly been on liberalising interest rates and encouraging entry into the formal financial institutions. However, international empirical

evidence has shown that savings are less responsive to interest rate changes. Thus, the key question is to what extent have the objectives of financial sector liberalisation regarding savings mobilisation and improving access to credit by SMEs and the poor been achieved.

1.3. Research Hypothesis

The literature on financial sector reforms suggests that savings can increase or decrease following financial sector reforms. The view that financial sector reforms lead to an increase in savings follows from the McKinnon (1973)-Shaw (1973). They argued that raising interest rates to their market level would provide an incentive for savers (the haves) to increase their financial savings in banks because the reward to their savings (positive real interest) will be high. Thus, following this view we would expect savings in Zimbabwe to have increased following the liberalization of interest rates in the banking sector in 1991.

The view that financial liberalization leads to a decrease in savings follows from the fact that financial sector reforms may remove borrowing constraints, thus increasing access to credit by households who were previously denied such credit. For example, regulatory changes in the reformed financial sector would allow banks to lend more freely to individuals for housing purchases or general consumption. An increase in consumer credit may reduce savings at least in the short-term as target savers no longer need to save first before making a purchase (see Bandiera et.al., 1999). The net effect of financial sector reforms will now depend on which of these two effects (increase in savings due to increase in interest rates or reduction in savings due to relaxation of borrowing constraints) is stronger. Thus, a priori the impact of financial sector reforms on savings is ambiguous.

McKinnon (1973) and Shaw (1973) suggested that an increase in deposit rates to their market levels would lead to a large pool of financial savings which can be on lend to

investors (the have nots). Thus, following this view we hypothesize that financial sector reforms may have increased financial savings in the banking system which were on lend to investors particularly the SMEs and the poor. This hypothesis also follows from the observation that since 1991 when financial sector reforms commenced the number of players in the formal, quasi-formal and informal financial sectors increased. It is expected that the increase in players in the banking sector created stiff competition in lending and deposit taking. Competition leads to dwindling market share in traditional markets for banks as new entrants take part of the market. Banks are then forced to search for new markets to lend to. Thus, the traditional neglected SMEs and the poor may be included in the diversified loan portfolio of banks. The SMEs and the poor have for long been denied credit because of high risks attached to of lending to them as compared to other factors.

1.4. Objectives of the Study

The objectives of this research are:

- To investigate whether there has been a statistically significant increase in the level of financial savings due to financial liberalization;
- To investigate whether the increase in financial savings, if any, has had a positive impact on total domestic credit.
- To examine whether there has been a significant change in borrowing constraints faced by the SMEs and the poor in the period of financial sector reform.
- To investigate the impact of the financial sector reform on the demand for credit and investment by SMEs and the poor.
- To come up with 'second best' policies which can be adopted to enable SMEs to effectively benefit from the financial sector reform.

1.5. The Scope of the Study

The study is limited to the study of the effect of the financial sector reforms in Zimbabwe on private financial savings and credit availability and demand. Non-financial

savings in the form of inventories and other physical assets and government savings are excluded on the grounds that they are not readily available for investment and on the basis that they are not largely interest rates determined respectively. The research adopts the definition of the small to medium enterprises as given in the Ministry of Industry and Commerce's white paper on the 'Small and Medium Enterprise Policy and Strategy' where an SME is defined in terms of number of employees, net assets and ownership structure. Only the economically active poor who would take up credit facilities from the financial sector are considered in this paper. These will therefore be subsumed under the small-scale enterprises:

Small-Scale Enterprise			
Sector	No. of employees	Asset Base (Z\$)	Capital Employed (Z\$)
Manufacturing	Less than 75	6 000 000	5 000 000
Other	Less than 50	3 000 000	2 000 000
Medium-Scale Enterprise			
Manufacturing	Less than 100	12 000 000	10 000 000
Other	Less than 75	7 000 000	5 000 000

2. Determinants of Savings

There is abundant theoretical literature on private savings behaviour. Comprehensive surveys by Gersovitz, (1988), Deaton (1990) and Schmidt-Hebbel et.al, (1996) suggest that this literature is somewhat fragmented. Different authors have analysed specific aspects of the problem². Because, of its many policy angles and vast theoretical complexities, no single model has been able to capture every dimension of the problem. However, the empirical

² For example some studies have analyzed how savings are affected by social security contributions; how interest rates affect intertemporal consumption and how the existence of liquidity constraints impact on private savings (see for example, Jappelli and Pagano, (1994), Ogaki et. al, 1996).

literature is less fragmented as authors typically concentrated on a few possible determinants of private savings with a view of understanding their evolution (Edwards, 1996).

2.1. Motives for Saving

There are various motives for which households save that can be identified in the economic literature. These motives have been categorised differently in the literature. The three main motives include the life cycle, precautionary and bequest motives³. Life cycle motives arise from temporary imbalances between income and expenditures at various stages in one's life cycle, which in turn are due to the differences in timing between income and expenditure streams. Thus, within the context of the life-cycle model, saving provides a mechanism for which purchasing power is shifted over time to smooth consumption. Examples, here include saving for retirement expenses, consumer durables, house purchase, children's education or marriage expenses.

The precautionary motive arises from the need to hedge against uncertainties concerning future income and/or expenditures. Typical examples include saving for income fluctuations, unemployment, illness, accidents, natural disasters and longevity risk. The bequest motive on the other hand arises from the need to leave assets behind for heirs in the form of transfers. The first two motives are consistent with the life cycle model of saving while the last one is consistent with the dynasty model depending on the nature of bequest motives. Bequests motivated by intergenerational altruism are consistent with the dynasty model while accidental bequest arising from longevity risk or other strategic bequest motive are consistent with the life cycle model (see Horioka and Watambe, 1997).

³ Horioka and Watambe (1997) estimated the contribution of twelve motives to overall household savings in Japan and found evidence that the retirement and precautionary motives, both of which are consistent with the life-cycle model, are important.

Other motives identified in the literature include investment motive where saving is motivated by rates of return on capital investment and availability of investment opportunities (Mwega, 1997). In the McKinnon (1973) complementarity hypothesis, households who face borrowing constraints when financial markets are repressed save to self-finance their required expenditures especially when they are lumpy. The foregoing discussion shows that the motives for saving by households are wide-ranging and complex. Thus in analysing the impact of financial liberalisation on domestic savings we need to bear in mind these underlying motives for saving within the entire population. This is essential in interpreting the impact of financial liberalisation, especially the deregulation of interest rates, on savings.

2.2. Financial Sector Liberalization and Private Savings

Financial sector liberalization is one of the components of economic reform packages that have been implemented by a number of developing economies especially in Sub-Saharan Africa to enhance medium to long-term growth. The transmission mechanism through which financial sector reform can lead to enhanced growth may be outlined as follows:

- a) financial sector reform raises returns on savings. This increases the marginal propensity to save and consequently the supply of credit increases,
- b) financial sector reform deepens the financial sector resulting in increased financial intermediation and savings mobilization. This results from increased bank branches and networks, increased financial institutions and products offered and,
- c) the increase in interest rates after financial liberalization raises the cost of capital. In the absence of adverse selection problems, the increase in interest rate to their market determined levels may improve the allocative efficiency of the financial sector and the quality of investment as investment projects with higher internal rates of return only will be financed.

The early literature on financial liberalization, following McKinnon (1973) and Shaw (1973), stressed the potential role of higher interest rates in mobilizing saving.

Changes in interest rates may affect the form, which savings take with funds moving from real savings to financial savings. Given this alteration of the composition of savings it is quite possible that the level of aggregate savings may remain unchanged because the increase in financial savings may be offset by the decrease in real savings.

Financial liberalization can also affect savings through increased access to consumer credit. For example, regulatory changes following financial liberalization may allow banks to lend more freely to individuals for housing purchases or general consumption. This is likely to reduce savings at least in the short-term. Thus, it is not clear *a priori* what the impact of financial liberalization on savings will be. The view that financial liberalisation increases household access to credit or housing finance and thus lead to a reduction of private savings has found empirical support from a number of researchers (see Japelli and Pagano, 1994). Thus, financial liberalisation may affect savings through one or both channels, each of which will also affect the sensitivity of savings to interest rates.

2.2.1. Portfolio Shifts

Financial liberalisation may provide incentives and avenues for wealth holders to shift the composition of their wealth portfolios from non-reproducible tangible assets to reproducible tangible assets and financial assets, which are more liquid and directly available for investment purposes. This contrasts with a repressed financial sector where wealth portfolios are dominated by illiquid and non-reproducible tangible assets. These portfolio adjustments can lead to transitory changes in the volume of financial saving.

When financial liberalization is combined with the liberalization of the foreign exchange market, it may induce large capital inflows. The capital inflows may be attributable to a return flow of past flight capital or new capital attracted by high interest

rates. If not sterilized, such inflows can result in a credit boom leading to real income surges, which in turn have a direct, but transitory, effect on savings.

From the above discussion it can be concluded that the impact of financial liberalisation on private savings may be difficult to determine *a priori*. This follows mainly from the ambiguous effect of interest rates on savings as income and substitution effects may offset each other. This is also confirmed by the general lack of consensus in both the theoretical and empirical literature on the sensitivity of savings to interest rate changes.

2.2.2. Interest Rates and Private Savings

The impact of interest rates on household savings is ambiguous because there are income and a substitution effects, operating in opposite directions. Higher interest rates increase the opportunity cost of consumption, hence households will increase saving (the substitution effect). An increase in the interest rate also increases the wealth of positive savers, hence their consumption increases (wealth/ income effect). In the earlier literature on financial liberalisation (see McKinnon, 1973 and Shaw, 1973), allowing real interest rates to rise to market levels altered the intertemporal rate of substitution. Recent theoretical models have also shown that the impact of interest rate on savings is indeterminate (see Bencivenga et.al., 1993). Empirical studies testing the relationship between savings and interest have not resolved the issue with some studies finding insignificant or small interest elasticities of domestic savings (see Fry, 1995).

2.2.3. Reasons for Low Sensitivity of Savings to Real Interest Rate Changes

Several reasons have been cited in the literature for the low response of savings to exogenous changes in real interest rate. The measurement of real interest rates can be imprecise. This may arise because expected inflation, used in the calculation of real interest

rate, is not directly observable. Thus, real interest rate is calculated using proxies of expected inflation. McKinnon (1991) also noted that aggregate savings as measured in the national income accounts (as a residual) might not respond strongly to higher interest rates. In countries where there is capital flight through over-invoicing of imports and under-invoicing of exports savings from the national income accounts may be an underestimation of actual savings by the extent of unofficial capital flight.

The availability of a variety of alternative non-financial assets may possibly be of greater importance to aggregate saving. The return on these non-financial assets may not be captured by deposit rates. Alternative returns to investment such as, return on owner occupied housing and other real estate investments can convey useful information on savings behaviour. Household savings for example, may be sensitive to the after tax rate of return on investment in real estate⁴. In addition, inventory goods or real assets constitute a sizeable proportion of private savings in many developing countries owing to long periods of financial repression, shallow financial markets, and high inflation (giving rise to inflation hedges). This form of savings tends to decline when the real interest rates rise and correspondingly, saving in financial assets increases.

Given that, financial saving is only one type of saving, the switch in the composition of saving following financial liberalization may leave total savings unchanged. Thus, unless the increase in financial savings swamps the reduction in real assets then the response of aggregate private savings to real interest rate changes will be negligible. The low response of savings to real interest rates can also be attributed to the predominance of contractual savings in total saving in many developing countries. Much of the savings take the form of

⁴ However, paucity of appropriate data on these rates of returns in developing countries have limited their use in applied work.

contributions to provident or pension funds and life insurance. Contractual savings are generally not responsive to real interest rate changes. Part of total saving is also accumulated by the public sector through surplus generated by tax measures or pricing policies of public enterprises.

2.3. Other Determinants of Private Savings

Other determinants of private savings that have been included in savings functions include inflation, foreign and government savings, macroeconomic instability, the structure of the economy, economic growth, and overall financial development. In the following section we briefly discuss some of these factors that have been included in savings functions in the empirical literature. The focus here is on the rationale of including the variables in a savings function. In models testing the impact of interest rates on savings some of the variables have been included as conditioning variables to avoid specification errors and its consequences.

2.3.1. Inflation

In most studies, expected inflation π^e is expected to impact on saving only through its role in the determination of real deposit interest rate. This model formulation assumes inflation neutrality, the absence of money illusion or a real balance effect. However, quite apart from its influence on real returns on saving, inflation may also influence savings through its impact on real wealth. If consumers attempt to maintain a target rate of consumption to wealth or of liquid assets to income, saving will rise with anticipated inflation.

Inflation also captures the effect of real income uncertainty on savings. An increase in uncertainty induced by high inflation may force consumers to hedge by spreading

potential loss of income over more than one period thus, increasing savings. Deaton, (1992) noted that consumers respond to unexpected changes in inflation by increasing involuntary savings. At higher rates of inflation, storable goods are substituted for money, as it becomes costly to hold money. Thus, the impact of expected inflation on private savings could either be negative or positive.

2.3.2. Economic Growth

To the extent that the economy is growing, workers' savings will increase relative to the retirees' dissavings and thus, measured aggregate savings will increase. An opposite effect occurs where workers will anticipate future income increases. This scenario leads to an increase in present consumption and reduces savings. Following from this analysis, the relationship between growth and savings can be ambiguous.

However, the stylized fact emerging from the literature is that the process of economic development involves initially low saving rate, a period of high growth accompanied by high saving rates and lower saving rates as the economy becomes more developed. Thus, per capita income is likely to influence savings significantly in developing countries. Generally at subsistence levels, the potential to save or ability to save is small. A rise in per capita income may increase the ability of households to save and hence lead to higher savings. Masson et. al. (1998) noted that the size of this effect is likely to decline as the per capita income continues to rise and the economy becomes more developed.

2.3.3. Foreign savings

In the theoretical literature open economy models add two perspectives to the analysis of domestic savings. First, domestic interest rates will be linked to international interest rates. Secondly, in open economies agents can use foreign borrowing to smooth

consumption. This means that foreign savings will generally act as substitutes to domestic savings. Thus, the coefficient between foreign savings and private savings measures the degree of substitutability. If foreign savings crowd out private savings the estimated coefficient of this variable would be negative. Given this inverse relationship, a lower current account deficit will probably be matched by an increase in domestic savings⁵.

2.3.4. Financial Development Indicators

Financial liberalization can in the long run lead to a competitive and highly developed financial system, which will be characterized by improved saving opportunities, including higher deposit interest rates, a wider range of savings media with improved risk-return characteristics. In many cases more banks and bank branches as well as other non-bank financial intermediaries emerge following financial liberalization.

The dominant measure of financial sector development or financial deepening in the literature is constructed as yearly ratios of narrowly and broadly defined money over GDP ($M1/GDP$ or $M2/GDP$). These measures have been incorporated in savings functions to capture the effect of overall financial sector development on private savings. However, this is a difficult variable to interpret. If it is taken, as has traditionally been the case, as a proxy for the depth and sophistication of the financial system, its coefficient should be positive (see McKinnon 1973). If it is taken as the extent to which households face a borrowing constraint, its coefficient should be negative (see Edwards, 1996). Generally the amount of credit extended to the private sector as a ratio of total domestic credit can be considered to be a closer proxy for borrowing constraints.

⁵ Edwards (1996) found evidence that foreign savings are negatively related to national savings.

2.4. Liquidity Constraints and Domestic Savings

Liquidity constraints negatively affect consumption in developing countries with thin and repressed financial sectors. Under such cases many people are target savers forced to save in order to make a specific purchase in future. Financial sector reform which relaxes consumers' liquidity constraints by producing higher credit supply may effectively discourage saving and in the long run reduce credit availability.

The extent to which individuals can actually dissave will depend on their ability to borrow for consumption against future income. If the borrowing constraints are binding, then the marginal utility of present consumption will exceed the (discounted) expected utility of future consumption. Thus, households would like to increase present consumption but will be unable to do so. This could arise because banks may be unwilling to lend due to uncertain future incomes, lack of collateral, or moral hazard behaviour on the borrowers side or other credit rationing measures. Thus, when borrowing constraints are binding consumers may be induced to consume less and savings increase. Even when constraints are not binding in the current period, the expectation that they will bind in future reduces current consumption (Edwards, 1996, Mwega, 1997). Thus, overall borrowing constraints are likely to increase savings⁶.

Published interest rates may not reflect capital market realities if households and small enterprises (SMEs) are constrained from borrowing what they would wish borrow because of financial repression or other reasons. To the extent that liberalization reduces these borrowing constraints or lowering uncertainty of future income, then present

⁶ Gersovitz (1988), however, observed that even though savings tend to increase with borrowing constraints, household's welfare would tend to be lower.

consumption will increase and thus savings will decline⁷. Jappelli and Pangano (1994) using cross-country data from developed countries (and required down payments for mortgages as a proxy for borrowing constraints) found evidence supporting the idea that relaxing borrowing constraints will reduce savings. In their study, savings increased with the size of the minimum mortgage down payment for housing in OCED countries.

The importance of borrowing constraints can also be gauged by inferring that any dependence of the change in consumption on income might reflect the inability of households to smooth the intertemporal pattern of their consumption through borrowing. An examination of Zimbabwean data for the period 1968 -1990 showed high dependence of current income and current consumption (see Chigumira, 2000, p.249). Thus, one can infer that prior to the commencement of financial reforms borrowing constraints were binding. Borrowing from abroad was restricted by the stringent exchange controls. Thus, opportunities for consumption smoothing were restricted.

2.5. Financial Sector Liberalisation and Access to Credit by SMEs and the Poor

A central postulation of the financial liberalization theory is that financial liberalization will improve credit availability (see Shaw, 1973). Accessibility to this increased pool of credit by SMEs and the poor is likely to increase if financial liberalisation leads to a relaxation of borrowing constraints, especially where banks dispense with the usual collateral security requirements. If financial liberalization has a favourable effect on the allocation of resources to the SMEs this will generate a general increase in income.

⁷ It should be noted that increased household borrowing may not all go to consumption or housing. Relaxation of borrowing constraints may promote human capital development, though this will normally be measured as consumption in National Income Accounts.

Ultimately this will, induce an increase in saving following the boost in the ability to save by the SMEs and the poor.

In Zimbabwe's pre-financial sector reform era, the major windows of finance for SMEs were the Small Enterprise Development Corporation (SEDCO), the Agricultural Finance Corporation (AFC), the African Development Fund (ADF) and the Zimbabwe Development Bank (ZDB). These institutions could, however, not provide adequate finance for SMEs because of their unsustainable reliance on the Government or donors for funding. Financial sector reforms, which increase competition in the financial sector and also motivate saving taking institutions to cast their banking outreach to the traditionally 'unbankable' SMEs and the poor may be expected to bridge the loan gap for these sectors.

However, from the banks' point of view it is generally more costly to lend to the SMEs and the poor than to large and long established companies with a business and banking track record. These lending costs include process costs, administrative costs and the risk of default attached to SMEs and the poor. For example, SMEs and the poor generally borrow small amounts such that the cost of processing such loans may outweigh the benefits to the lender. The projects for which the SMEs and the poor apply for funding are generally sparsely located. This makes it more difficult and expensive for banks to monitor and evaluate them. In addition entrepreneurs in the SMEs sector need special training and information dissemination, which is an extra cost to the lending institutions.

On this basis the marginal cost of lending to the SMEs is higher than that of lending to big and established companies. Bank lending practices, which emphasizes exclusively on

profitability⁸ against other lending criteria such as the viability of the project or social outreach, will naturally under lend to the SMEs and the poor even after financial sector reforms. This is because the marginal cost of lending to micro-borrowers is higher than that of lending to corporate borrowers. This is illustrated in Figure 1, where SMEs only get L_s loans at a higher interest rate of r_s % compared to L_1 and a lower interest rate of r_1 % for the bigger borrowers.

[See Figure 1, end of document]

2.6. Financial Reform and the Cost of Capital

Financial liberalisation is expected to enhance competition among financial institutions as legislative barriers to entry are removed. In an oligopolistic financial sector with a few market leaders the problem of very high lending rates and very low deposit rates, not justified by market fundamentals, may emerge. Symptoms of this situation are currently prevalent in Zimbabwe where the disparity between lending and deposit rates averages more than 30 percentage points. Such a system does not only have the problem of failing to raise adequate savings but it also crowds-out the demand for credit for investment especially by SMEs and the poor with limited access to other sources of funding such as retained earnings, cheaper off shore borrowing and equity financing.

The relationship between interest rates and investment implies moderate interest rates are needed for optimum savings mobilisation, credit and investment (Figure 2). Too

⁸ It should be noted that the emphasis of bank lending on profitability and not other lending criteria marks the fundamental distinction between development financial institutions (which have a social objective function) and private capital in development. Banks generally provide working capital more than funds for capital development, which most SMEs need as seed capital.

low rates of interest result in low credit availability and too high rates discourage the demand for credit and investment.

[See Figure 2, end of document]

2.7. Bank Lending Criteria and Access to Credit by SMEs and the Poor

In the pre-liberalised Zimbabwean financial sector, SMEs' portfolios were composed of inside money (currency), informal market loans and inflation hedges. Rotating and savings clubs, moneylenders, micro-finance institutions as well as friends and relatives were the main sources of credit for SMEs and the poor prior to financial liberalisation. The increase in the formal financial sector deposit rates attracted savings from the informal financial sector and assets held as inflation hedges were liquidated and transformed into financial savings, as money market rates become attractive after financial liberalisation.

It is possible that the high money market rates and the improvements in savings media in the formal financial sector following financial sector reforms may have reduced the volume of resources flowing to the informal sector. This could have impacted negatively on credit availability in the informal sector, which has been the traditional source of business finance for emerging SMEs and the poor. Given the traditional stringent lending criteria of banks, there is no guarantee that the large pool of financial savings in the formal financial sector generated by attracting resources from the informal sector and inflation hedges will also benefit SMEs and the poor through greater access to credit. This is likely to occur because the restrictive lending criteria of formal financial institutions tend to discriminate against SMEs and the poor.

Bank lending and risk management techniques in Zimbabwe have not changed significantly even after the reform. In the controlled environment before liberalization

banks' lending criteria mainly emphasised risk. In particular, commercial banks' finance is generally biased in favour of large enterprises, which are less risky, and have assets that can be attached as collateral. This also reflects the tendency of risk averse banks to lend where there are lower costs and risks.

To avoid taking excessive risks banks generally consider collateral security, character of borrower, business track record, profitability of the venture, production capacity and initial capital prior to loan advancement. However, trade liberalisation also made future profitability of firms uncertain because of fluctuations in the demand for firms' products especially where there are cheaper foreign products being imported into the country. Thus, banks may choose not to use past profitability as a measure of future profitability in assessing loan applications by prospective clients in industries affected by an influx of cheap foreign products. This is likely to lead to credit rationing even in a liberalized environment.

Under such circumstances, large and well-established companies with assets that qualify as collateral security, public enterprises that enjoy government guarantees will continue to enjoy preferential treatment in accessing credit at the expense of SMEs and the poor. Most SMEs are start-up entities with no assets that qualify as collateral security and they have no past business track record that can enable banks to have an opinion on their capabilities and the viability of the ventures for which the loan is applied for. This missing information on the character and capabilities of SMEs and the poor acts as a deterrent for risk-averse banks to extend credit to these sectors even in a liberalised environment.

In Zimbabwe prior to financial reforms there was collusion rather than competition among banks such that, a borrower denied credit by one bank was unlikely to obtain credit in another bank. Prior to 1997 the structure of the commercial banking was the same as it

was prior to financial reforms. Thus, the collusive behaviour and credit rationing based on risk related lending is likely to have remained intact even after the introduction of financial reforms. This is particularly so with the removal of exchange controls, which acted as a de facto mechanism for assessing the creditworthiness of borrowers.

Of concern, is the fact that most banks now require equity contribution from clients, which is on average at least 25% before a loan, is advanced. Although this is done to reduce the agent problem between banks and borrowers, most SMEs do not normally manage to raise the required percentage. Collateral as a hedge against loan default is another stumbling block, which restricts SMEs' access to credit. In Zimbabwe, collateralisation is done both at the discretion of the financial institution and also as a statutory requirement for safe bank lending practices to protect depositors' money. Most SMEs and the smallholder farmers and the poor do not have such collateral. This is especially because of the communal land tenure system, which does not allow land and buildings to be offered as collateral security.

This systematic bias against financing SMEs and the poor (even in a liberalized environment) can be explained by Akerlof's (1970) theory of the "market for lemons". This theory is illustrated by Figure 3, which shows the risks and rate of return faced by small-scale enterprises.

[See Figure 3, end of document]

Because, small businesses are regarded as high risk, the level of risk associated with the riskiest small business tends to be applied to all businesses. Consequently, bad businesses tend to drive good businesses out of the financial markets, as the latter have to raise equity or debt on terms that exaggerate their risk. The gap between the true risk and the perceived risk can be termed the "Lemon Gap". Only in cases where financiers are in a

position to assess carefully the true risk of small businesses can the cost of capital match the true risk. This may be the case with local moneylenders, but is seldom the case with formal sector financial institutions.

The costs of loan investigation and administration are not proportional to the size of the loan, and weigh more heavily on smaller loans than larger loans. The cost of loan investigation can largely be eliminated if the lender requests for collateral instead of monitoring the use of the loan. However, reliance on heavy collateral security is an impediment to those firms with high growth potential but limited tangible assets. Borrowers that are endowed with assets in place (mostly established businesses) tend to be favoured by the collateral security requirement at the expense of small and new entrepreneurs. In this regard high collateral requirements can lead to under investment particularly by SMEs that may be more efficient and dynamic than large enterprises.

The elimination of the lemon gap may be socially desirable in relation to the benefits derived by increased investment and employment in the SMEs sector and poverty alleviation for the poor. In most developing countries the lemon gap has been reduced through the provision of subsidized institutional finance for SMEs and credit guarantee schemes. More recently venture capital companies have provided equity finance to high risk and high return SMEs, which have a high growth potential.

An efficient supply of finance to SMEs and the poor may also require that the liberalization of the level and structure of interest rates be accompanied by the development of schemes for sharing risks and administrative costs between the public and private sectors. Thus, financial reforms that pay attention to interest rate deregulation without addressing the

issues on risk sharing in particular may not succeed in raising financial savings and improving accessibility to credit by the SMEs and the poor.

3. Research Methodology

A study of this nature can use various approaches. These include the with-without approach; the before-after approach, and the actual-versus-targets approach. The with-without approach requires putting in place assumptions to project what would be the current state of the variables of interest without financial reform in order to compare this with the realized state of the variables of interest. This is highly abstract and subjective, as conclusions will heavily depend on one's assumptions and projections. For, the sake of simplicity and objectivity this paper relies more on the last two approaches.

The analysis is two pronged in that secondary data for the period 1977 to 2001 is used to econometrically test the determinants of private savings and credit demand. Quantitative and qualitative analysis of primary data gathered from the SMEs and the poor and financial institutions is done to supplement the econometric analysis. In the econometric analysis three major relationships are investigated, these include the private savings function (S_t), the total supply of credit function (CR_t) and the supply of credit to the private sector inclusive of the SMEs and the poor (PCR_t). The supply of credit to the SMEs could not be explicitly estimated because paucity of data on this variable. Primary data analysis will be used to deduce whether the SMEs and the poor had increased credit availability due to the reforms. The demand for credit positively correlates with investment hence inference on investment demand will not be done explicitly.

3.1. Econometric Analysis

Most empirical examinations of the effects of financial liberalisation on saving have involved adding one or more variables to established econometric specifications either of saving or of the rate of change in consumption. These studies are generally based on cross-country regression models that can be encompassed in the following equation which includes most of the determinants of private savings discussed earlier⁹:

$$S_t = a_0 + a_1 L_t + a_2 G_t + a_3 F_t + a_4 M_t + a_5 D_t + a_6 E_t + a_7 P + U_t, \quad (1)$$

where, L_t is a vector of life cycle variables, including age dependency ratio, the rate of growth of per capita GDP, the ratio of the young and the old. G_t is a vector of variables related to fiscal policy. In principle it includes the government savings rate, government consumption and the ratio of social security expenditures to total government expenditures (which are used as a proxy for expected social security benefits). F_t is a vector of variables that capture the characteristics of the financial sector, including its degree of development, the extent of borrowing constraints, real interest rates and the spread between borrowing and lending interest rates. M_t refers to macroeconomic stability variables, including the rate of inflation. E includes variables related to the external sector, such as the current account balance (or foreign savings). S_t is the dependent variable measured as a ratio of private savings to GDP. P_t captures political variables and U_t captures all other variables that may influence savings but are not included in specification.

However, the rich menu of variables estimated in cross sectional studies is difficult to fully exploit within a time series framework, because of endogeneity problems. Some recent studies have explored the impact of a few variables on savings using the cointegration and error-correction approaches to capture both the short and long-run dynamics of private

⁹ Edwards (1996) using data from 36 countries estimated a similar model for the period 1970-1992.

savings (see, Isaksson, 1997, and Bandiera et. al., 1999). Furthermore, the choice of variables is limited because of the small sample periods and availability of data, which inevitably limits the degrees of freedom in the specified systems. Thus, most researchers using time series data focus on only a few of the variables specified in equation (1)¹⁰.

In this study we explore the impact of a few chosen variables on savings using the time series approach. Thus, our models will not explore the whole range of variables depicted in equation (1) because of data limitations. We use the instrumental variable technique to estimate our models using two stage least squares (2SLS) estimator. The instrumental variable technique was used to overcome contemporaneous correlation, which could arise from measurement errors or simultaneity bias. Two stage least squares is the most frequently used method of obtaining consistent estimators of parameters in a simultaneous system of relationships. The uses of elaborate cointegration and error correction techniques could yield more insights. However, in this analysis we side step these techniques because our sample size is small and thus, it would be difficult to get meaningful results because of the small sample problems.

3.2. Estimated Models

3.2.1. Private Savings Function

We adopt the following private financial savings function, which is a modified version of equation (1)¹¹

$$S_t = a_0 + a_1 y_t + a_2 r_t + a_3 r_t * D_{91} + a_4 D_{91} + a_5 (FS)_t + a_6 S_{t-1} + v_t. \quad (2)$$

¹⁰ For example Bandiera et al. (1999) used time series analysis to investigate the impact of financial reforms on savings in eight developing countries, with sample sizes ranging from 15 to 25 annual observations for the period 1970 to 1994.

¹¹ Similar models have been used by Fry (1995).

We use real interest rates¹² as the proxy for financial sector reform. Of major interest, is the relationship and the strength of the relationship between savings (S_t) and the real deposit rate (r_t). This will indicate whether the increase in real deposit rates following the financial sector reform significantly raised financial savings for on lending in the economy. The impact on savings of growth in real income (y_t) and ratio of foreign savings to GDP [i.e., (FS_t)] whose magnitudes all changed over the sample period and which could have affected financial savings during the same period is captured by the inclusion of these variables in the specified model. The effects of habit persistence, customs and inertia on the adjustment of savings are captured by (S_{t-1}). The impact on savings of other savings-conducive changes, which came together with the economy's financial sector reforms, is captured by the dummy variable (D_{91}). This takes values of zero prior to the reform period (1980-1990) and one in the post reform period (1991-2000). The dummy ($r_t * D_{91}$) allows the investigation of whether there was an increase in the marginal propensity to save or not due to the reform. The independent variables have been lagged once to reduce the problem of spurious regression

3.2.2. *The Credit Supply functions*

This relationship examines the impact of the reforms on the supply of loans and investment. Our major interest is on the investigation of the extent to which the increase in real lending rates enhanced or discouraged the supply of and demand for credit at an aggregated level and for SMEs and the poor. We are also interested in investigating how the increase in savings (if any), and increased financial sector competition increased or reduced

¹² The literature on interests provides different methods of calculating real interest rates. In this we use a simple method that is commonly used in the literature of subtracting realised inflation from nominal interest rates. Please note that in the savings function we use real deposit rate (deposit rate minus realised inflation) and in the credit functions we use real lending rates (lending rates minus realised inflation).

the supply of and accessibility to credit by SMEs and the poor. The following credit supply model is estimated:

$$CR_t = b_0 + b_1 S_t + b_2 lr_t + b_3 D_{91} + u_t . \quad (3)$$

This relationship is analyzed both for the total credit supply and for the supply of credit to the private sector for which, the SMEs and the poor are part. This model captures both the credit availability and the cost of capital impacts on the supply of credit due to financial sector reforms. The savings variable (S_t) captures the impact of the state of savings on credit availability. The real lending rate (lr_t) captures the Keynesian cost of capital impact on the demand for credit. The dummy variable D_{91} is included also to capture the impact of other policies and events that could have positively/negatively impacted on the supply of credit. In a financially liberalized economy there are supply-leading forces, which result in the creation of differentiated and more attractive financial products that can be accessed by a wide spectrum of borrowers including the poor. This most likely induces psychological effects that increase the demand for and supply of credit. Financial repression existing in the background of a generally controlled economy reduces the motivation to borrow and invest.

3.3. Sources of Data

The data sets that are used in this analysis come, mainly from central statistical office (CSO) Digest of Statistics and National Accounts Report and Reserve Bank of Zimbabwe Quarterly Statistical Bulletins (RBZSB). The data frequency is annual. Primary data is drawn from the questionnaires for the SMEs and the poor and for the financial institutions.

4. Data Analysis and Discussion of Results

4.1. Primary Data Analysis and Findings

For our data analysis a sample of 372 small to medium enterprises and 36 financial institutions around Bulawayo and Harare was interviewed to obtain primary data that would supplement secondary data analysis. The analysis of this data is presented below.

4.2. Financial Deepening and Savings

Evidence shows that there was a noticeable improvement in Zimbabwe's financial deepening after the inception of the financial sector reforms in 1991. This was mainly attributable to the significant increase in the number and variety of financial institutions and financial assets that came into existence after the reforms and the subsequent increase in banks' branch network into the traditionally 'unbanked' rural growth points. The ratio of nominal money supply (M_2) to GDP increased sharply from an average below 20% before financial liberalization to above 30% after the reforms. The savings ratio also showed noticeable upward trend in the early 1990s. In the late 1990s, however, the savings ratio had started showing downward trends due excessively high and unstable inflation. This prompted savers to switch over to inflation hedges such as real estate, other non-financial savings and the stock market. The financial deepening indicator (M_2/GDP) and the savings ratio have been plotted to highlight these observations in Figure 4.

[See Figure 4, end of document].

It seems that financial deepening and the subsequent increase in savings did not commensurately benefit the poor and the SMEs in terms of an increase in credit supply. The increase in bank branch network tended to be more focused at mobilizing savings from these groups rather than providing them with investment loans. For example, the Post Office

savings bank attracts substantial savings from the small and generally marginalised savers in both rural and urban centers. However, the POSB acts as a safe depository because it neither makes loans nor extends overdrafts to its clients. Such small savers find it even more difficult to access credit when they need it from commercial banks where they do not hold accounts due to high minimum deposit requirements. This is supported by the fact that among the small to medium enterprises interviewed only 49% of those who had applied for a bank loan managed to get it even if 78% of them maintained a business bank account with the financial institutions.

4.3. Private Sector Credit and Investment

In the early stages of the financial sector reforms, in Figure 5, the levels of private sector credit and investment showed signs of improvement than before 1991 and in the late 1990s.

[See Figure 5, end of document]

This occurred because the commencement of reforms generated a lot of optimism. This optimism coupled with the relaxation of bank lending restrictions and the prospects of high profits led firms to expand capacity or engage in new business ventures. Thus, firms increased demand for credit from banks.

However, the optimism generated at the onset of reforms was dampened by the deterioration in the macroeconomic environment in the late 1990s. The ensuing high and unstable inflation and exorbitant lending rates negatively affected the demand and supply of credit to the private sector. High interest rates, which were far above the rate of return on investment discouraged investors from borrowing. Banks were also discouraged to lend at such high rates because of adverse selection problems (investors who borrow at those exorbitant rates are likely to be risky borrowers). With the worsening macroeconomic

environment, firms also faced declining demand for their products and consequently declining profitability. Thus, the concoction of declining profitability coupled with high cost of servicing debt and the reluctance of banks to lend to firms whose fortunes are declining (risky firms) caused investment to fall in the late 1990s as depicted in Figure 5. The decline in investment may have been caused by a shift away from financing fixed investment by banks to money market instruments particularly less risk treasury bills.

4.4. Credit availability to the SMEs

Although both the private sector credit and investment trends indicate upward trends after reform, it has been observed that much of this benefited the formal and established sectors of the economy and the government¹³ rather than the SMEs and the poor. This disregards the fact that the SMEs and the poor significantly contribute towards domestic savings, especially through the Post Office Savings Bank, which has an extensive branch network countrywide¹⁴. Our survey showed that for the SMEs that applied for a bank loan after the financial sector reforms, 49% got the loan. This is marginally above approximately 48% who had their loan applications approved by the financial institutions before the reforms. The results are supported by earlier findings from other studies such as the results from the RPED survey data reported in Table 1, below.

¹³ Financial liberalisation may exacerbate the demand for bank credit by the public sector thereby limiting resources available to the private sector. This may arise if an increase in deposit rate reduces the willingness of the private sector to purchase government bonds, thus constraining the public sector to finance its deficit with more credit from the banking system (see Chigumira, 2000, p.171).

¹⁴ The main attraction of POSB to small savers is that the minimum deposit is very low compared to commercial banks and building societies and the interest rates are tax-free. However, the POSB does not extend loans to the public. It invests mainly in government and municipal instruments.

Table 1: Sources of start up finance by firm size in Zimbabwe

Percentage of firms which used	Micro	Small	Medium	Large
Own Savings	90	80	58	52
Friends and Relatives	13	2	7	11
Bank Loan	3	14	9	9
Others	13	19	22	25

Source: RPED study on Enterprise finance in Zimbabwe –April 1995

The table shows that a large percentage of the micro, small and medium enterprises continued to self finance their businesses in 1995 compared to large firms. The reliance of firms on self-finance can be taken as an indicator of stringent borrowing controls or lack of credit.

The persistently high government borrowing even after the reforms has tended to significantly crowd out private sector borrowing, especially the poor and SMEs who can hardly borrow at high lending rates (Figure 6).

[See Figure 6, end of document]

After financial liberalization over 80% of the SMEs were aware of bank loan facilities, more than 75% hold bank accounts and 50% had applied for a bank loan. For example lack of information by the SMEs and the poor on the existence of these loan windows such as the World Bank US\$15m SMEs (May, 1995) loan facility, and how to access it meant that the SMEs and the poor failed to fully utilize this cheap loan facility despite the low interest rate of 9% p.a on the loan facility.

The low loan approval confirms the view that firms in Zimbabwe particularly SMEs face stringent borrowing constraints. To circumvent these borrowing constraints established

firms rely on retained earnings to expand their capacity. Collier and Gunning's (1999, p.88) observation that loans account for less than two percent of total investment in Zimbabwe support this view. Their observation was based on the RPED survey carried out between 1992-1996 in which firms reported that access to credit was one of the major problems that inhibited firms to invest. There are many reasons why the SMEs in Zimbabwe continue to have limited access to credit.

Firstly, the lending methodologies of the traditional banking sector continue to emphasize on conventional collateral security, which most SMEs and the smallholder farmers do not have. The other reasons why the SMEs loan gap continue to exist after the financial sector reforms include lack of good management skills, lack of past existence (no business track record) and inability to contribute own equity, all of which are emphasized by the mainstream financial institutions. The use of collateral substitutes such as group lending, small household assets and sureties, which most of the SMEs would afford is still uncommon with the banking financial institutions in Zimbabwe. In Figure 7, of the interviewed mainstream financial institutions only 5% have consistently used these for the benefit of the SMEs.

Secondly, SMEs together with the other private sector investors are being crowded out by the high lending rates in the financial sector, which shot up to as high as 70% in 2000. This was mainly as a result of high fiscal expenditure and inflation in the late 1990s. This may reflect the general reluctance of banks to lend at high interest rates for the reasons discussed earlier as well as the effect of a drop in profitability and the increase in uncertainty caused by the worsening macroeconomic environment. The effect of these factors is

reflected in the increase in average excess liquidity ratio¹⁵ in the banking sector, which rose to levels above 40% between the late 1990 and 2000.

Lastly, the small percentage of loans going to the SMEs and the poor is partly attributed to the low turnout by this sector towards bank loans. Of those surveyed, for example, 84% had knowledge of the existence of SMEs loan facilities in the financial sector but only 50% had applied for a bank loan. At least 67% of the SMEs finance their own capital investments and working capital requirements from relatives and own savings or retrenchment packages. The same percentage also gets their business advice from relatives and friends rather than from the banks. Besides high lending rates and inability to produce collateral security, this low loan turnout is partially caused by the existence of imperfect information about the availability and terms of loans in the banking sector as indicated by 60% of the SMEs interviewed.

4.5. The viability of lending to the SMEs and the poor

Our empirical evidence on SMEs and micro lending in Zimbabwe has shown that lending to this sector can be viable and sustainable as long as appropriate lending methodologies are used. For the few banks and micro-finance institutions, which use group lending and other collateral substitutes, their loan portfolios are on average above 192% and 107% respectively with an average portfolio at risk of 6%. This suggests the possibility of implementing both supply leading and demand following strategies in the financial sector to reduce the loan gap of this potentially important sector. In the long run this sector will graduate into wholesale banking to the advantage of the lending financial institutions. Many financial institutions have of late recognized the viability of lending to SMEs, the

¹⁵ Liquidity ratio is expressed as total liquid assets of the financial institution (i.e. commercial banks) as a percentage of total liabilities to the public. Excess liquidity ratio is what is the excess over the statutory limit on liquidity ratio.

smallholder farmers and the poor and have set up windows for these. Examples are the Commercial Bank of Zimbabwe's community banking department, AgriBank's micro-finance section and Barclays' small business centre facility.

4.6. The role of Micro Finance Institutions (MFIs) in Zimbabwe

Micro finance institutions in Zimbabwe are registered under the Money Lenders Act and they provide consumer and micro project loans. These institutions play an important role in reducing the loan gap of the SMEs and the poor in Zimbabwe. The survey that we carried out showed that while the expected loan application rejection ratio for the SMEs by the traditional mainstream financial institutions is 50%, it is only 10% with the Micro finance institutions. The MFIs have managed to viably and more effectively reach this traditionally unbanked sector because of their more appropriate lending methodologies, which include the use of collateral substitutes and the acceptance of simple project proposals. It has also been observed that the increased lending competition, which the MFIs have brought after the financial sector reforms has tended to force the traditional mainstream financial institutions to also turn to the same sector to expand their clientele base.

4.7. The role of development finance institutions

There are at least five development finance institutions mainly involved in financing long-term capital investments. These are Government and or donor funded financial institutions hence most of them have suffered sustainability problems due to falling funding. It has also been observed that the lending methodologies and loan requirements tend to discriminate against the SMEs and the poor. Emphasis is put on collateral requirements, equity contribution generally of at least 20%, comprehensive business proposals mainly in manufacturing and exportable sectors and high minimum loan requirements, which are above the maximum loan requirements of some SMEs. Agricultural produce procurement

firms such as the Cotton Company of Zimbabwe and the Grain Marketing Board have, however, assisted in bridging the SMEs loan gap, especially the smallholder farmers, by launching inputs credit scheme.

5. Presentation and Interpretation of Econometric Results

The econometric results and analysis from the estimated savings and credit supply functions are presented below. We present estimates of the conventional models in logs (except real interest rate, inflation rate and the foreign savings ratio are in levels) as the performance of these was found to be better than estimates in levels. In section 3.1 we presented a single general equation, which have been used in most empirical examinations of the effects of financial liberalization on savings. In this section we report results based on two equations, which include some but not all the variables contained in equation 1. It would have been desirable to estimate the complete model but we did not do so because of lack of data on some variable, endogeneity and multicollinearity problems. To reduce the effects of these problems we estimated two models using the instrumental variable technique. In the two models we used different measures of income and opportunity cost variables. For example in model 1 we used real income and in model two we used real per capita and in model 2 we used real interest rate as the opportunity cost variable while in equation 1 we used realized inflation (as a proxy of expected inflation) as the opportunity cost variable.

5.1. The savings function

We set out as part of our objectives to investigate whether there has been a statistically significant increase in the level of financial savings due to financial liberalization (Table 2). We have done this by considering the impact of real deposit rates (a proxy of financial liberalization) on savings.

Table 2: 2SLS Results for the Savings function

	Model 1*	Model 2**
Constant	-9.3500 (-2.021)	-5.397 (-1.110)
Ly_t	0.1160 (1.976)	
$L(y/pop)_t$	-	0.4534 (2.135)
r_t	-	0.0600 (1.029)
INF_t	0.2727 (2.020)	-
D_{91}	0.1943 (0.928)	0.1943 (0.928)
$r*D_{91}$	-0.0189 (1.519)	0.0154 (0.306)
FS_t	0.0006 (2.036)	0.0075 (2.532)
LS_{t-1}	0.446 (2.824)	0.530 (2.588)
R^2	0.97	0.96
SE Regression	0.354	0.45
DW Stat	1.909	2.23
N	25	25

*With inflation as the opportunity cost of money demand.

**With interest rate as the opportunity cost of money demand.

We uncovered a positive but insignificant relationship between real interest rates and savings. The finding of a statistically insignificant coefficient of real interest rate is not at variant with other studies. As noted earlier a number of studies report an insignificant and/or small interest rate elasticities in their savings function (see Fry, 1995).

The insignificance of the real interest rate in our model suggests that savings did change significantly following the liberalization of deposit rates (r_t). The statistical insignificance of the real deposit rate in savings function may also be a reflection of the fact that real deposit rates were negative for a large part of the sample period. Real deposit rates only became positive in the early and mid 1990s. The real interest rate variable could therefore be capturing the effect of financial repression as opposed to financial liberalization. By 2000, for example, the average nominal deposit rate charged by banks on savings accounts was below 14% against an inflation rate of more than 60%.

The insignificance of the deposit rate in savings determination is also partly explained by the nature of the majority of savers in Zimbabwe. Many savers are still target savers due to continuing high credit constraints. Target savers accumulate savings before purchasing a needed physical asset. Normally such savings are pushed by the desire to have the asset rather than the deposit rates per se. Some of the financial savings that are recorded by financial institutions are determined by the institutional arrangements and hence are unintentional. For example salaries of government employees and other private sector organizations are deposited in the employees' savings and current accounts. These salaries are automatically counted as savings with financial institutions. However, such savings are not dependent on the level of deposit rates but on the prevailing institutional arrangements.

The estimated coefficient on the inflation rate is positive and significant. This suggests that saving were rising with anticipated inflation rate (realized inflation rate) during the sample period. This may occur when consumers attempt to maintain a target rate of consumption to wealth or of liquid assets to income. Inflation also captures the effect of real income uncertainty on savings. Thus, an increase in uncertainty induced by high inflation may force consumers to hedge by spreading potential loss of income over more than one period thus, increasing savings. This fact is also supported by Deaton's, (1990) observation that consumers respond to unexpected changes in inflation by increasing involuntary savings. As noted earlier, the savings ratio started showing downward trends due excessively high and unstable inflation in the late 1990s, which prompted savers to switch over to inflation hedges.

The estimated coefficients on real income (Ly_t) and per capita income $L(y/pop)_t$ are both positive and significant. This suggests that real income is a significant determinant of financial savings over the sample period. As noted earlier as real income increases, the

ability of households to save increases. Economic growth in the early 1990s was stimulated by economy wide structural reforms, which were co-implemented with financial sector reforms. This led to an increase in real disposable incomes. It can be inferred that the increase in real income, subsequently led to an increase in the savings ratio.

We included the dummy variable (D_{91}) to capture the impact on savings of other savings-conducive changes, which came together with the economy's financial sector reforms. The estimated coefficient on the dummy had the expected positive sign but was insignificant. This may suggest that the other savings-conducive changes that accompanied financial liberalisation did not have a significant impact on savings. We also included in our model the dummy ($r_t * D_{91}$) to capture the effect of a possible increase in marginal propensity to save caused by financial reforms. The estimated coefficient of this dummy had opposite signs and was insignificant in both models. This evidence suggests that marginal propensity to save did not increase during the sample period.

The evidence from the models suggests that only real income and inflation were driving savings during the sample period. The theory of financial liberalisation suggest financial sector reform raise returns on savings, thus increases the marginal propensity to save. Financial sector reforms are also supposed to lead to the deepening of the financial sector resulting in increased financial intermediation and savings mobilization. Our econometric results do not reveal evidence of financial deepening or the increase in marginal propensity to save.

However, the analysis of the M_2 /GDP ratio and savings ratio reported in section 4.2 show evidence of a noticeable improvement in financial deepening and the savings rate. The increasing trend in savings was reversed in the late 1990s when controls on interest rates

were reintroduced. Thus, it is not surprising that the econometric models that were estimated over a sample period when interest rates were controlled for a greater part of that period show no evidence that financial reforms resulted in increased savings. The increase in savings is revealed for a short period during the early to mid 1990s by the aforementioned analysis of M_2 /GDP ratio and savings ratio. This occurred at a time when economic and financial sector reforms were being pursued with vigor, before the reintroduction of interest rate controls and other restrictive policies.

The effects of habit persistence, customs, and inertia on the adjustment of savings are captured by (S_{t-1}) in the model. The estimated coefficients of this variable in both models are positive and significant. This implies that habit persistence, customs, and inertia are important in the adjustment of savings over the sample period. Thus, financial reform measures that stimulate banking habit would indirectly stimulate savings. The coefficients of the foreign savings ratio are negligibly small but significant. This implies a very weak positive relationship between foreign savings and domestic savings.

5.2. The Supply of Credit functions

We also estimated the total domestic credit and the private sector credit functions (Table 3). Reliable data on the supply of credit to the SMEs and the poor could not be obtained. Conclusions on credit trends to these sectors are therefore based on inferences from the total domestic credit and the private sector credit functions as well as the primary data analysis presented in section 4.

Table 3: 2SLS Results on Credit Supply

Variable	Total Credit Supply	Total Private Credit Supply
Constant	-4.351 (-1.322)	-1.098 (-0.111)
LS_t	0.942 (6.182)	0.634 (2.146)
Lr_t^*	-0.049 (-4.293)	-0.029 (-3.126)
D_{91}	-0.129 (-0.506)	0.564 (2.694)
LCR_{t-1}		0.864 (2.028)
R^2	0.96	0.97
SE Regression	0.304	0.246
DW Stat	1.122	1.254
N	25	25

* Lr_t - is the lending rate and not $\log r_t$

The results from the total credit supply function show a significant increase in the level of credit in relation to the saving rate although the dummy variable comes out with a negative coefficient. There is also evidence on the crowding out effect of the high lending rates on total domestic credit.

The estimated private sector credit function also shows a significant positive impact of increased savings on bank credit to the private sector. The increase in private sector credit after the financial sector reforms could also be partly a result of increased competition in the financial sector. It could also result from the removal of credit directives on bank lending by the monetary authorities. Evidence also shows that the increase in the lending rate (cost of borrowing) impacted negatively on private sector borrowing. This contradicts the view that it is not the cost of credit but its availability/accessibility that constrains investors from accessing credit.

Findings from primary data, however, indicate that much of the increase in total domestic and private sector credit benefited the established business entities in the formal sector and the government rather than the small to medium enterprises and the poor. This is supported by RPED survey data reported in Table 1, which shows that a large percentage of

the micro, small and medium enterprises continued to self finance their businesses in 1995 compared to large firms.

6. General Findings and Policy Recommendations

Generally it has been observed that financial sector reforms in Zimbabwe had some positive effect on domestic financial savings mobilization. This resulted from increased financial depth in the form of increased entry into the financial sector, increased bank branch networking and the widening of the variety of financial products, which can be accessed by the majority of the populace. The increase in real incomes (ability to save) after the early years of economic reforms had a positive effect on savings. However, this was dampened by the negative impact of high and unstable inflation starting from the late 1990s. After this period savers tended to switch back to physical inflation hedges as opposed to financial savings. This suggests that high and unstable inflation reversed the upward trend in savings that was witnessed in the early 1990s. High inflation coupled with controlled interest rates may result in negative real interest rates, which would further curtail savings.

The impact of increased savings mobilization on credit availability and bank loans and advances has been observed to be positive. Both total domestic credit and private credit increased against savings as a measure of credit availability. The high lending rates, however, reduced this increased financial sector liquidity effect, especially in the late 1990s when credit supply and private investment had started falling. Much of the increase in the private sector credit was mainly for established borrowers as opposed to the small to medium enterprises, which got on average less than 5% of the total domestic credit supply even if their proportion of savings in the economy's total financial savings is high. This

evidence suggests that the expected benefits of financial sector reforms on the SMEs have were not realized.

The failure by the financial sector reforms to significantly benefit the poor, the smallholder farmers and the small to medium enterprises can be attributed to a number of factors. Firstly, it has been observed that banks continued to use conventional lending methodologies, which focus on profitability, collateral security, character of borrower and business and banking track record. These lending criteria generally discriminate against the SMEs because most of them are still relatively new and do not have a business and banking track record. The SMEs and the poor have no assets, which qualify as collateral security. Generally SMEs and the poor hold land and buildings without title deeds, which are not accepted by banks for collateralization. Thus, the issue of collateral security has been identified as the main stumbling block on the SMEs and the poor to access loans from banks.

Secondly the implementation of financial sector reforms in an unstable macroeconomic environment led to high bank lending rates, which discouraged SMEs from borrowing. The unstable macroeconomic environment during the 1990s, also adversely affected the internal rates of return on projects of most SMEs and the poor, thus reducing the chances of banks extending credit to the SMEs and the poor as default risks rose. The high lending rates that followed the decontrolling of interest rates also increased the borrowing constraints faced by the SMEs and the poor. This sector therefore lost out on the benefits of financial reforms.

Having realized that SMEs and the poor were loosing out in terms of accessing credit the government, international financial institutions and donors teamed up to provide

subsidized loan windows, which were designed to benefit this sector. However, lack of information by the SMEs and the poor on the existence of these loan windows and how to access them meant that the SMEs and the poor still failed to fully utilize these cheap loan facilities. Most of the SMEs and the poor we interviewed pointed out that they failed to tap into these facilities due to lack of information on the existence of the loan facilities or how to access them.

The emergence of micro-finance institutions particularly in the late 1990s significantly narrowed the loan gap of the poor and SMEs. These institutions have managed, with noticeable degree of success, to service the poor and the SMEs because of their more appropriate and effective lending methodologies and their strategic locations in relation to the micro-borrowers. Most of the conventional banking institutions, which have recently created credit windows to lend to SMEs have drawn some lessons and inspiration from the experiences of the micro-finance institutions¹⁶. Agricultural procurement companies such as the Cotton Company of Zimbabwe and the Grain Marketing Board have also to a large extent reduced the SMEs and smallholder farmer's loan gap by providing seed and inputs loans.

It should be noted that the supply of credit to SMEs and the poor by micro-finance institutions as well as government and donor funded soft loan credit windows might not be sustainable in the long term. There have already been signs of drying up of government and donor funding targeted to this sector. Thus, the mainstream banking institutions need to

¹⁶ It should be noted however that viability issues remain critical with regard to lending to SMEs. While microfinance institutions seem to have made inroads in lending to this, sector banks may have not gone into this sector in a big way because there seems to be enough profits for banks in their traditional markets. Perhaps banks may consider increasing lending to SMEs and nurturing them into viable businesses once competition intensifies in the banking sector and profits from their traditional markets dwindle. The profit motive of banks as private business entities also makes it difficult for banks to take on board development objectives, which government and donor funded microfinance institutions sometimes pursue.

devise ways and products, which reduce the costs and risks of lending to SMEs and the poor. This would unleash the potential of the sector to generate employment and enhance economic growth.

The emphasis on interest rate liberalisation in Zimbabwe's financial sector reforms has made it difficult for the economy to obtain any noticeable gains with regard to private investment particularly by the poor and the small to medium enterprises. The effect of raising the real deposit rate on credit, investment and growth is double-edged. While very low or negative real interest rates tend to cause financial dis-intermediation, very high real interest rates reduce credit, investment and growth. To avoid lending rates rising to excessive levels that discourage demand for and supply of credit and investment, interest rates should be strategically managed instead of being left to be determined on a *laissez-faire* basis. The strategic raising of the deposit and lending rates needs to be done in a way that ensures deposit rates that are positive enough to offer positive returns to savers and lending rates should be moderately high to offer a good return on lenders while not discouraging investment.

The main policy issue on interest rate liberalisation is the need to implement it in a stable and less inflationary environment. In Zimbabwe where money illusion is likely to exist, excessive inflation rates, which push nominal interest rates to high levels significantly, reduce borrowing and investment even if real interest rates are low or negative. This was the case in the late 1990s where savings and investment rates had begun to fall. Failure to check and contain inflation may therefore reverse the gains from the financial sector reforms in the long run. It is therefore recommended that restrictive fiscal policies in terms of reduction in government borrowing and expenditure should be co-implemented with financial liberalization. The use of tight monetary policy alone to contain inflation as has been done

by the monetary authorities tends to worsen inflation. This is because most firms in the economy rely on cost-plus pricing and raising interest rates (cost of capital) through tightening the monetary policy stance may fuel inflation.

We also recommend the establishment of a more deepened financial sector with many institutions. Even after the financial sector reforms Zimbabwe's financial sector remained highly oligopolistic with only about four market leaders. A situation like this is not health with regard to real competition that would ensure aggressive lending and reaching the traditionally 'unbanked' poor and SMEs. This sector can only be identified as a potentially viable and sustainable market niche if there is enough competition in the financial sector. The monetary authorities are therefore advised to put in place rules and regulations that encourage entry and real inter- and intra-market competition in the financial sector.

With regard to credit accessibility by the poor and the SMEs, there is need to revise the lending criteria of the traditional financial institutions from their conventional approaches to those that apply to micro-borrowers. These include the use of solidarity groups, village banking, and group lending where group members co-guarantee each other. With such risk sharing schemes, banks will manage to lend to the SMEs at low cost, low risk and low interest rates without any form of conventional collateralisation. There is also need on the part of the Reserve bank to consider other forms of collateralisation that are more appropriate to the small to medium scale firms and the smallholder farmers.

In addition, there is need to consolidate the micro finance institutions into the main stream banking sector by way of regulating them and allowing them to mobilize savings. Alternatively these institutions can also be encouraged to convert into regulated financial institutions. These have already created a culture of lending to the SMEs and the poor hence

allowing them to take savings would boost their financial resource base. Risk shared loan facilities for the SMEs and the poor where the government or donors and banks pool financial resources together for lending to this sector should be encouraged in order to reduce the lemon gap as depicted in Figure 3. Alternatively, the government can guarantee SMEs loans obtained from the banks. This will bring confidence through learning by doing to the traditional financial institutions with regard to lending to the poor and SMEs.

Information is more of a public good; hence profit seeking financial institutions may fail to produce it adequately because of free rider problems. Thus, the government should invest in information production and dissemination through organisations dealing specifically with SMEs and the poor, whenever loan facilities that benefit SMEs and the poor exist. This will increase awareness and uptake of the loan facilities by the intended beneficiaries (the SMEs and the poor). Lack of information has resulted in schemes meant to alleviate the plight of SMEs and the poor being hijacked by the unintended beneficiaries.

7. Conclusion

The evidence from this study clearly indicates that financial sector liberalisation may have led to increase in financial savings but has not benefited the SMEs and the poor in terms of increasing their access to credit. Financial sector liberalisation in an unstable macroeconomic environment led to high lending rates, which discouraged SMEs and the poor from borrowing given the low internal rates of returns for their projects. Thus, for financial sector liberalisation to be successful they should be implemented not in isolation but in conjunction with other matching and appropriate policies in the real, financial, external and public sectors. In addition these reform measures should be timed and sequenced appropriately.

Care should be taken to ensure that the SMEs and the poor are not disadvantaged by reforms that are meant to benefit them as well. The SMEs and the poor need to be well informed of opportunities and be encouraged to take up such opportunities. The general recommendation given in this paper is that for financial liberalisation to succeed there is need to create a stable macroeconomic environment. This recommendation is supported by international experiences, which have shown that a stable macroeconomic environment is a precondition for the success of financial reforms (Fry, 1997).

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APPENDIX I: Questionnaires used for data collection from Financial Institutions

- Q1. Do you think the financial sector reform has significantly increased savings mobilization in Zimbabwe compared to the period before Liberalisation?
Yes No
- Q2. Has the financial sector reform increased the level of competition in Zimbabwe's financial sector?
Yes No
- Q3. Do you think the financial sector reform has led to a significant increase in the general lending by Banks?
Yes No
- Q4. Does your institution have a specific lending facility to the poor and the Small to Medium Enterprises (SMEs)?
Yes No
- Q5. If Yes to Q4; when was this facility put up?
Before the Financial Sector Reform
After the Financial Sector Reform
- Q6. Which sectors of the poor and SMEs does your bank mainly lend to (You may tick more than one if appropriate)?
Agriculture
Services ie saloons, security, consultancy etc
Light Engineering ie Welding; light mechanics; carpentry, etc
Food
Venting
Other (Specify)
- Q7. What is the attitude of the poor and the SMEs towards borrowing?
Willing
Aggressive
Reluctant
- Q8. In your own opinion; what factors after the financial sector reform continue to limit the availability of credit to the poor and the SMEs? (You may tick more than one if appropriate)
Lack of collateral
Poor and unattractive business proposals
High lending rates
Non-availability of credit
High administration costs associated with lending to the poor and the SMEs.
Other (Specify).....
- Q9. How can credit availability and accessibility by the poor and SMEs be improved?
.....
what extend do you think the poor and the SMEs if they are given adequate credit can contribute to poverty reduction and economic development in Zimbabwe?
Significantly
Insignificantly
- Q11. To what extend has the establishment of Micro Finance Institutions in Zimbabwe Bridged the finance gap faced by the poor and SMEs before and after Liberalisation?. Comment.
.....
- Q12. What other comments can you give on the above mentioned research topic.
.....

APPENDIX II: Questionnaire used for data collection from SMEs

- Q1. What form of business do you do? (please tick the appropriate)
 Vending/selling vegetables, clothes, etc
 Retailing
 Welding, carpentry, Mechanics, or other light engineering jobs
 Sewing
 Horticulture or any other agricultural activities
 Other (please specify).....
- Q2. When did you start your business and what were the reasons of starting it.....
- Q3. Approximately how much was your start-up capital?.....
- Q4. Where did you get the money to start the business?(please tick the appropriate)
 Financial institution (specify).....
 Own savings
 Retrenchment packages or proceeds from disposal of assets
 From relatives, friends etce
 Government
 Donor
 Other (Specify)
- Q5. Where do you get the money to run your business?
 Financial institution (specify).....
 Own savings
 Retrenchment packages or proceeds from disposal of assets
 From relatives, friends etce
 Government
 Donor
 Other (Specify)
- Q6. Are you aware of the existence of bank loans for small businesses such as yours?
 Yes No
- Q7. Have you tried to apply for a bank loan for your business?
 Yes No
- Q8. If Yes to Q6; How often have you or do you apply for such loans (Specify approximate number of times per year).....
- Q9. If Yes to Q6; what was or is the purpose of such loan(tick the appropriate)?
 Start-Up capital
 Operational or Working capital
 Other(Specify).....
- Q10. What was the loan amount that you applied for or that you normally apply for?
 (You may specify the approximate amount)
 Less than \$30 000 More than \$30 000
- Q11. Did you get the loan that you applied for?
 Yes No
- Q12. If Yes to Q8; did you get the exact amount, less, or more?.....
- Q13. When do you think it was easier to get a loan from the financial sector(tick the appropriate)?
 Before Financial Sector Reform ie before 1991
 After Financial Sector Reform ie after 1991
- Q14. After the Financial Sector Reform; what factors do you think have resulted in the accessing of loans by the Small Businesses and the poor continuing to be a problem?
 (Tick the appropriate)
 Banks asking for collateral Security
 Banks being discriminatory against SMEs in their lending
 High interest rates
 Non availability of Funds
 Other(Specify).....
- Q15. Do you think if the poor and the Small businesses where to be offered with loans,

the majority of them would be willing to borrow?

Yes No

Q16. Do you think if the poor and Small businesses were to be given adequate loans, their operations AND incomes would improve?

Yes No

Q17. For your business, how much were getting as your average net profit per year Before getting a loan facility from a bank (state average figure).

\$.....

Q18. After the loan facility from the bank, how much are you now getting as your average net profit per year (state average figure)

\$.....

Q19. How else does your Bank assist you? (tick the appropriate)

Business advice

Business consultancy

Training

Trade facilitation

Credit guaranteeing

Other(Specify).....

Q20. To what extent do you think pressure groups representing the poor and the small to Medium businesses have assisted these in getting loans from banks?

Significantly

Insignificantly

Not at all

Q21. In your own opinion, what must banks do to help small businesses and the poor to get loans?

.....

.....

Q22. What must the Government and pressure groups do to help small businesses and the poor to get loans?.....

.....

Q23. Any other important comments on the above mentioned topic of research

.....

.....

APPENDIX III: Data

Yr	S	Y	Y	DCR	PCR	lr	r	FS	D	M ₂	INF	y/pop
1977	927	3064	2198	949	729	9.6	4.3	157	0	552	10	457
1978	1032	2998	2359	945	709	9.6	4.2	206	0	626	6	433
1979	1241	3112	2822	998	723	9.6	4.2	74	0	710	18	436
1980	1456	3441	3441	1252	1056	9.1	4.4	157	0	952	5	468
1981	1757	3872	4433	1562	1291	13.3	8.7	440	0	1035	13	509
1982	2043	3974	5197	1904	1469	14.9	12	531	0	1238	11	522
1983	2159	4037	6306	2196	1678	15.1	12	454	0	1270	23	522
1984	2431	3960	6404	2146	1739	15	10.5	102	0	1553	20	498
1985	2918	4213	9097	2381	1972	15	9.8	159	0	1619	8	2050
1986	3249	4335	10361	2692	2197	15.8	9.8	-13	0	1838	14	2029
1987	3854	4687	11200	3132	2670	15.1	9.8	-130	0	2064	12	1990
1988	4731	4989	14109	3559	2853	15	9.8	-211	0	2562	7	2075
1989	5871	5666	17509	4525	3079	14	9.6	0.5	0	3140	13	2117
1990	7043	5538	21494	5878	3921	14	9.7	365	0	3802	17	2196
1991	8602	5381	29623	7817	9825	17.3	16.6	1559	1	4687	23	2247
1992	9692	5364	34392	9612	11863	27.5	17.7	3062	1	5683	42	1982
1993	11593	5191	42481	13692	20451	32	17	905	1	9081	27.6	1940
1994	16728	5616	56159	16737	16986	32.5	20.7	1127	1	16010	22.3	2003
1995	13882	5036	61763	20091	21974	32	17	1767	1	21631	22.6	1925
1996	14712	5692	84767	25723	32764	30	14.5	940	1	25677	21.4	2006
1997	11157	5708	101019	44902	44445	29.8	19.4	9231	1	37514	18.8	2014
1998	26414	5823	135722	76327	56665	41.5	28.2	6627	1	43133	46.6	2017
1999	23488	5584	221588	87467	65853	46	29.1	-1111	1	58397	56.9	1876
2000	28070	5205	311890	144418	86975	56	29.8	5455	1	99449	57	1620
2001	51445	4694	509361	258601	145335	48	32	46145	1	196858	76.7	1521

Source: CSO & RBZ (Various)

APPENDIX IV: List of Acronyms

ADF = Africa Development Fund
 AFC = Agricultural Finance Corporation
 CSO = Central Statistical Office
 ESAP = Economic Structural Adjustment Programme
 MFI = Micro- Finance Institutions
 RBZ = Reserve Bank of Zimbabwe
 RPED = Regional Programme on Enterprise Development
 SEDCO = Small Enterprise Development Corporation
 SMEs = Small and Medium scale Enterprises
 VCCZ = Venture Capital Company of Zimbabwe
 ZDB = Zimbabwe Development Bank
 ZIMPREST = Zimbabwe Programme for Economic and Social Transformation

Figure 1: Cost of Lending and Credit availability to SMEs

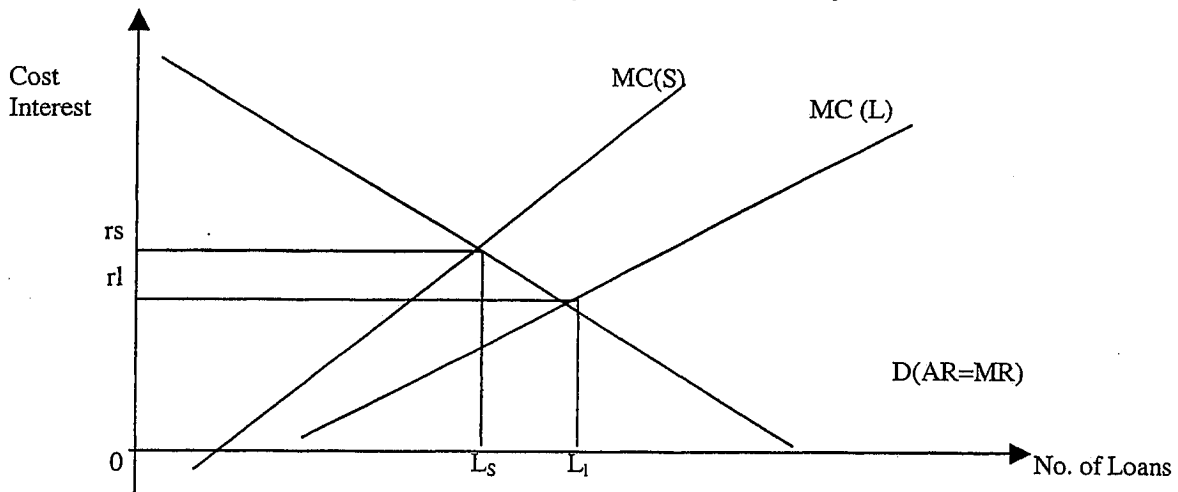


Figure 2: Investment and interest rates under reform

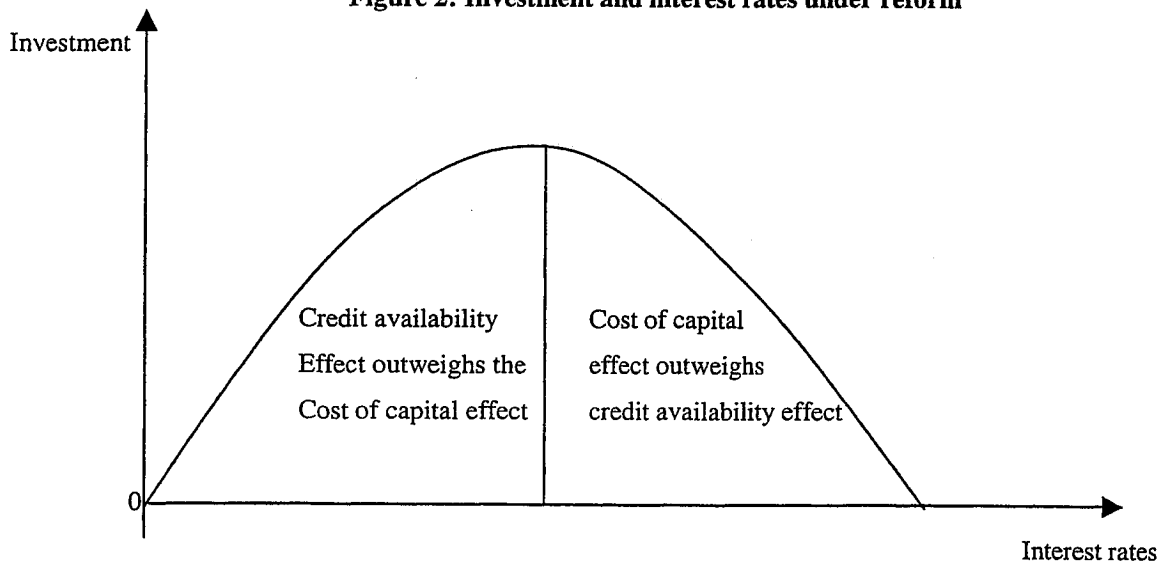


Figure 3: Risks and Rate of Return Faced by Small -Scale Enterprises

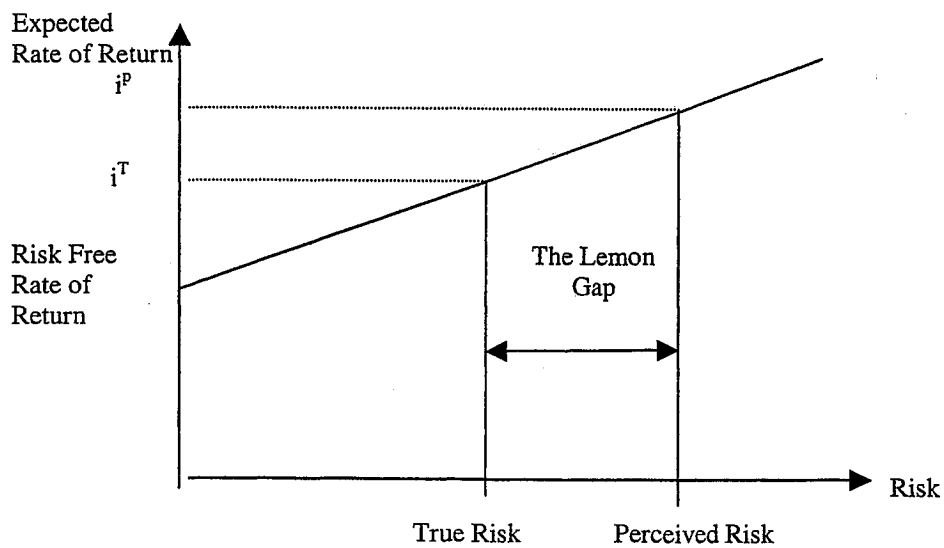
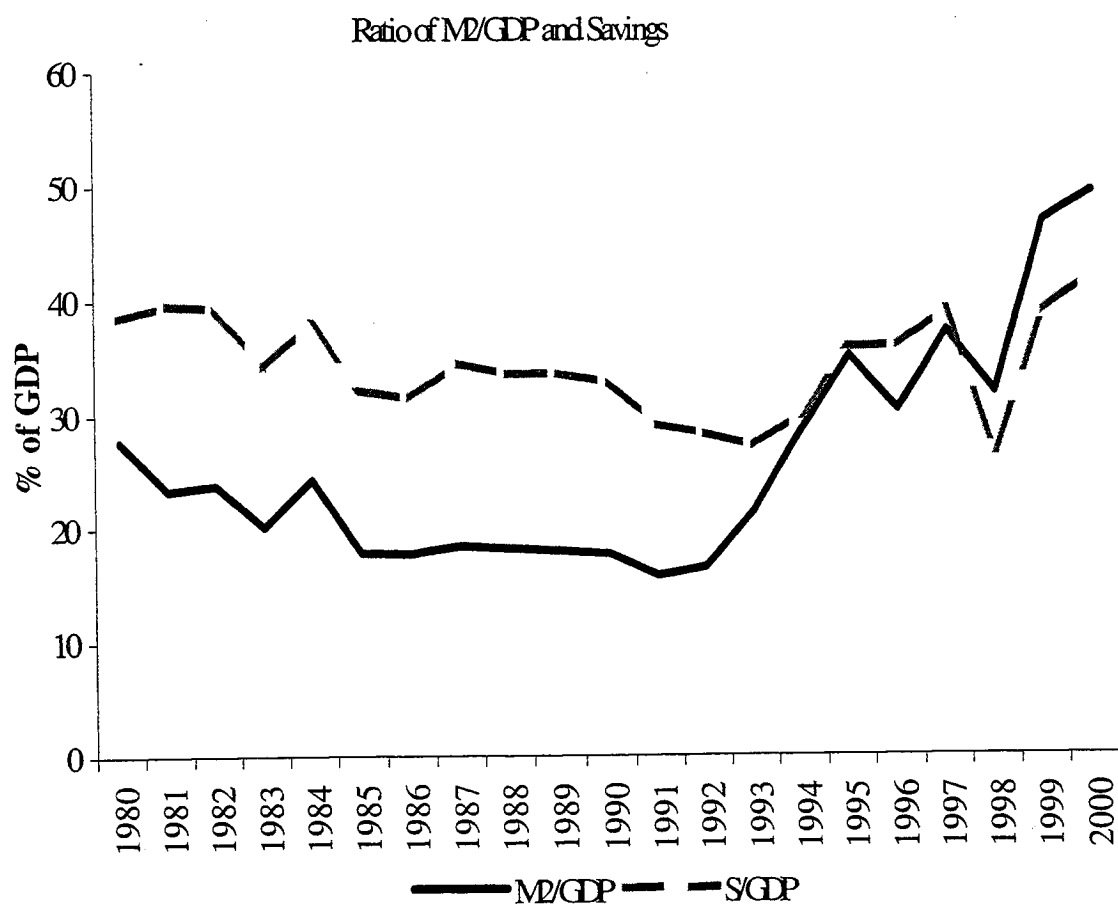
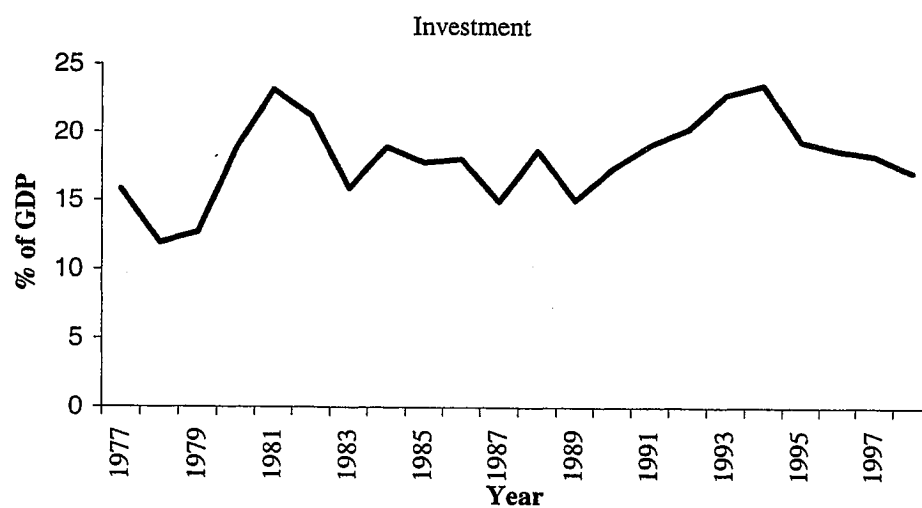
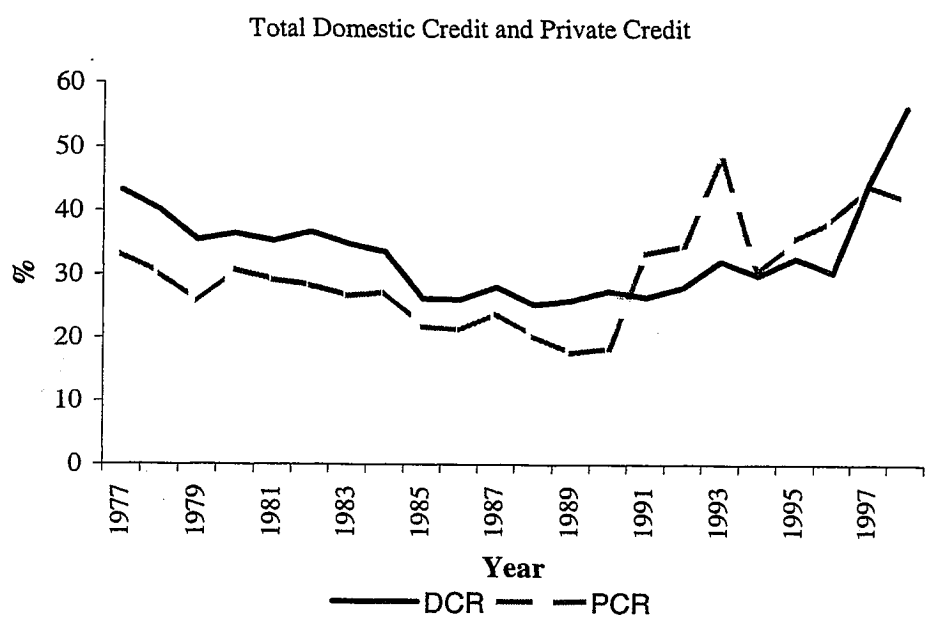


Figure 4: Degree of Financial Deepening and Ratio of Financial Savings



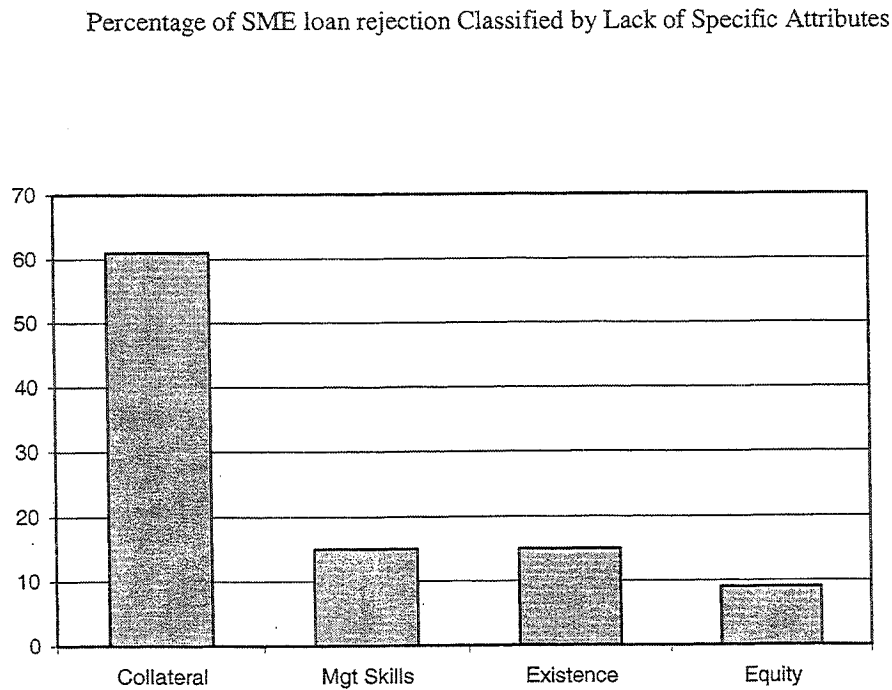
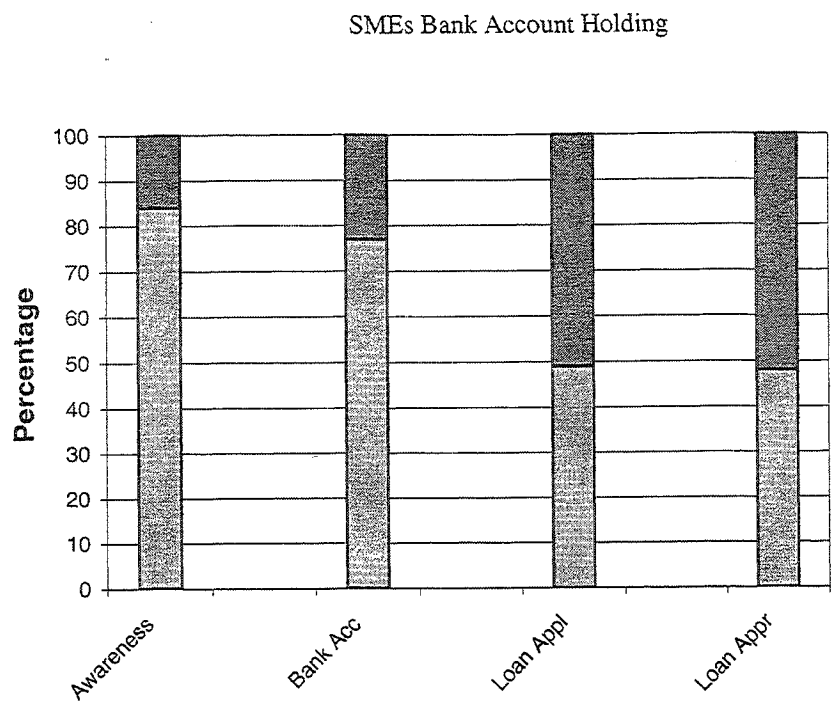
Source: RBZ (various)

Figure 5: Domestic Credit; Private Credit and Investment Trends



Sources: RBZ & CSO

Figure 6: SMEs Bank Account Holding and the Loan Gap & SMEs Loan Rejection Classified by Cause.



Source: Own Survey