

**EFFECTS OF INTEREST RATE REGIME ON THE INTERMEDIARY ROLE OF  
BANKS IN ZIMBABWE**

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**Abstract**

*This study was carried out to establish the relevance of the current interest rate regime, in relation to the role played by the banking sector of intermediating between the surplus and deficit units of the Zimbabwean economy. The paper analyzed the status quo of the interest rate structure with the inflation relationship. It identified factors that contributed to the current position of financial institutions' intermediary role in the economy. This paper used questionnaires, unstructured interviews, and document review to gather data. The study showed that the current hyperinflationary environment has reduced savings due to erosion of disposable income and distortion of interest rate structures. It was found that the control and management of interest rates, by the monetary authorities, has resulted in the distortions on the financial market, discouraging potential savers. The borrowing for productive purposes at market interest rates is at its all time low as the interest rates for loans are punitive. There is need for the authorities to ensure that the interest rate regime is accommodative and attractive for steady mobilization of funds. A study on the compatibility and introduction of Islamic Banking, where no interest is charged on loans and deposits, was recommended.*

**Introduction**

There is great financial disintermediation in Zimbabwe, aggravated by the current hyperinflationary environment. The situation of the deficit and surplus units directly interacting with each other has become prevalent in the economy. There is need for the intermediary role of banks to be improved for the financial sector to make a meaningful contribution to the growth of the economy. Van Horne (2003) described an intermediary role

as the function carried by banks or financial institutions in bridging the gap between surplus units (savers) and deficit units (borrowers). Banks' primary role is to attract deposits and manage all market risks associated with a bank's liabilities and assets (Black, 1999). The market risk for an asset can arise from unfavorable change in interest rates (interest rate regime) and increasing levels of disintermediation, as found by Slivka (2001).

The research was prompted by Zimbabwe's troubled economy (which is near collapse), with rampant inflation and little production due to prohibitive cost of finance. Levels of savings were mainly determined by the prevailing interest rate regime considering the levels of inflation. Financial markets are said to be efficient when they send resources to the place where they are valued most highly, as found by Parkin et al. (2003). The instability of Zimbabwe's economy has hampered the intermediary role of financial institutions, encouraging direct dealings between savers and lenders. This status quo in Zimbabwe has been worsened by a fixed exchange rate regime that resulted in the growth of a foreign exchange parallel market (Kateera, 2003).

The changes in interest rates affect a banking institution's earnings by altering interest sensitive income and expenses. Rosenburg and Guy (2002) found that interest rate changes also affect the underlying value of an institution's assets, liabilities, and off-balance sheet instruments through changes in the present value of future cash flows. In its Risk Management Guideline, the Reserve Bank of Zimbabwe defines interest rate risk as the exposure of a banking institution's on- or off-balance sheet position to adverse movements in interest rates, resulting in a loss to earnings and capital. The primary forms of interest rate risk, to which banking institutions are exposed, include re-pricing risk, basis risk, yield curve risk, and optionality risk.

The research was also motivated by the realization that over the last five years, financial disintermediation worsened as the country's economy contracted following the 2003/2004 banking crisis. For nine years, economic growth has been negative, and is expected to worsen if no remedy is taken (The Zimbabwe Independent 7/04/2007). Hyperinflation has marginalized a large part of the deposit market and reduced the demand for credit, while causing volumes of reductions in savings. Hence, the need to lock in value at the earliest opportunity, by purchasing durable assets by those customers who still possess spending power, will create new trends in the economy. In the absence of influx of foreign capital, domestic resource mobilization can go a long way into improving production in the economy (Bloch, 2007). It is paramount to come up with new strategies in addressing the interest rate regime that directly affects the relationship of financial institutions, savers, and investors.

Prevailing deposit and borrowing rates were averaging 300 and 800 percent, respectively, as of June 30, 2007, with inflation at 3,700 percent as of May 30, 2007 (The Herald 6/06/07). The gap between the deposit and lending rates is too wide, indicating some profiteering by some financial institutions. The negative real interest rates obtained in the financial market also prompted the surplus units to deal directly with the deficit units, and with notable cases of strategic partnerships of entities. The governor of the Reserve Bank of Zimbabwe (RBZ) reported that the low interest rate and dual interest rate policies had given rise to speculative activities aggravating the situation (RBZ Report, 2006). Interest rate regimes should be for long-term planning purposes and ensure stabilization of the economy as a whole. The anomalies need to be corrected and backed by proper monetary policies for the success of the economy.

This research will assist the policy makers in formulating the most appropriate interest rate regime to solve the problems bedeviling the country. This paper also seeks to ascertain how the current interest rate policy has affected the operations of financial institutions, and suggest ways to improve the effective role of intermediation of banks.

### **Research Questions**

The paper thus strives to provide answers to the following questions:

- (i) What factors contributed to the current position of financial institutions' intermediary role in the Zimbabwe economy?
- (ii) How effective is the current interest rate regime to the intermediary role of financial institutions in the country?

### **Literature Review**

The interest rate regime may contribute to the erosion of confidence to savers or surplus units who deposit their funds with banks for onward lending to the productive sector (Booth & Officer, 2005). The control of interest rates within a certain margin or to a ceiling has caused ripples in the Zimbabwe's banking sector (The Zimbabwe Independent 04/01/2008). Beidleman (2000) stated that both commercial banks and thrift institutions are financial intermediaries, middlemen between savers and borrowers. Banks accept deposits from individuals and firms, then use those deposits to make loans to individuals and firms. The borrowers are likely to be different individuals or firms to the depositors, although it is not uncommon for a household or business to be both a depositor and a borrower at the same institutions (Porter, 1992; Pike & Neale, 2002). Depositors and borrowers sometimes have

different interests, for instance, depositors typically prefer short-term deposits; they do not want to tie their money up for a long time (Levich, 2001; Allen, 1997; Edwards, 1996). On the other hand, borrowers usually want more time for repayment. Levich (2001) found that a bank may be willing to serve as an intermediary because it hopes to earn a profit from this activity. It pays a lower interest rate on deposits than it charges on loans in order for the difference to be a source of profit for the bank (Brealey & Myers, 2001; Damodaran, 2006; Baumol & Quandt, 2005; Smith, 1986).

Boyes and Melvin (1990) argued that regardless of the interest rate regime structure, banks that are poorly managed can fail. Banks that are properly managed tend to succeed in attracting deposits. Poor management of banks may cause panic, resulting in depositors rushing to withdraw their funds (Pindyck & Rubinfeld, 2004; Amacher & Ulbrich, 2005). This has been experienced in Nigeria's financial sector, compounded by poor supervision and destabilized the economy (Aluko, 2008). The market does not always work efficiently and sometimes government action is necessary to overcome market problems and lead to a more efficient use of resources (Baughn & Donald, 2003). Market failure is a state in which the market does not use resources efficiently (Parkin et al., 2003).

The proponents of the market system argue that interest rates should be determined by the market, and failure of which may result in compounding problems that other markets created (Baughn & Donald, 2003; Shapiro, 2002). Critics hold that the market system of equilibrium price fail to allocate resources to their most highly valued users and ensure that consumers get the goods and services they want and are able to pay for (Gunter & Giddy, 2001; Grenadier, 1999). The dual interest rate system may create many problems, such as speculation in the economy (Fry, 2005). The system, which is not manipulated by the

government, is not free of problems (Ederington & Lee, 1996; Haugen, 1999). Boyes (1991) stated that many people do not like some results of the market system and may try to use their political and dual system to effect change. Melvin (1990) argues that controlled interest rates may result in lack of efficiency in the system.

Clayton and Brown (2004) observed that a doubling of the money supply, either over several years in a moderate inflation or over a few days at the height of a hyperinflation, is not uncommon. According to Fama and Schwert (1977), interest regime plays a special role in determining inflation, not because interest affects savings more directly than other factors do, but because empirically variations in interest rates account for most of the variations in the growth of savings. Romer (1990) identified a clear and strong relationship between interest rate regime and money supply. There are interesting links between the growth of the nominal money stock and the behavior of inflation, real and nominal interest rates, and real balances. The interest rate policy that is consistent with a permanent drop in inflation is a sudden upward jump in the money supply, followed by low growth (Case & Fair, 1999).

The clearest examples of declines in inflation, the ends of hyperinflations, are accompanied by spurts of very high money growth that continue for a time after interest rates have stabilized (Sargent, 1982). If interest rates are fully flexible in the long run, then the real rate eventually returns to normal following a shift to higher money growth. Thus, if the real rate effect dominates the expected-inflation effect in the short run it may increase it in the long run. As Friedman (1999) pointed out, this appears to provide an accurate description of the effects of monetary policy in practice. The Federal Reserve of the United States of America (USA) expansionary policies in the late 1960s, for example, seemed to lowered

nominal rates for several years, but, by generating inflation, raised them over the longer term (Pindyck & Rubinfeld, 2004).

Economists, do not all agree on macro economic policy (Shapiro, 2002). Sometimes disagreements arise from normative differences or differences in personal values, regarding what the truly pressing needs are that should be addressed (Clayton & Brown, 2004). Other disagreements are sometimes based on different views of how the economy operates and what determines the equilibrium level of maintaining the intermediary role of financial institutions in an economy (Clayton, 2005).

New Keynesians believe that the economy is not always in equilibrium (Parkin et al., 2003). They believe that the government must take an active role in the economy to restore equilibrium. In the money and capital markets, government intervention is necessary to stabilize aggregate demand by controlling interest rates. Keynesians argue that whatever the source of the instability, they tend to look to active government policy to return the economy to equilibrium. According to Dransfield (2003), Keynesians traditionally assumed that monetary policy affects aggregate demand by changing the interest rate and, consequently, investment spending.

Monetarists believe that changes in the money supply have broad effects on expenditures through both investment and consumption (Begg & Fischer, 2000). They assert that changes in interest rate policy have a short-term effect on real savings. Attempts to exploit the short-term effects of expansionary monetary policy produce an inflationary spiral, in which the level of income increases temporarily, then falls back to the potential level while interest rates rise (Clayton & Brown, 2004). Monetarists have faith in the free market (price) system that leads them to favor minimal government intervention. They also argue that

interest rate policy heightens the effects of the business cycle. To prove their point, monetarists link changes in the growth of the money supply to business cycle fluctuations (Black, 2001). Specifically they suggest that periods of relatively fast money growth are followed by booms and inflation, and that periods of relatively slow money growth are followed by recession (Case & Fair, 1999). Monetarists favor non-activist government policy because they believe that a government's attempts to make the economy better off by aiming at monetary and fiscal policies at low inflation and low unemployment often makes things worse (Begg & Fischer, 2000).

Policymakers have to recognize that an economic problem exists and formulate an appropriate policy (Clayton & Brown, 2004). Monetarists argue that policymakers should set policy according to rules that do not change from month to month or even year to year. Their argument is that by reducing discretionary shifts in policy, economic growth is steadier than it is when government consciously sets out to achieve full employment and low inflation (Case & Fair, 1999; Maunder et al., 2000).

Empirical evidence has shown that the fixed peg has promoted a black market for foreign currency. Controlled prices have triggered a black market for basic commodities, whilst the controlled interest rates have promoted the borrowing of cheap local currency for speculative purposes on the hard currency (Clayton & Brown, 2004; Begg & Fischer, 2000; Parkin et al., 2003; Van Horne, 2003). Undoubtedly, the controls on interest and foreign exchange rate controls are not achieving the desired results (Kateera, 2004).



## **Research Methodology**

This paper used direct observation, questionnaires, unstructured interviews, and document review to gather data. Data for the research was gathered from financial consultants, economists, and bank managers based in Harare, Zimbabwe regardless of the time constraints they had. The research is a problem study designed to explore the problems caused by the interest rate regime in the banking sector. An initial list of questionnaires designed to capture bankers' perceptions regarding the interest rate regime, and its effects on banks, borrowers, savers, money, and stock market, literature was generated and reviewed extensively. The questionnaire consisted of two parts: items designed to capture respondent's perspectives on the impact of the interest rate regime on the intermediation of banks, and a section designed to capture information on expectations and suggestions on the way forward. Five volunteer bank executives reviewed the questionnaire for readability, clarity, and completeness. In addition, a faculty member specializing in banking issues examined the questionnaire. A total of 46 questionnaires were emailed with a cover letter explaining the purpose of the study. However, only twenty-three were useable as in the remaining questionnaires, substantial portions were not filled out. Nine personal interviews were conducted to afford greater exploration and time to probe and delve into the major emerging issues (Fowler, 1988; Easterby-Smith et al., 1995; Saunders et al., 2000). The main disadvantage of this method is its time-consuming nature, exacerbated in this case by geographic distance (Fowler, 1988; Hussey & Hussey, 1997). Ruyter and Scholl (1998) have indicated that, owing to the wealth of information that may be obtained from interviews, it is sufficient to hold only a small number.

## Results

**Table 1. Profile of Respondents**

Respondent Title	Questionnaires (n)	Interviews(n)	% (N)
Financial Consultants	02	2	13
Economists	13	3	50
Bank Managers	08	4	37

Table 1 shows the profile of the respondents. Half (50%) of the respondents were economists and the remainder were financial consultants and bank managers. When asked if banks are effectively playing their pivotal role in the economy, nearly 96% of the respondents were of the opinion that banks are not playing their intermediary role effectively and efficiently in the economy. Only 4% thought that banks were still in control of the major economic activities because there will be no economy to talk about without banks. A majority of the respondents (87%) agreed that the hyperinflationary environment had affected the level of savings mobilization by banks as the disposable incomes had been eroded.

All respondents (100%) agreed that the interest rates offered by banks discourage people from banking. The depressed interest rates on deposits have scared away savers from investing with banks. Interest rates offered are way below the inflation rate which results in negative returns, hence, the public has no incentive to keep their funds in banks. It was found that the current interest rate regime has failed to address the issue of disintermediation in a hyperinflationary environment. There are no more savings, as the disposable income has been eroded. It has become difficult for savers to leave their funds in low yielding savings accounts with banks, as the negative real interest rates prevail.

On borrowing, more than 95% of the respondents agreed that the lending rates offered by banks were too punitive and application for credit facilities had declined. It was found that 90% of the credit facilities being approved by banks were subsidized by the government for the productive sector. It was also found that smaller businessmen and traders are in dire straits. They form the bulk of the bank's customers, but many have drastically cut back on borrowing due to the punishing interest rate regime. Credit now is more and more the preserve of big corporations and the government (via Treasury Bills) and all of the respondents admitted that investment is fleeing. All economists (50%) agreed that the low interest rate or dual policy posed an opportunity to borrow cheaply and take advantage to buy foreign exchange on the parallel market and thereby hedge inflation.

More than 91% are of the opinion that the shortage of goods, especially basic commodities on the formal market or shops, has contributed to the public being discouraged to save their funds in banks. The availability of goods on the informal market has encouraged hoarding of goods and are, therefore, keeping their funds in goods rather than in savings.

All respondents reported that shortage of foreign currency has contributed to financial disintermediation of banks as the disposable income finds its way to the foreign exchange parallel market to hedge against inflation.

Eighty six percent of the respondents agreed that the withdrawal limits set by the central bank have gone along way into discouraging people from saving. It was found that the inconvenience caused by this, combined with some cash shortages, has reduced the public confidence in the banking system of the economy.

About 22% of the respondents reported that lack of access to banking facilities, especially to rural folks, where the larger population dwells, has contributed immensely to the financial disintermediation.

On the factors that have contributed to the capital flight, from the money market to stock and property markets, 91% of the respondents agreed that hyperinflation and stringent interest rate policies are the major causes. They reported that negative real interest rate is the major reason for capital flight and all economists cautioned that if remedy is not taken the whole banking system faces collapse. All bank managers (37%) interviewed are of the opinion that while interest rate risk is assumed by financial institutions as part of normal financial intermediation, the excessive interest rate risk has posed a significant threat to many banking institution's financial condition.

When asked: What measures can be taken on the interest rate regime to improve the intermediary role of banks? Responses varied but the general consensus was that the government should deregulate the financial sector. Ninety six percent of the respondents agreed that the Treasury Bill (TB) rate, which is important in pushing aggregate interest rates up, must be raised above inflation levels if the economy is to recover. The act of increasing interest rates will ignite the economy back to recovery, as the consumer expenditure in Zimbabwe is not driven by borrowing. In addition, 19% suggested that whatever the choice of monetary policy the RBZ will take, the money market must give positive real rates of return. All economists (50%) are of the opinion that removal of controls on interest rates and/or foreign exchange will go a long way in solving the problem of financial disintermediation. All economists interviewed agreed that to ameliorate the prevailing financial disintermediation there is need for the government to establish a viable exchange

rate for exporters. In addition, financial consultants interviewed believed that there is also need to address high inflation and high domestic and foreign debts, and improve the country's international image. This will have an effect of stabilizing all variables affecting the effectiveness of the interest rate regime in the economy.

## **Discussion**

The purpose of the study was to establish how the interest rate regime has affected the intermediary role of banks, and suggest ways to improve their effectiveness in the economy. The adjustment and the realignment of the interest rate structure is designed to dissipate inflationary pressures and defend the currency, while ensuring consistency of returns between yields of different structures (Allen, 1997). Respondents observed that in Zimbabwe, the current interest rate regime is discouraging, with negative real interest rates prevailing on all investments. This perception is supported by the fact that people are not borrowing and banks are living on Treasury Bills due to an unfavorable interest rate policy in place. Government debt rose to over ZWD2 trillion, from ZWD500 billion since the beginning of the year 2007, with the interest component on TBs constituting over 75 percent of the debt. This study also showed that high fiscal deficits and excessive borrowing from the domestic market against the background of the absence of foreign resources, has led to the continued increase of government's domestic debt, hence, keeping the interest rates low. One problem that arises from significantly increased levels of government borrowing is that they compete with the private sector for funding its expenditures and this will result in the 'crowding out effect'.

This study showed that against a multiple and diverse interest rate, the use of accommodation rates, as a tool of fighting inflation, has not been effective. In fact, the interest rate structure and the foreign exchange regime have scared away potential foreign investors or investment in general. There is instability in the money and capital market with a gross distortion of prices of funds.

The respondents agreed that for the situation to improve a holistic approach is necessary, where all stakeholders have to contribute. The interest rate regime should be accommodative, attractive, and ensure increase and steady mobilization of funds. An interest rate regime should also avoid or reduce capital flight to other markets, such as property and speculation on the stock market. The monetary authority should also ensure that the regime is designed to attract foreign investment and increase capital finance. The research established that interest rate risk policies and procedures should be clearly defined and consistent with the nature and complexity of a banking institution's activities. The policies should also clearly define hedging strategies, and position-taking opportunities in this hyperinflationary environment. Financial institutions should have interest rate risk measurement systems that capture all sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. Banks should have adequate internal controls to ensure the integrity of their interest rate risk management process.

From an operational perspective, this research indicated that banks should take a strategic approach to improving portfolio profitability, risk insulation, and also to synergies banking assets with trading assets. The purpose is achieved through effective sourcing of liability, proper transfer pricing, availing arbitrage opportunities, on line and offline exchange of information between the money and foreign currency dealers, single window

service to customers, effective management information system (MIS), improved internal control, minimization of risks, and better regulatory compliance. Majority of financial consultants are of the opinion that banks treasury can develop Interest Rate Swap and other cross currency derivative products for hedging bank's own exposure and also such products to customers or other banks. This will hedge customers' funds against inflation and may improve the intermediation role of banks in the economy.

The study showed that some form of Islamic Banking may go a long way into solving the disintermediation of banks in the economy as no interest is charged on loans and deposits. This would improve the capacity of the productive sector as currently, little or no production is taking place due to the punitive rates being charged to borrowers. Instead they take a predetermined percentage of the borrowing firm's profits until the loan is repaid, then share those profits with depositors (Vernardos, 2007). In fact, in some banks deposits have grown faster than good loan opportunities, forcing the banks to refuse new deposits until their loan portfolio could grow to match available deposits (Mirakhor, 1999). Islamic banking, therefore, becomes important for future studies in Zimbabwe.

On the face of it, it seems that a good case towards relaxing interest rates regime by the monetary authority could be made. It would boost, one would hope, savings and reduce the volatility which is inherent in different financial markets. In short, one can not properly address the benefits of a flexible interest rate regime without answering the question: Where does the financial instability come from? It may stem from the lack of credibility of the government with respect to fiscal sustainability and underlying inflation. Or from the extrinsic noise that arises from the booms and bust of financial euphoria. The question then is whether interest rate liberalization can fit the bill and protect the economy from these risks.

The local banks operate or accept deposits and make loans either to the public or the private sector. In case of a financial crisis, the risk that the banks will lose access to depositors funds remains intact. The optimal response of the authority in front of such risk is easily derived from the textbook. The risk of a credit crunch and of generalized default is, therefore, still alive. Long-term policy credibility has to be earned. As the domestic reforms that earn credibility abroad are often unpopular, the interest rate regime is but one of the difficult choices to be made by emerging markets and developing countries. If one thinks that the critical driving force behind such risk is the lack of fiscal discipline, liberalization can only be an answer if one believes that governments debt will be held in check.

One can argue that the rest of the economy would be better insulated from government default. One can also not avoid thinking that liberalization can only go well if some fiscal straight jacket is also provided. The question then becomes, taking for granted that semi-constitutional commitments to low deficit are feasible, whether it remains optimal to go towards liberalization. The current macroeconomic environment and the policies that go with it are likely to entail a set of social costs that we might not wish to bear in the long term. High inflation, for one, entails such a cost since it is known to exacerbate inequalities in income. Inflation works like a regressive tax since households, irrespective of their income levels, bear the same burden. From this perspective alone, a growth strategy premised on higher inflation is perhaps not tenable.

## **Conclusion**

In conclusion, one sees that the country has no easy solution at hand. The experiences of different countries or their histories are too diverse to make a one-fits-all



formula attractive in terms of effective interest rate regimes. Decisive fiscal adjustment is essential in the near term. Determination of interest rates should be left to the market in conjunction with establishment of a strong, credible exchange rate controls. Subsidies or concessionary loans to selected sectors of the economy should be done away with. The tightening of monetary policy is welcome, and a further sustained tightening along with the establishment of a monetary anchor is urgently needed to bring inflation under control. The TB rate, which is important in pushing aggregate interest rates up, must be raised above inflation levels if the economy is to recover and create conducive conditions for the banking sector to play its intermediary role. Lending policies should be well articulated. The monetary authority should take immediate corrective measures to mop up excess liquidity, allow interest rates to become positive in real terms, and dismantle the distortionary subsidized credit facilities.

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