

MEFMI FORUM

ISSUE 7 - March 2009

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MEFMI

MACROECONOMIC AND FINANCIAL MANAGEMENT
INSTITUTE OF EASTERN AND SOUTHERN AFRICA

Occasional papers published by MEFMI

The Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) publishes the MEFMI FORUM in English.

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From the Desk of the Editor in Chief



In the face of the current global crisis, the year 2009 is bound to present unprecedented economic challenges to many developing countries. In the MEFMI region, these challenges are compounded by the fact that, our economies are all at various development stages and they have their inherent problems that still require mitigation strategies to be identified and implemented. Consequently the papers in this addition present different perspectives on the prevailing challenges in the MEFMI region.

First off, we try and explore the reason why MEFMI countries' financial markets are still undeveloped despite the deregulation and liberalisation of their economies. The paper in this issue endeavours to give a brief historical perspective on the MEFMI region's financial market as well as provide an indication as to how countries can develop their domestic financial markets.

Our second article is a summary of a study commissioned by MEFMI in 2008 to examine the role of Central Banks in the domestic clearance of local foreign currency cheques. The article also indicates how best banks in the MEFMI region can facilitate the development and operation of these clearing arrangements within or outside the central bank. The key questions were: whether the operations of the foreign currency accounts have implications on the conduct of monetary policy and whether there are any risks to the monetary and financial stability of the member states. Highlights of the findings of the study are provided as well as a conclusion and recommendations.

As part of its corporate social responsibility agenda, MEFMI makes annual presentations to students at Africa University in Mutare, Zimbabwe. In 2008, the Macroeconomic Management Programme made a presentation on the Effectiveness of Monetary Policy. The thrust of the paper was to indicate the critical role that monetary policy plays in controlling the supply and availability of money, and how through this, a government is able to influence the overall level of economic activity in a manner that is in line with its broader macroeconomic objectives. The paper also provides evidence on how world economies, including many in sub-Saharan Africa, have made significant progress in stabilising their economies through the conduct of monetary policy.

The last article in this publication is an abridged version of a paper presented by a MEFMI Fellow for his accreditation at the end of 2008. The paper entitled Financial Programming as a Policy Management Tool, looks specifically at the current Zimbabwe economic situation and how best the country can arrest its inflation which was at 231 million percent as at end July 2008. The paper also presents the various economic policies Zimbabwe can adopt, in a consistent framework in order to achieve and maintain macro-economic stability and hence contribute to the goal of rapid and sustained growth.

We hope you will find these articles stimulating. Should you wish to contribute articles to MEFMI Forum, please do not hesitate to contact us. Guidelines on any contributions are outlined in this issue.

Elias E. Ngalande (PhD)

Guidelines for the MEFMI Forum

1. PREAMBLE

The MEFMI Forum is a bi-annual publication of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI). The Institute is a regionally owned capacity building organization that is headquartered in Harare - Zimbabwe. Its current country membership includes: Angola, Botswana, Kenya, Lesotho, Malawi, Mozambique, Namibia, Rwanda, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. MEFMI's mandate entails fostering best practices through strengthening of sustainable human and institutional capacities in key identified priority areas of debt management, financial sector management and broader macroeconomic management. Sharing and dissemination of pertinent information and experiences is one of the modes of delivery employed by the Institute. The Forum, among other traditional and new information technology-driven mechanisms, plays a pivotal part in this regard.

2. OBJECTIVES

The overall aim of the Forum is to provide a widely accessible and informative media for the regular regional and international exchange of pertinent ideas, issues, speeches, experiences, new developments and sound or best practice.

Within this context, these guidelines are designed to:

- Inform stakeholders of the legal and institutional framework within which the Forum is published and disseminated;
- Provide editorial policy guidelines that set the required quality standards for the Forum; and,
- Lay down procedures for the sourcing and submission of contributions for publication in the Forum.

3. EDITORIAL GUIDELINES

The Forum shall be published twice a year for the benefit of all MEFMI stakeholders;

Contributions should be made in the English language;

Contributions shall ordinarily be published on a continuous first-come-first-served basis, thus allowing for the deferring of some successful articles received late to subsequent issues of the Forum;

Contributions shall be published on a voluntary or *pro-bono* basis, with modest honoraria being paid to only defray personal expenses incurred;

The terms of reference of MEFMI resource persons shall provide for customization of their presentations into short background papers for the MEFMI Forum articles;

Special contributions may be occasionally commissioned on an exceptional case-by-case basis;

Contributions submitted for publication should be related to capacity building in macroeconomic and financial management;

The contributions should be incisive, informative and as far as possible original, with proper acknowledgement of the work of others used, so as to avoid plagiarism;

Contributions will only be published with the authors' consent and their acceptance of liability for content and implications of their contributions;

Personal details, such as authors' names, titles, designations, name of employers and recent photographs may be inserted into respective contributions for ease of identification and reference;

The MEFMI website versions of the Forum issues shall have been appropriately adapted for ease of access by all stakeholders under varying information technology capabilities;

The Editor-In-Chief shall reserve the right to decline to publish articles that are inconsistent with the above guidelines and / or to annul part or all of any honoraria that may be due to the affected contributions

4. LEGAL AND INSTITUTIONAL FRAMEWORKS

The authors of articles published in the Forum are deemed to accept personal liability for the content and implications of materials they submit for publication;



MEFMI shall not under any circumstance be held liable for contributions published through the Forum, and a disclaimer to this effect shall be inserted into every issue of the Forum;

The MEFMI Forum shall be published and disseminated through the office of the Editor-In-Chief, which is supported at various stages by the Editorial and Tender Committees and a Networking and Publications function from within the MEFMI Secretariat;

Prior written permission and /or acknowledged reference to the relevant issue of the Forum should be cited for any use of materials published in the Forum.

5. TARGET AUDIENCE AND CONTRIBUTORS

The Forum shall be open for contributions and readership from a wide, diverse and expert stakeholder base from within the relevant MEFMI client institutions, member States, partners and other regional and international peers and networks;

The Forum shall be distributed to stakeholders and other relevant parties in hard copy and / or in electronic form, including through posting on the MEFMI website.

6. ELIGIBILITY CRITERIA

In addition to complying with the editorial guidelines as set out in section 3 above, contributions should meet the following specific criteria for eligibility for publication:

Contributions should be relevant to macroeconomic and financial management;

The contributions should be topical, analytical and applied than being of a purely research or theoretical slant;

Contributions should be concise and brief, within a maximum limit of 5000 words, excluding diagrams and other necessary illustrations;

Contributions need to properly acknowledge others' work, including appending of relevant bibliographies, references, etc;

Where appropriate, prior clearance or authentication by employers or relevant authorities should be sought in cases where country-sensitive or country-specific information is involved;

Contributions should adhere to the following lay-out:

Title

Author and Designation

Overview / Executive Summary / Preamble

Introduction

The issues

Purpose / objective/s

Methodology

Scope

Body

Facts

Analysis

Interpretation

Conclusion / Recommendations

Bibliography

There should be adherence to the following submission procedures:

Meeting submission deadlines, i.e. articles should be received 2 months prior to date of next publication;

Submission of contributions in both hard and soft / MS-Word copies.

Current Perspective, Challenges and Consensus on Developing Domestic Financial Markets in MEFMI Member Countries

By Alphious Ncube and Solomon Kavuma

Summary

This paper presents the current perspective on the development and challenges of the domestic financial markets in developing countries with specific reference to the MEFMI region countries (Angola, Botswana, Kenya, Lesotho, Malawi, Mozambique, Namibia, Rwanda, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe). The main objective of the paper is to explore the reasons as to why financial markets in most MEFMI member countries are still undeveloped despite the deregulation and liberalisation of their economies. The key question is; why are the markets in most member countries still narrow and shallow and, what can be done to widen and deepen them. To achieve this objective, this paper provides a brief introductory background highlighting key historical perspectives; it is then followed by the current perspective to give a flavor of the effect and impact of economic liberalisation as well as the challenges and consensus views on developing the domestic financial market.

The paper concludes by providing a set of pre-requisites that MEFMI member countries need to satisfy before some meaningful progress towards developing domestic financial markets in the region can be attained.

1. Brief Historical background

Prior to the early 1990s, domestic financial markets in most countries in the MEFMI region were highly regulated. Among other things, they were characterised by controls in the foreign exchange market, administered interest rates and selective credit rationing. The controls created a lot of market inefficiency in terms of allocation of resources and the development of money and capital markets. As important developments in the global economy started to bear fruit, policy makers in these countries started to show growing interest in the establishment of market oriented financial institutions. This development arose as a result of globalisation which sparked tremendous infrastructural changes and growth in the financial markets of developed economies. The markets in the developed economies became more transparent, efficient and increasingly integrated with other global financial markets.

In relation to the MEFMI region countries, the

important changes were sought in the context of strengthening the weak internationalisation process through instituting internationally recognised best practices and economic reforms with respect to micro-institutional infrastructure and conducive macroeconomic environment. In this regard, a number of MEFMI countries commenced instituting the necessary macroeconomic adjustments and financial market reforms in the late 1980s.

Interest rate controls were removed and auctioning of government securities was introduced. Foreign exchange markets were liberalised and capital account convertibility allowed. Open market operations were introduced; capital market regulatory authorities and stock exchanges were put in place. For example, in Malawi and Uganda the stock exchanges were set up in the early 1990s while in Zambia they were set up in 1994. Central Banks and planning authorities in these countries embarked on accelerated programmes to build capacity in market oriented, supervisory and regulatory frameworks.

The reforms and policy prescriptions under the economic adjustment programmes were expected to underpin a sound operational framework for domestic financial market development in terms of improvements in the institutional settings, market infrastructure, legal and regulatory frameworks. By the mid 1990's most MEFMI countries had attained a certain level of achievement towards their mission.

Capital inflows in the form of foreign direct investments (FDI), private remittances, growth trends in the official foreign exchange reserves portfolios, relative stability in both the foreign exchange market and in general the macroeconomic environment were the conspicuous features of the economy at the time.

However, despite these efforts, a sense of direction and progress achieved so far by the domestic financial market have not caught up with the internationally acceptable levels and practices. Against this backdrop, it is imperative to have an overview on the status of these markets, assess why they have lagged behind and possible solutions towards developing the domestic financial markets.



2. Current perspective of the domestic financial markets in the region

MEFMI region countries have over the last ten years made substantial positive steps towards strengthening their domestic financial markets. Broadly, the steps have been recognised in the context of institutional settings, market infrastructure and legal and regulatory frameworks. However this progress has had little impact on the development of the domestic financial markets to internationally acceptable standards. The markets are still weak and raise significant micro-market and macroeconomic issues.

Judging by the following indicators of financial market development: market turnover, market infrastructure, legal and regulatory framework, diversity of investor base, and openness to foreign investors, countries such as Botswana, Kenya, Namibia and to a lesser extent Uganda, are better developed compared to all other MEFMI countries. A general overview of the nature and characteristic of these regional markets reveals the following:

(a) Small market turnover

Most of the MEFMI regional countries still experience low or relatively small volumes of trade. The size of the domestic market plays a crucial role in the development of the domestic financial market. Low volumes of trade mean low liquidity as measured by the turn-over ratio. With low levels of liquidity due to low trading volumes, which is further worsened by restrictive regulatory and fiscal criteria, it becomes difficult for these economies to propel efficient domestic market growth with their own trading systems, market analysis, brokerage services, and investor attraction to mention but a few.

(b) Limited market depth

The markets are still shallow, dominated by short term Treasury Bills (TBs) of up to 182 days as well as short to medium-term fragmented government bonds which go up to ten years. Stock market exchanges are still underdeveloped and only exist in few countries¹.

Treasury bills are important tools for better fiscal management. They also greatly contribute to the development of money market benchmarks. However their short term maturity profile (usually three months) limits price discovery and constrain market making. Another characteristic with respect

to market depth is that the bond market is dominated by fragmented government bond markets and a few corporate issuances. Fragmentation creates investor skepticism about the strategy, timing, and risk-return assessment while the short to medium maturity profile makes it hard to create a fungible benchmark yield curve for pricing the long end of the curve. This inability to price bonds across the curve affects price stability and negatively impacts long term investors, growth of financial intermediaries and domestic financial markets in general.

(c) Narrow investor base

The markets are still dominated by commercial banks as major players in the domestic financial market whose investment strategy is to buy and hold securities up to maturity. This sort of investment approach dampens secondary market trading. With respect to institutional investors, (pension funds, insurance companies, contractual saving institutions), participation is almost non-existent in most markets except Kenya, Namibia and Botswana. These institutions are not independent and in most countries are required by statute to invest in government designated assets thus constraining the development of the domestic financial markets.

(d) Poor market infrastructure

• Primary issuance modalities

Most MEFMI countries use the auction method to issue government bonds. Primary dealing is limited to commercial banks. These primary dealers act as a conduit between debt managers and investors in the primary market. Usually dealers monopolise book-making, distribution and provision of information and market making services to investors. Further to the above, the primary dealership platform is not well developed and transparent. Invitation to tender for bids is by open box system as opposed to wire service facilities like Reuters, Bloomberg, and other internet connection. This box system exposes the auction system to operational risk and systemic risks in the sense that it does not record or monitor what and when a bid was dropped in.

Setting of the Treasury Bill prices in the absence of a consistent money market benchmark yield curve and the treatment of *bid outliers*², puts a big question mark on the quality of pricing and throws the whole process in a grey zone area.

¹ Kenya, Namibia, Uganda, Botswana and Malawi

² Those bidders who bid prices out of the normal range (Too low and too High)

- Low financial intermediation

The market is dominated by few commercial banks and most of them with a high foreign ownership concentration. Participation by non-bank financial institutions, insurance companies, pension industry and brokers is almost non-existent; where available, participation is within a set of defined rules and regulations. Their important role lies in competing with the commercial banks. Absence of such competitors kills healthy market competition which helps on pricing, kills financial innovation that would promote investment diversification, limits market information which would help to check on the transaction costs and risk profiles of the investment consequently creating market inefficiency. The markets are also prone to the risk of same players forming cartels to distort prices in the market.

Banks in these countries also have a tendency of limiting extension of credit to small and medium local investors. By denying credit facilities to these investors, they constrain efforts to familiarize them with information requirement and financial discipline needed to develop the investments and creditworthiness culture; a necessary condition for the development of the domestic financial markets. They also tend to practice selective interbank lending.

Experience has shown that big banks, especially foreign owned banks, conceive the small local commercial banks to be very risky either due to inadequate collateral, deficiencies in settlement systems or lack of appropriate lending contracts / legal arrangements. As a result they accumulate a lot of reserves as opposed to lending it out thus dampening active trading in the interbank market. In the event that there is need to cover their liquidity requirements, local banks fall back on central banks at high borrowing rates. This raises the cost of liquidity in the market thereby increasing the cost of securities and consequently affects monetary policy transmission targets.

- Skills base

Skills base in these countries to develop and/or to be employed by the financial markets is limited. Skills like fund management services that would be used to create competition and develop the market are almost non-existent, while those like necessary understanding of brokerage services, asset pricing techniques, making the market, derivative market trading to mention but a few are conspicuously

lacking in some of these markets. It therefore becomes difficult to develop a market without grounded skills in these areas.

- Financial instability

Financial stability in the context of supervisory and regulatory environment is very poor in these economies. There is a wave of banking crises (*historical and current*) in most of these countries and this sends wrong messages to the investors³. Investors will always want to pool funds in an economy that is free of banking crisis. Mergers and takeovers, bank closures and bank dissolution issues are quite common in most of these countries.

- Corporate governance, transparency and accounting

Corporate governance is an important factor in attracting investment. However, the markets are characterised by poor corporate governance, auditing and accounting skills. In most cases the markets are corrupt, crony, and lack transparency. This distorts the efficient allocation of resources and poses serious operational risks.

- Volatility in the foreign exchange market

Local foreign exchange markets also raise fundamental macro and micro economic issues. Liquidity which is usually provided by foreign exchange is a big challenge in the absence of diversified players, alternative investment instruments, and derivatives and hedging techniques.

- Legal and regulatory frameworks

An appropriate and transparent legal and regulatory framework will win and attract the confidence of local and foreign investors. In the MEFMI member countries however, the existing legal and regulatory frameworks lag behind fast changing technology. Issues related to business conduct, disclosure requirements, operational guidelines and prudential regulation are still inappropriate. In many other cases commercial courts are nonexistent and where they exist, they take ages to decide on a court case.

Given the above overview, financial market development will be greatly premised on working around those challenges to finding a possible and working solution. The widely acceptable norm is that improvements in the macro and micro institutional framework will attract a diversified investor base that will in turn bring about linkages that will spark financial market development in the region.

³ Poor information disclosure, governance and management and poor sovereign rating, etc.



3. Current perspective on the development of the domestic financial market

Overall there is a general consensus that there is need to bring about greater balance and development of the domestic financial markets in the MEFMI region. The list of the requirements for the development of the domestic financial market is long but does not necessarily have to be uniformly implemented in an even manner across the region. Rather, a selective approach and sequencing would be ideal depending on the stage and level of the country's domestic market environment. Greater challenge might only be experienced with countries that are at the lowest end of the spectrum.

The current perspectives on the development of financial markets can be broken down into the micro institutional aspects of market development and macro economic considerations.

3.1 Micro institutional aspects of market development

- Institutional quality and corporate governance

The quality of institutions is important for financial market development. In most of the MEFMI region countries, corporate governance problems arise out of lack of transparency, market discipline where institutions / banks tend to be owned and run as family businesses, and weak protection of minority shareholders. These factors raise great concern in the face of potential investors as they become skeptical about respect for their investment as well as their rights in the event of financial disputes. Market indiscipline raises the appetite for higher returns which in turn calls for unwarranted risks. Rewards on investments supersede the market rewards driving reasonable risk-averse investors (who are usually a big percentage of the total investors) away from such investments. By promising to reward investments highly, operating costs tend to go thereby bringing in the element of default in case of bond issuers or institutions going bust.

The markets are also characterised by poor corporate governance, auditing and accounting skills. In most cases there is no transparency and members of the board of directors lack independence. They pay homage to appointing authorities and execute decisions within the interest of the appointing authorities. This poses serious operational risks as some of the decisions may not necessarily be commercially palatable.

Any economic environment perceived by the investor to have tendencies of corruption, opaqueness or cronyism will weaken the investment climate and distort efficient allocation of resources.

The current perspective therefore is that there must be ongoing processes to employ good corporate governance and institutional quality. The general view is that investors are aware that this can't be achieved overnight and would be glad to see a well managed on-going process.

- Information disclosure

Financial markets depend on information and transparency to operate effectively. Without reliable and timely information, investors cannot evaluate the risks associated with investment opportunities. No credible investor would fully participate in a market that does not have full information disclosure and transparency about its operations. The consensus view is to adopt globally acceptable international financial accounting and reporting frameworks.

- Appropriate legal and regulatory frameworks

Generally, the current legal and regulatory frameworks in the MEFMI region are not well developed. For example, some portions of the legal and regulatory frameworks deter institutional investors like the pension fund industry, insurance and other contractual saving funds from participating in certain sections of the markets.

Likewise participation by non-bank financial institutions is also restricted in a similar manner. Further to the above is that current market innovations, especially in the derivative markets, and the speed at which they are being incorporated in the market have superseded the present legal and regulatory frameworks. These innovations carry along contractual obligations which have to be fulfilled by either party involved. Absence of the value of sound legal and regulatory systems pause serious concerns about the development of a healthy and stable financial market. Any resolution to a crisis will depend on the quality and level of the legal and regulatory system. There is therefore need to foster reforms in this area to build investor confidence and sentiments. Potential and prudent investors will always look out for the existence of such appropriate institutions before deployment of their funds.

- Lack of coordination by regulatory bodies

The existence of multiple regulatory bodies as well as lack of coordination amongst these hinders development in the domestic financial markets. The



consensus is that policy makers should ensure that regulatory services are not duplicated to constrain effective coordination between regulators and policy makers with the market practitioners.

- Wider investor base

Many institutions are springing up every day to respond to the demands not met by existing commercial banks. These institutions are part of the greater domestic financial service providers that offer products and services which in a way stimulate savings and investments. In so doing they familiarise the general public with the necessary connections and skills to develop an investment and savings culture. The consensus is that these intermediaries need to be freed from excessive regulatory restrictions and be allowed to participate in the domestic financial markets. By doing so they will reduce the operational risks associated with the dominance and monopolistic tendencies of commercial banks. Further, as these intermediaries get assimilated into the culture, they will start competing for investment opportunities. This interaction in a competitively healthy environment will provide more solid ground for the development of the financial market and other financial innovations.

Similarly, institutional investors like pension and insurance funds are by statutory requirement restricted to invest in government specified projects. They do not have the independence to participate in commercially viable investments because of statutory restrictions. By their nature, these institutions are long term investors who mobilise a lot of funds from the public. By involving them as market players, they would open up demand for the longer dated securities; ease the pressure at the short end of the curve that usually undermines monetary policy transmission mechanism, reduce the concentration of credit risk in the banking sector, provide a non inflationary source of funds to the public and also ultimately contribute to the development of the yield curve. Their involvement as market intermediaries also help in the redistribution of risks.

- Stop fragmented bond issuances

Most of these markets are characterised by fragmented issuances. Fragmentation makes it extremely difficult for the creation of the benchmark yield curve, a key building block to the development of liquid bond markets and overall credit curve. Further, the benchmark yield curve not only makes it easy to price other fixed income instruments and development of other segments of the financial markets like foreign exchange hedging, but also

provides information about the expectation of likely macroeconomic developments and market reaction to monetary policy.

- Building appropriate skills base

Several MEFMI member countries face the problem of having and building appropriate and necessary skills base to run a domestic financial market. Skills like pricing of the instrument, brokerage, reading of market information, derivative market trading, hedging techniques, and approach to speculative tendencies, are nonexistent and where they exist are shallow. Without such basic skills, it becomes extremely difficult to move the market forward. Thus, appropriate training for all stakeholders should be undertaken by the relevant institutions in these countries. These measures would provide incentives to market participants and subsequently initiate some trading activities.

- Establishment of credit rating bureaux

Credit rating information will ensure proper and sound counterparty credit risk management principles.

- Regional integration

The view is that after reaching a certain level of development, domestic financial markets should be steered towards regional market integration. It is believed that regional integration would enhance the liquidity scale and capacity to enable individual markets to compete globally and manage the volatility effectively. However the key question about this new thrust resonates around the degree of exposure and contagion effects brought about by this development and whether the region would be able to handle it effectively.

3.2 Macroeconomic considerations

Domestic financial markets are unlikely to develop in an environment dominated by an unstable macroeconomic climate. Fiscal discipline, choice of appropriate exchange rate regime, and good political environment are required for building and attracting investor confidence.

4. Current regional challenges

The ultimate objective is to establish a market that is internationally competitive and efficient in mobilising resources. However the major challenges will lie in the following areas:



4.1 Sequencing of the above views

All the above views look important, and the key question is whether it matters which one comes first and when.

4.2 Different stages of market development

A number of countries seem to be at different stages of market development and some with different exchange rate regimes. If the region is to achieve harmonisation, there has to be a strategy in place on how MEFMI countries should approach the various country differences in terms of the legal aspect, exchange rate regimes, political differences, among other issues.

5. Conclusion

There is enormous literature supporting the view that financial market development is a big contributory factor in economic growth and development of a nation. The much needed attributes by these countries (*efficient credit creation, better rates of return on investments to accumulate capital, technological innovation and productivity growth*) to promote economic growth and development is manifested in the extent of the depth and width of the financial markets.

In general, development of the domestic financial market is increasingly seen as one of the key requirements to strengthen the financial markets. There is great diversity in terms of the levels of development across the MEFMI region countries. Going forward the list of requirements to develop the market is long and will not be uniformly applied across the region. Significant country specific needs should be taken into account - notwithstanding that countries should focus on developing efficient, vibrant, domestic financial markets that would serve as a strong engine for regional market and economic development.

Summary of the Operations of Foreign Currency Deposit Accounts and the Local Foreign Currency Cheques Clearing Arrangements in MEFMI Member Countries

By Bell Consulting Services

Summary

This paper is a summary of a study carried out by Bell Consulting Services¹ on The Operation of Foreign Currency Accounts and the Local Foreign Currency Cheques Clearing Arrangements in MEFMI Member Countries². The main objective of the study was to examine the role of Central Banks in the domestic clearance of local foreign currency cheques and to indicate how best the banks can facilitate the development and operation of these clearing arrangements within or outside the central bank. The key questions were; whether the operations of the foreign currency accounts have implications on the conduct of monetary policy and whether there are any risks to the monetary and financial stability of the member states. This paper highlights the findings of the study and provides a conclusion and recommendations raised in the study.

1. Background to the Study

The risks associated with the processes and procedures of clearing and the ultimate settlement of local foreign currency cheques are not fully understood by all key market participants who are in the MEFMI region. This knowledge gap prompted the Governors of Central Banks of the East African Community countries - under the framework of their Monetary Affairs Committee - to request MEFMI to undertake a study on the operations of foreign currency deposits and the clearing of the locally issued foreign currency cheques. MEFMI agreed to undertake the study with a widened coverage of the MEFMI region. The inclusion in the study of the other countries outside the East African Community was felt necessary in order to have a more balanced view of the issue, taking into account the MEFMI membership. In addition, it was considered that other MEFMI member countries struggling to establish clearing arrangements of their own could benefit from the outcome of the study.

2. The Study Objective

The main objective of the study was to examine the role of Central Banks in the domestic clearance of local foreign currency cheques and to indicate how best the banks can facilitate the development and operation of these clearing arrangements within or outside the central bank. The key questions were whether the operations of the foreign currency accounts have implications on the conduct of monetary policy and whether there are any risks to the monetary and financial stability of the member states.

The study was also expected to deliver a proposal on an appropriate institutional, legal and policy framework for establishing efficient and risk free foreign cheque clearing systems.

3. The Methodology

The study was carried out by desk research, field research, and structured mail questionnaire sent to MEFMI member states. The field research involved visiting a sample of six MEFMI member countries (Kenya, Tanzania, Uganda, Mozambique, Zambia and Zimbabwe). The mail questionnaire was sent to Lesotho, Malawi, Namibia, Rwanda, and Swaziland. Burundi was also included in the mail survey at the request of the East African Community's Monetary Affairs Committee. The interviewees included departments of central banks involved in monetary and exchange rate policy formulation, financial markets, and banking operations and payments system developments. Other interviewees were commercial banks and their industry associations.

4. Main Findings of the Study

I. All MEFMI member countries covered by the study had allowed operation of foreign currency accounts (FCAs) by their residents. However not all countries had put in place formal mechanisms for exchanging

¹ Bell Consulting Services is a consulting company registered in Kenya. MEFMI commissioned them to conduct the Study that was completed in July 2008. The Final Report of the Study has been circulated to MEFMI member states. The consulting team included; Wilson Kinyua (lead consultant), Eunice Kagane, Meshack Onyango Jamasai, and Aloys Ayako.

² The Consultants visited a sample of six MEFMI member countries - Kenya, Tanzania, Uganda, Mozambique, Zambia and Zimbabwe. They sent structured questionnaires to Lesotho, Malawi, Namibia, Rwanda, and Swaziland. Burundi was also included in the mail survey at the request of the East African Community's Monetary Affairs Committee.



of value between holders of the FCAs. Mechanisms for facilitating local foreign currency cheques clearing (LFCCC) differed considerably ranging from infant systems where cheques are exchanged bilaterally between banks as is the case in Mozambique and Rwanda, Club systems as in Uganda and Malawi, to the more established systems in Kenya and Zambia where clearing and settlements are conducted over electronic platforms.

II. None of the selected MEFMI member countries offered Intra-day Liquidity Facility (ILF) to facilitate the clearance and settlement of the LFCCs.

III. In the banking systems where the LFCCC systems have been most successful, it was observed that they shared certain common characteristics. These common features include:

a) Active involvement of the central banks as a critical factor in terms of operations and compliance with the Core Principles³;

b) Existence of governance structures that gave a careful balance between the role of central banks and commercial banks;

c) Establishment of a consultative forum to coordinate payment system reform to accommodate the LFCCC arrangement; and,

d) A legal framework that enabled central banks to carry out their oversight role and development functionality.

IV. An effective and efficient LFCCC system can be operated, not only within the central banks but also outside the central banks as epitomised by the Zambian scenario.

V. All MEFMI member countries covered by the survey, were observed to experience varying levels and forms of dollarisation ranging from insignificant as in the case of Kenya and Malawi to high dollarisation as the case in Mozambique, Rwanda and Zimbabwe. It was also observed that dollarisation was unofficial in all countries except in Lesotho, Namibia, and Swaziland which were semi-officially dollarised with the South African Rand having the status of the 'alternative legal tender'.

Although dollarisation appeared to be a source of concern, and in some instances feared, none of the countries surveyed had undertaken any specific

empirical study to ascertain its potential negative or positive impacts on the economy generally, and on the conduct of monetary policy. However it was noted that the operation of FCAs had influenced the central banks' choice of instruments for conduct of monetary policy. Nearly all central banks in the respective countries had put in place measures to mitigate against potential monetary and systemic risks of dollarisation. Some of the measures taken to mitigate potential risks include:

a) Targeting money supply (M2) in combination with Inter – Bank Foreign Exchange (IFEM) operations or the broad money aggregate (M3) in the determination of cash reserve requirements;

b) Strict enforcement of foreign exchange rules, guidelines and regulations aimed to reduce foreign exchange exposure risk to the banking system;

c) Requiring comprehensive risk management plan which sets out policies, procedures and other safeguards necessary to manage and control foreign exchange risk;

d) Imposing single borrower exposure limits, forex limits based on core capital and stringent offshore placements requirements, all aimed at reducing market risks; and, requiring commercial banks to make extra provisions for forex credit facilities provided to non-exporters of goods and services.

e) Dollarisation occurs in response to economic instability and high inflation and the desire of residents to diversify and protect their assets from the risk of devaluation of their own currencies and the introduction of both FCDs accounts and open architecture LFCCC arrangements are no causal factors nor do they exacerbate the depth of dollarisation in the domestic economy. Not all countries viewed dollarisation as a threat. The countries in the CMA had benefited from their semi-official status.

f) The application of information and communication technologies to payment system processes has led to gradual change in the provision of clearing and settlement arrangements within the selected MEFMI member countries.

g) The domestic financial market has not caught up with the internationally acceptable levels and practices.

³ Core Principle refers to the set of principles issued by the Bank for International Settlement for Systemically Important Payment Systems.

5. Conclusions

The Study concluded by making the following recommendations:

- a) Central banks need to regulate the Inter-bank Foreign Exchange Markets (IFEM) operations as they may influence monetary policy stances to varying degrees depending on the mitigating measures deployed by the banks.
- b) Central Banks should facilitate the introduction of open LFCCC systems to level the playing field in the forex trade.
- c) Central Banks must get concerned about the settlement arrangements in the IFEM to minimise systemic risk.
- d) An appropriate LFCCC arrangement must pass the test of compliance with the Core Principles. The Core Principles should be complemented by the international corporate governance standards and best practices and prudent payment system risk management guidelines.
- e) It is important to have an overview on the status quo of the MEFMI regions financial markets, assess why they are underdeveloped and possible solutions towards developing the domestic financial markets.



Effectiveness of Monetary Policy - A Paper Presented To Honours Seminar – Africa University, Mutare, Zimbabwe, March 2008

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1.0 Introduction

Monetary policy is defined as central bank's actions to influence the availability and cost of money and credit, as a means of helping to promote national economic goals. By controlling the supply and availability of money, a government is able to influence the overall level of economic activity in a manner that is in line with its broader macroeconomic objectives. The main goal of monetary policy is "price stability" usually expressed as a condition of low and stable inflation sustained over time. The focus on the goal of price stability is motivated by the observed negative effects of inflation including:

- Erodes living standards
- Adversely affects income distribution
- Reduces incentives to save
- Distorts price signals
- Destroys economic efficiency
- Loss of international competitiveness

There is no doubt that monetary policy is a potent force with empirical evidence that shows that over the past decade, world economies including many in sub-Saharan Africa have made significant progress in stabilising their economies through the conduct of monetary policy as indicated in table 1 below. These improvements have yielded tangible benefits in terms of historically low rates of inflation. For instance, sub-Saharan Africa, in recent years has experienced the lowest inflation in over 30 years with inflation in 2007 in 32 out of 44 countries in single digits. Having successfully stabilised their economies, the countries have been able to reorient their fiscal policies towards promoting economic growth and poverty reduction.

Elsewhere in the world, for instance in Germany, where hyperinflation was experienced in 1923, monetary policy measures succeeded in bringing down inflation to low and very stable levels in subsequent years.

An over-restrictive monetary policy, on the other hand, is not recommended as this can lead to a recession. For instance, in the US, when Chairman Paul Volcker who became Chairman of the Federal Reserve in 1979 applied the monetary brakes during the high inflation of the 1980s, the result was an economic downturn and a large drop in inflation. The Bank of Canada headed by John Crow, targeted 0-3% inflation in the early 1990s and curtailed economic activity to such an extent that Canada actually experienced negative inflation rates in several months for the first time since the 1930s.

Monetary policy is essentially aimed at achieving an optimal level of money supply which results in price stability. With price stability, a stable financial environment is created in which savings and investment can occur, allowing for the growth of the economy as a whole to occur. This argument was popularised by Irving Fisher under the "quantity theory of money". His argument was that there is a direct relationship between the quantity of money in an economy and the level of prices of goods and services sold. In its simplest form, the theory is expressed as:

$$MV = PT$$

Variables defined as follows: M = Money Supply, V = Velocity of Circulation (the number of times money changes hands), P = Average Price Level while T = Volume of Transactions of Goods and Services.

Assuming that the velocity of circulation of money (V) and the volume of transactions of goods and services (T) are constant in the short run and money supply is exogenous, a rapid increase in money supply leads to increase in inflation. Monetary growth that surpasses the growth of economic



Table 1: Inflation and Real GDP (%)			Projections	
	2003	2006	2007	2008
Consumer Prices (Average)	9.7	7.3	7.5	6.8
Oil Exporters	18.7	8.2	6.1	6.7
Angola	98.3	13.3	11.9	8.9
Non oil Exporters	7.5	7.1	7.9	6.8
Kenya	9.8	14.5	6.9	7.2
Malawi	9.6	9.0	7.0	6.0
Mozambique	13.5	13.2	6.4	5.7
Rwanda	7.4	8.8	8.2	5.0
Tanzania	4.4	7.3	5.6	5.0
Uganda	5.7	6.6	7.5	5.1
Swaziland	7.4	5.3	8.1	7.9
Zambia	21.4	9.1	11.3	5.7
Real GDP	4.3	5.5	6.2	6.9
Oil Exporters	7.4	5.7	7.6	10.6
Angola	7.8	29.6	32.4	25.5
Non oil Exporters	3.3	5.2	5.4	5.4
Kenya	2.8	6.1	6.4	6.5
Malawi	4.2	7.9	5.5	5.2
Mozambique	7.9	8.5	7.0	7.0
Rwanda	0.9	5.3	4.5	4.6
Tanzania	5.7	6.2	7.1	7.5
Uganda	4.4	5.4	6.2	6.5
Swaziland	2.9	2.8	2.3	3.0
Zambia	5.1	5.9	6.0	6.2
<i>Source: IMF, African Department database and World Economic Outlook</i>				
¹ <i>Excluding Zimbabwe</i>				

output results in an increase in inflation, as there will be too much money behind too little production of goods and services. It follows that in order to curb inflation, monetary growth must be kept consistent with growth in output.

2.0 TOOLS OF MONETARY POLICY

Central banks attempt to achieve economic stability by varying the quantity of money in circulation, the cost and availability of credit, and the composition of a country's national debt. To achieve these, central banks have both direct and indirect instruments available to them namely; open market operations (OMO), reserve requirements and the 'Discount Window'. Monetary authorities can also use moral

suasion to influence markets towards its desired monetary goals.

2.1 Open Market Operations

Open market operations (OMO) involve the buying or selling of government instruments (bills/bonds) by the monetary authority in the open market to influence the level of liquidity in the economy. If the monetary authority buys instruments, the effect would be to expand the money supply and hence lower interest rates, the opposite is true if instruments are sold. This is the most widely used instrument in the day-to-day control of the money supply due to its ease of use, and the relatively smooth interaction it has with the economy.



2.2 Reserve Requirement

Reserve requirements are a percentage of commercial banks' and other depository institutions' demand deposit liabilities that must be kept on deposit at the central bank. Though seldom used, the monetary authority may change this percentage any time, thereby affecting the money supply and credit conditions. If the reserve requirement ratio is increased, this would reduce the money supply by requiring a larger percentage of the banks' and depository institutions' demand deposits to be held by the central bank, thus taking them out of supply. As a result, an increase in reserve requirements would increase interest rates, as less currency is available to borrowers. This type of action is only performed occasionally as it affects money supply in a major way. Altering reserve requirements is not merely a short-term corrective measure, but a long-term shift in the money supply. Nowadays it has been viewed as an implicit tax on financial institutions subject to them and therefore the ratio has been lowering gradually from time to time.

2.3 Discount Facilities

The Discount Window is a window where distressed commercial banks, and other depository institutions, are able to borrow cash reserves from the monetary authority at a discount rate. This rate is usually set below short-term market rates (T-bills). This enables the institutions to vary credit conditions (thereby affecting the money supply. Punitive discount rates signal a tightening of monetary conditions..

2.4 Moral Suasion

This is a persuasion tactic used by a monetary authority to influence and pressure, but not force, banks into adhering to policy. Tactics used include closed-door meetings with bank directors, increased severity of inspections, appeals to community spirit, or vague threats.

3.0 MONETARY POLICY FRAMEWORKS

One of the principal objectives of monetary authorities is to promote price stability through conduct of monetary policy. This objective derives from the fact that price stability maintains the real value of the domestic currency that is critical for efficient utilisation of resources in the development process. The other principal objective is to ensure a sound and proper functioning financial system to safeguard the interest of depositors and the economy as a whole through oversight functions. In addition to the principal objective, there are other secondary objectives such as issuing of bank notes

and coins, provision of banking services to commercial banks and the government and conducting foreign exchange operations as the custodian of official foreign exchange reserves.

In pursuing the price stability objective, monetary authorities operate different monetary policy frameworks consistent with their peculiar economic and financial environments to ensure effectiveness of monetary policy. The most common frameworks of monetary policy are:

3.1 Monetary - aggregate targeting framework

In this framework the focus is on monetary aggregates such as M1, M2, and M3. M1 is the money supply, the financial assets used for actual payments, including currency and checkable deposits. On the other hand, M2 is a broader measure of the money supply and includes highly liquid near monies (savings deposits) in addition to currency and checkable deposits while M3 is a broader measure that includes M2 plus slightly less liquid assets.

In this framework, the monetary authority seeks to influence the total amount of money circulating in the economy. A central bank can use OMO to change the monetary base. The central bank would buy/sell bonds in exchange for hard currency. When the central bank disburses/collects this hard currency payment, it alters the amount of currency in the economy, thus altering the monetary base. As the monetary base changes it affects interest rates to move in the desired direction.

This is the most common approach in sub-Saharan Africa as most financial systems here are still relatively underdeveloped. In a relatively closed financial sector dominated by a few commercial banks, monetary control is usually exercised by the setting of only two instruments, namely; the reserve requirements and the discount rate. Adjustments in either parameter would automatically induce banks to change the terms of their loans and deposits, leading to changes in the economy-wide stock of money and in turn aggregate spending. Even more rudimentary techniques based on quantity controls rather than on price signals proved effective as long as financial markets remained underdeveloped and insulated from foreign influences. As markets begin to develop, open market operations tend to assume a more important role.



3.2 Exchange Rate Targeting Framework

An exchange rate is the price of one country's money in relation to another's. It may be fixed or flexible. An exchange rate is fixed when two countries agree to maintain a fixed rate. An exchange rate is flexible, or "floating," when two countries agree to let international market forces determine the rate through supply and demand. The rate will fluctuate with a country's exports and imports. Most world trade currently takes place with flexible exchange rates that fluctuate within relatively fixed limits.

Some modern nations, especially smaller countries target exchanges rates. That is, they implement monetary policy that ensures that the exchange rate between their domestic currency and that of another country, usually a larger country like United States is essentially fixed. This provides a direct link between the two countries, meaning any monetary policy by the larger country also affects the smaller one. This policy is essentially based on maintaining a fixed exchange rate with a foreign currency. Currency is bought and sold by the central bank on a daily basis

to achieve the target exchange rate. This policy somewhat abdicates responsibility for monetary policy to a foreign government and it is assumed that the country has the capacity in terms of foreign exchange to defend the agreed level of foreign exchange.

3.3 Currency board

A currency board is a monetary authority, which is required to maintain a fixed exchange rate with a foreign currency. They differ from conventional pegs discussed above in the nature of restrictions they set on changing the level of exchange rate, and most importantly on the sources of reserve money creation (IMF, 1997).

This policy objective requires the conventional objectives of a central bank to be subordinated to the exchange rate target. The currency board in question will no longer issue fiat money but instead will only issue a set number of units of local currency for each unit of foreign currency it has in its vault such as in the common monetary area. The surplus on the balance of payments of that country is

BOX 1

Exchange rates are analysed in nominal and real terms. The nominal exchange rate (e), is the price in domestic currency of one unit of a foreign currency, for instance, one US dollar is equivalent to 30,000 Zimbabwe dollars. On the other hand, real exchange rate (RER) is defined as the foreign price relative to the domestic price:

$$RER = e \left(\frac{P^*}{P} \right)$$

, where P is the domestic price level and P^ the foreign price level. P and P^* must have the same arbitrary value in some chosen base year. Hence in the base year, $RER = e$.*

The RER is only a theoretical ideal. In practice, there are many foreign currencies and price level values to take into consideration. Correspondingly, the model calculations become increasingly more complex. Furthermore, the model is based on purchasing power parity (PPP), which implies a constant RER. The empirical determination of a constant RER value could never be realised, due to limitations on data collection. PPP would imply that the RER is the rate at which an organisation can trade goods and services of one economy (e.g. country) for those of another. For example, if the price of goods increases by 10% in Zimbabwe, and the Botswana currency simultaneously appreciates by 10% against the Zimbabwe, currency, then the price of the goods remains constant for someone in Botswana. The people in the Zimbabwe, however, would still have to deal with the 10% increase in domestic prices.



reflected by higher deposits local banks hold at the central bank as well as (initially) higher deposits of the (net) exporting firms at their local banks. The growth of the domestic money supply can now be coupled to the additional deposits of the banks at the central bank that equals additional hard foreign exchange reserves in the hands of the central bank. The virtue of this system is that questions of currency stability no longer apply. The drawbacks are that the country no longer has the ability to set monetary policy according to other domestic considerations, and that the fixed exchange rate will, to a large extent, also fix a country's terms of trade, irrespective of economic differences between it and its trading partners.

The loss of monetary autonomy to issue fiat under a currency board is outweighed by the effects of monetary stability achieved on being a member of the monetary area which exerts positive influences on growth. This allows member countries to establish credibility by linking their monetary policy to the anti-inflationary preferences of the dominant central bank. In a nutshell, as countries join regional economic groupings of various forms, it is common that the larger monetary arrangements tend to assume a larger role in policy making which does not imply a loss of autonomy. A good example is in the common monetary area that brings together South Africa, Namibia, Swaziland and Lesotho. In the European Union, the European Central Bank plays a larger role than the national member central banks but this does not imply loss of autonomy.

3.4 Inflation Targeting Framework

Inflation targeting is a new and important framework for monetary policy which gained prominence due to the problems associated with monetary targeting approach particularly the unstable relationship between monetary aggregates and the goal variables of growth and inflation.

It is characterised by the public pronouncements of official quantitative targets (or target ranges) of the inflation rate over one or more time horizons, and by explicit acknowledgement that low and stable inflation is monetary policy's primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining those objectives. The prerequisite for adopting inflation targeting includes

most of the following:

- Sound fiscal policy
- Effective monetary policy and transmission mechanism
- Central bank independence
- Stable exchange rate
- Achievement of low stable inflation
- High level of policy coordination amongst government agencies
- Proper pricing policies in goods and resource markets
- Sound competition policy
- Availability of supportive technical capacity in modeling and analysis

The Inflation Targeting approach is motivated by the following factors:

- Because the numerical inflation target becomes the overriding objective of monetary policy it helps discipline monetary policy and strengthens accountability of the authority.
- Inflation targeting increases the co-ordination between monetary policy and other economic policies. It is more effective if there is a commitment from various quarters. At a minimum, there has to be agreement between the monetary authority and the government. The process would be easier if a similar commitment is obtained from the private sector as well as from the trade unions.
- By adopting a forward-looking approach, inflation targeting allows monetary policy to reduce volatility in business activity and smooth out the growth trend. A feature of monetary policy internationally in the past was the 'stop-go' phenomenon where monetary policy was tightened only when inflation had clearly moved up. So, instead of being pre-emptive, monetary policy was reactive in the sense that it was only changed when inflation became entrenched in expectations and therefore in wage demands.
- Inflation targeting is a forward-looking approach and an inflation-targeting central bank has to decide how its current policy stance will affect future price movements. The difference between inflation targeting and other frameworks is that inflation



targeting makes forecasting explicit and more transparent.

- Finally, the pursuit of inflation targets does not mean that a monetary authority is not concerned about the attainment of sustained high economic growth and employment creation. Monetary policy cannot contribute directly to economic growth and employment creation in the long run. However, by creating a stable financial environment, monetary policy fulfils an important precondition for the attainment of economic development.

Inflation targeting is increasingly becoming the monetary policy framework of choice in a growing number of emerging markets and developing countries. Since it was first introduced by New Zealand in 1990, a number of central banks, joined in, including Canada, Chile, Israel (1991), the United Kingdom (1992), Sweden, Finland (1993), Australia, Spain, Mexico (1994), the Czech Republic (1997), Brazil, Poland (1999), Thailand and South Africa (2000).

The IMF cross country findings indicate that countries adopting inflation targeting have, on average, outperformed countries implementing other monetary policy frameworks. For example, Chile in the 1990s reduced its targets and its measured inflation rate by 1 or 2 percentage points a year to an average rate of 3,8 per cent in 2000. Israel managed to reduce inflation from around 18 per cent in 1991 to about 1 per cent in 1999 and to zero in 2000, despite episodes of inflationary pressure. In Brazil, which only adopted an inflation-targeting regime in June 1999 when the Russian crisis forced it to abandon its crawling peg exchange rate, the early signs are promising. Inflation was 8,9 per cent at the end of 1999, and the first inflation target was met.

4.0 MONETARY POLICY TRANSMISSION CHANNELS

The transmission of monetary policy refers to the various channels through which monetary policy affects major macroeconomic variables such as prices and aggregate demand in the economy. Conceptually, the Polak Model (1997), which was further developed by him and L. Boissonneault and some of their IMF colleagues, provides the basic foundation of how monetary policy is transmitted in the economy. This model provides the building blocks for the financial programming model used widely by the international monetary fund. Polak applied the quantity theory of money to explain movements in income, imports and the balance of

payments by isolating the marginal propensities to import and demand money.

The model assumes a constant demand for money function which, in the classical Quantity Theory of Money, would imply a constant velocity of circulation of money. In developing countries, where the market for financial assets is underdeveloped, the demand for money is mainly for use as a store of value and transactions purposes. It is therefore likely to remain constant as the interest rate does not play any significant role in influencing the amount of money people would like to hold. The model further assumes that capital movements, exports and domestic credit are exogenous to the economy. Capital movements are assumed exogenous mainly because of the weak role played by the interest rate in the financial market. Domestic credit is therefore the policy variable which can be used by authorities through control over commercial banks.

In the medium to long-term, monetary policy actions induce changes in aggregate expenditures, especially investment and consumption, which then results in changes in aggregate production, the price level and employment as shown in chart 1 below. However, the actual transmission mechanism runs through the following routes, termed as the transmission channels of monetary policy:

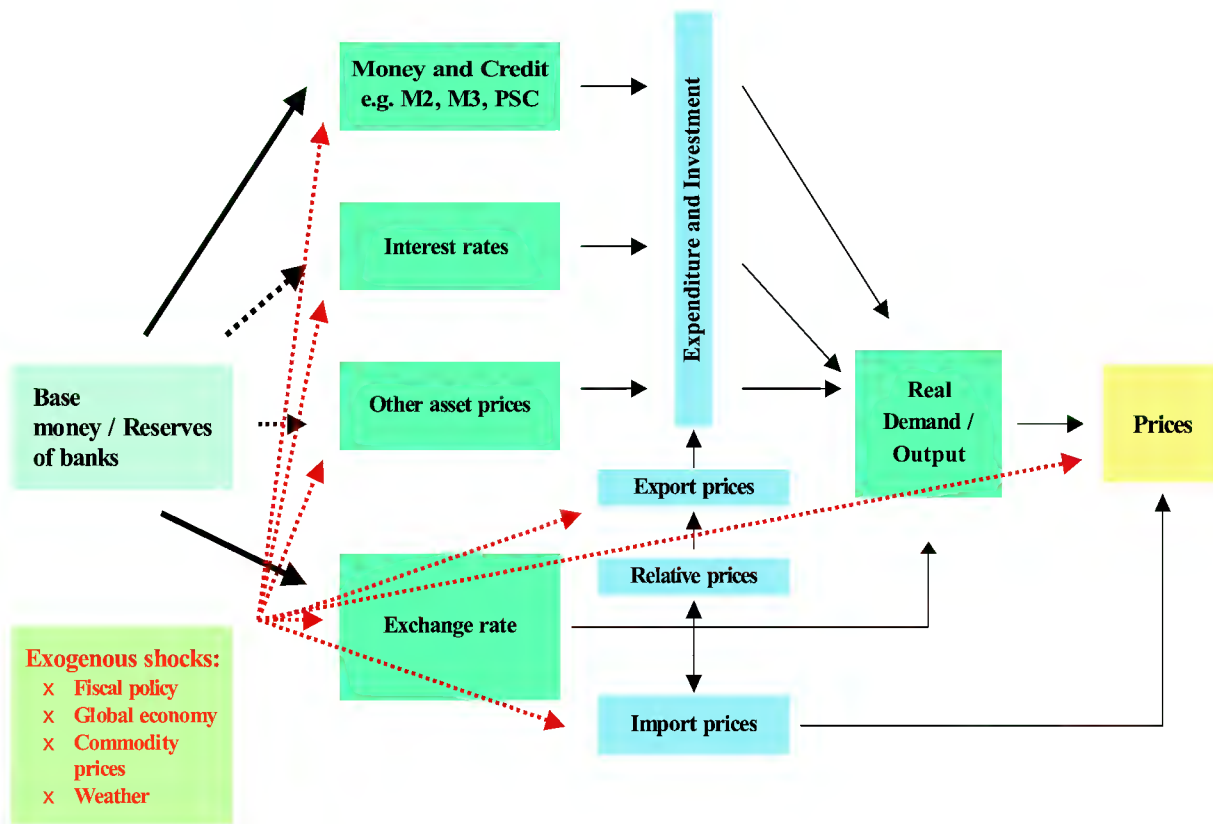
- **Interest Rates:** The most notable monetary policy channel works through interest rates. Monetary policy, particularly open market operations, trigger changes in interest rates which affects the cost of borrowing by both the household and business sectors and subsequently investment expenditures and consumption expenditures. The result is changes in aggregate production and other macroeconomic variables.

- **Exchange Rates:** This is a monetary policy channel that has become increasingly important with the integration of the global economy. Monetary policy induced changes in interest rates also affect the flow of financial capital between countries, which then affects currency exchange rates. Currency exchange rates consequently impact on the relative prices of imports into and exports out of a country. The resulting change in net exports then changes aggregate production and other macroeconomic variables.

- **Wealth:** One of two related monetary policy channels works through the value of financial assets. By changing the financial wealth of the economy, monetary policy induces an adjustment in the



Figure 1: Transmission mechanism, instruments and targets



portfolio of consumer assets. In particular, consumers are induced to modify the relative mix of financial and physical wealth, which is accomplished through consumption expenditures and which then affects aggregate production and other macroeconomic variables.

• **Equities:** The second of two related monetary channels working through value of financial assets relates specifically to the value of corporate stock. As the value or price of equities change relative to the resource cost of producing capital goods, the financial return on investment by the business sector also changes which induces changes in investment expenditures and subsequent changes in aggregate production and other macroeconomic variables.

• **Bank Lending:** One of two related channels based on credit works through the willingness of banks to make loans to the business sector. As monetary policy changes the amount of available bank reserves, banks are more or less willing to make loans for business investment expenditures, which like the other channels also affect aggregate production and other macroeconomic variables.

• **Balance Sheet:** The second of two related monetary policy channels based on credit works through the balance sheets of business sector firms. As monetary policy affects the value of financial assets, the relative values of assets and liabilities change. As net worth changes, business sector firms are more or less able to borrow funds that are used for investment expenditures, from banks and other sources. This results in a change in investment expenditures and subsequently changes in aggregate production and other macroeconomic variables.

These six channels of monetary policy are neither independent nor mutually exclusive, nor are they equally important. Some channels tend to generate a bigger impact on the macroeconomy and that impact changes over time under different circumstances. However, they inevitably work together.

4.1 Some experiences with various Monetary Policy Frameworks in Sub-Saharan Africa

Countries with a fixed exchange rate like in the CFA Franc Zone have continued to enjoy the stability and credibility benefits of a strong nominal anchor, but they face important challenges. Given the exchange



rate target, inflation partly reflects underlying trends in the real exchange rate. However, monetary policy needs to play a supportive role, coordinating with fiscal policy to provide an environment conducive to growth while avoiding excessive inflation and managing capital inflows and terms of trade shocks. Countries that peg to the appreciating euro for example, Cape Verde and Comoros have to their advantage imported a downward price pressure (IMF, 2007).

For countries with a flexible exchange rate, reserve accumulation has often limited exchange rate volatility. In Kenya, the central bank holds to both a managed float and a reserve money target but there is movement towards inflation targeting.

The degree of financial market sophistication varies across sub-Saharan Africa with for instance, South Africa and Kenya having relatively more developed markets while others like Malawi, Rwanda, Tanzania and Zambia have relatively less developed financial markets. The latter pursue a monetary targeting regime and have achieved economic stabilisation in spite of operating under less developed financial markets. But even with the best of structures, there is no guarantee that policy will necessarily flow efficiently in view of prevalence of exogenous factors which distracts policy transmission.

Real exchange rates have been appreciating substantially, especially where the oil exporters predominate including Angola leading to loss of competitiveness. This partly reflects appreciation pressures arising from the oil boom. Against the backdrop of loss of price competitiveness, preserving competitiveness will require both supportive fiscal policy reforms to address long-standing structural obstacles, such as inadequate infrastructure, deterrents to doing business, and low productivity.

In South Africa, a flexible exchange rate policy is part of the Reserve Bank's inflation targeting regime, along with a declared policy of buying foreign exchange to build up reserves when the currency is strong. Tracking inflows, gross foreign reserves have risen gradually, and the nominal exchange rate has fluctuated without a defined trend. Continued inflation pressures led the Reserve Bank to resume its monetary tightening in mid-2007. This dictates policy implemented by the other members of the common monetary area, namely Lesotho, Namibia and Swaziland.

In Nigeria, the central bank pursues a money

targeting regime while maintaining a stable exchange rate. Foreign reserve accumulation beyond the level of fiscal savings has helped stabilize the official exchange rate against the dollar since 2004, and inflation has been in the single digits since last year.

But in view of unfavourable external economic relations and shrinking capacity utilisation in Zimbabwe, the prevailing monetary policy approach is currently eclectic in nature, targeting demand management using dual interest rates and exchange rates, and using extra-quasi fiscal activities to generate a positive supply response. The Reserve Bank has been caught between multiple objectives of jump-starting the supply side with financial injections while at the same time battling to combat inflation trends. The battle on inflation is far from won. The impact of the well meant supply side initiatives are still to register fully. Severe distortion still prevail in key indicator prices and the Reserve Bank still faces severe challenges in the transition period ahead coupled by severe externally determined constraints.

5.0 EFFECTIVENESS OF MONETARY POLICY

The effectiveness of monetary policy, its timing and its eventual impact on the economy differ and are not obvious particularly in developing countries. This can be explained by the following factors:

5.1 Policy Lags

Whichever method of policy is desired, a major problem exists. This problem is based on the fact that it takes time for economic problems to be noticed and dealt with. **Detection lags** refer to the amount of time between the onset of an economic problem and its detection. This problem is more serious in developing countries where economic information is imperfect and there is a serious lack of means to obtain them on timely basis and to reflect them on policies. **Policy lags**, on the other hand, refer to the amount of time between the enactment of macroeconomic policy and the moment when that policy takes effect.

For example, if the economy is contracting, it must contract for a while before policymakers recognise the contraction. When it is finally recognized, the policymakers must then decide which policy or policy rule to institute. Finally, once the policy or policy rule is instituted, it takes a fair amount of time for it to affect the economy. In the end, lags create significant delays in the progression from problem to solution



in macroeconomic policy.

The delays created by lags can have one final and very important effect. If lags are so long that the economy corrects itself before the macroeconomic policies take effect, then the policies can actually worsen the situation. For instance, if the monetary authorities lower interest rates to stimulate the economy, but the economy begins to correct itself before the policy takes effect, then the economy will be over-stimulated, resulting in possible inflation.

Due to shallow financial markets in developing countries, policy lags tend to be rather longer. It can take up to 24 months for policy to affect prices.

The lack of timely signals from real economy is often encountered in developing countries in view of low frequency real sector data. Thus, timeliness and accuracy of data cannot therefore be overemphasised, not only to guide policy, but more importantly to provide early signals about the pulse of the economy.

5.2 Problem of excess liquidity in the banking system

In many developing countries commercial banks' holding of cash and deposits at the central bank is in excess of statutory requirements sometimes by a wide margin. This is common in oil rich economies where accumulation of revenues is accompanied by limited opportunities for lending. Rising aid flows can also lead to excess reserves particularly if economies have absorptive constraints. The problem of excess liquidity is explained by underdeveloped financial markets common in developing economies. This makes it difficult to regulate the money supply using the required reserve ratio and weakens monetary policy transmission mechanism thus undermining use of monetary policy for stabilisation purposes.

In a typical liquidity trap, where the rate of return on lending is too low to cover intermediation costs (and where bonds and reserves are perfect substitutes), banks have a higher yield on reserves than they do on loans, then a monetary policy expansion by the central bank just leads to an increase in excess reserves, even beyond banks statutory requirements. Unlike the case for liquidity trap, in developing countries, lending interest rates could be high and positive but banks may be unwilling to lend if lending is regulated. Asymmetric information may also make banks reluctant to reduce their lending rate to attract new borrowers because of adverse selection and the resulting increase in bad loan portfolio. Hence the loan market does not clear. In the presence of excess

reserves, a contractionary monetary policy will simply cause banks to reduce unwanted reserves and monetary policy will be ineffective.

5.3 Prevalence of exogenous shocks

Price stability, the objective of monetary policy is usually subject to factors beyond the control of monetary authorities. These exogenous shocks include inclement weather conditions, oil price shocks and other adverse global developments including abrupt changes in aid flows. In a stochastic setting, even when a program is consistently formulated and policy makers have no incentive to depart from pre-announced policy measures exogenous shocks large enough to throw the program off track may occur. These factors tend to blur the efficacy of monetary policy.

5.4 Poor policy coordination

The success in monetary policy formulation and implementation requires closer coordination of policies in the economy. In most developing countries because of weak policy coordination monetary and fiscal policies tend to conflict, particularly when fiscal pressure to levy inflation tax by expanding the monetary base is dominant. Similarly, where monetary targeting framework is used, monetary authorities are faced by difficulties in forecasting liquidity particularly with transactions relating to payment for goods and services consumed by the government partly due to lack of policy coordination and effective cash management and expenditure control systems.

Fiscal discipline does not necessarily mean the pursuance of a contractionary policy. It refers to implementing fiscal policy which supports the achievement of monetary policy goals and other broader economy wide goals. For instance, under the Poverty Reduction and Growth Facility (PRGF) optimal levels of resources are allocated to the social sectors of the economy in a compatible manner without compromising on the set monetary policy objectives.

5.5 Shallow financial infrastructure

The primary difficulty here is that few developing countries have deep financial markets in government debt. With market imperfection and market failure problems in the environment where monetary authorities implement their policies there are limited choices of instruments for monetary policy and

market mechanism does not work sufficiently. In addition, due to weak financial infrastructure, monopolistic tendencies do exist in financial sector of most developing countries. The degree of market power of the few banks has substantial effects on raising lending rates and lowering deposit rates rather than monetary policy. For instance, in some countries over 70% of the banking system deposits are controlled by only three banks.

5.6 Effects of innovations

Innovations arise out of improved information technology and the development of new financial instruments such as debit cards, credit cards, e-money and financial market instruments such as bonds and stocks which have become much more liquid than before. Rapid changes in households' holdings of money and near-money assets can make the velocity of money (Either M1, M2 or M3) unstable. These near money assets make the demand for money less predictable and more unstable, thereby complicating the conduct of monetary policy. Thus, the quantity of money can be an unreliable guide to changes in aggregate demand. To achieve its objectives, monetary authorities must gear themselves to deal with these changes. Some have responded to this problem by shifting to a broader definition of money that includes some near-money assets.

In addition, currency substitution from the domestic to foreign currency in high-inflation countries, the domestic currency's function as a store of value has virtually disappeared, because residents find it less risky and often more profitable to keep assets in foreign currency. These economies have remained highly dollarised even when inflation falls substantially. Currency substitution substantially undermines the authorities' ability to conduct monetary policy, as the foreign currency component of the total money supply cannot be directly controlled.

5.7 Lack of technical skills and institutional capacity

In developing countries monetary authorities are still faced with lack of critical skills and institutional capacity to formulate and implement policies. This has become more critical particularly as a result of innovations arising out of the dynamic economic environments that they operate in. This calls for more sophisticated monetary policy frameworks such as inflation targeting which require critical skills such as a solid modelling capacity.

5.8 Challenges of global capital flows

Global capital flows is desirable when allowed to flow freely across borders in search of the best investment opportunities. In developing countries, where domestic resources are in short supply, this provides an important opportunity for broadening of domestic financial markets, increased investment and faster economic growth. But capital flows also expose countries to external disturbances and can have a destabilising effect. The dangers of sudden outflows are well understood, but capital inflows also carry risks that may create difficulties for monetary policy management and inflation control as well as for exchange rate stability and export competitiveness. This is particularly true in countries with vulnerable financial sectors and inappropriate macroeconomic policies. Unrestrained capital was responsible for the financial crisis that rocked several Asian economies in 1997 and 1998.

This calls for appropriate policy measures to be taken, both at the national and international levels, to help countries minimise the potentially disruptive effects of capital flows on their economies. Capital account liberalisation needs to be undertaken as an integral part of economic reforms and coordinated with appropriate macroeconomic, exchange rate, and financial sector policies. Most important, the liberalisation of inflows through the banking system should be supported by banking reforms, as well as by greater transparency and better information flows, to enable markets to make informed decisions and reduce the risk of subsequent reversals of market sentiment. It is also critical to recognise that a country's economic policies will be constrained by its choice of exchange rate arrangements. Therefore, attention has to be given to the maintenance of an appropriate, sustained, and consistent policy mix to prevent a country from attracting short-term inflows on such a scale that they cannot be absorbed.

5.9 Credibility Issues

The effectiveness of monetary policy to a large extent depends on the credibility of those in charge of monetary policy because of expectations. Expectations play a crucial role in the price setting mechanism. In anchoring these expectations, the credibility of the central bank and its framework is often of utmost importance. In developing countries with long history of high inflation, large fiscal deficits and limited experience with reform and liberalisation, this credibility is hard to establish. This is especially so if the central bank is not independent. It is



important that appointment criteria for central bankers be based primarily on competence and not other secondary considerations. Credibility problems may occur if policy makers are not able to implement their programs purely on the grounds of propping up some political agenda/s.

6.0 POLICY RECOMMENDATIONS

In view of the foregoing, a need arises to transform the financial and economic landscape to cope with the ever growing complexity in the operating environment. This necessitates an extensive retooling of central banks' monetary policy instruments and procedures. An important ingredient to this change should be a strong focus on the market conforming procedures: working with the grain of the market, rather than against it, and applying instruments with strong market foundations. With globalisation and attempts to improve on the effectiveness of policies, developing countries and emerging markets must embrace and implement deliberate policies under financial liberalisation to improve the functioning of their markets. The following trends are recommended.

6.1 Greater market orientation of policy instruments and operating environment

First, the deepening of financial markets and the growth of non-bank intermediation dictates that central banks increase the market orientation of their instruments. Indeed, a higher proportion of reserves are now supplied through operations in open markets, with the use of standing facilities limited to providing marginal accommodation or serving as emergency finance. This, however, does not imply an erosion of the power of standing facilities in affecting liquidity conditions; indeed, it is often the marginal changes in bank liquidity, which have the greatest impact on interest rates.

Secondly, the increased importance and flexibility of the price mechanism in the new market environment implies that central banks must focus more on interest rates rather than bank reserves in trying to influence liquidity.

Thirdly, with implementation of universal policies, there is reduced market segmentation, and thus the greater ease and speed with which interest rate changes are transmitted across the entire spectrum of yields, has enabled central banks to concentrate on the very short end of the yield curve where, given payment and settlement arrangements, their actions

tend to have the greatest impact. The move to real time gross settlement systems (RTGS) in several countries may increase the short-term focus of policy implementation even further.

Finally, the greater market orientation of the central banks' instruments has been associated with a preference for flexible instruments. In the highly volatile financial environment marking several of the emerging market economies, flexibility in the design of the policy instruments may be particularly important. Much of this greater flexibility has come from the growing use of repurchase operations.

6.2 Greater Transparency and communication

A second feature is the growing appreciation of the role of transparency and communication as instruments of monetary policy. Clear signalling of the central bank's policy stance, and possibly even its future intentions, are part and parcel of effective policy making in today's modern financial markets. Most monetary authorities nowadays make their monetary statements openly for the public to understand them. Monetary authorities must embrace communication as a hidden but essential pillar of central bank policy making, that is, the power of "open-mouth" policies alongside that of "open market" operations. Most central banks in sub-Saharan Africa now provide economic information and data and policy to the medium term.

6.3 Focus on a combination of policies

The need for a combination of sound and well co-ordinated policies in an economy is important because these have implications for overall macroeconomic stability. While monetary policy can deal with inflationary pressures arising from excess demand, there is need for a combination of policies to deal with structural bottle-necks that constrain supply of goods and services which cannot be addressed by monetary policy. A combined monetary-fiscal effort is therefore recommended. These include sector-wide policies that address supply shocks improving the infrastructure to reduce the cost of production and maintaining a buffer stock for food to deal with price spikes in economies prone to cycles of unfavourable weather conditions such as droughts.



6.4 Strengthening the Financial System

• Central bank Independence

A law that provides considerable freedom to a central banker with respect to policy choices and instruments, to achieve a clear and well publicised mandate of price stability, provides him/her with the institutional leverage to pursue the mandate with minimal burden of financing government budgets. However, independence does not preclude central banks from consulting with the government on monetary and other policies.

Central bank independence is measured using a variety of factors including the appointment mechanism for the governor and the board of directors, the turnover of central bank governors, the approval mechanism for conducting monetary policy and existence of ceilings on total government borrowing from the central bank. Several empirical studies have shown that central bank independence contributes significantly to explaining cross country variations in the rate of inflation with those enjoying the highest degree of autonomy having the lowest levels and variability of inflation (Pierre-Richard Agenor and Peter Montiel, 1996). In the context of developing countries, where central bank financing of the fiscal gap is the root cause of inflation, an independent central bank charter is recommended.

• Financial Liberalisation

Apart from strengthening the oversight function a number of other reforms are required to deepen the financial system. There is need to liberalise to expand the space for competition since an oligopolistic banking system contributes to inefficiency in the financial sector.

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Financial Programming as a Policy Management Tool: A paper submitted to MEFMI Secretariat in partial fulfillment of the requirements of the Fellowship Apprenticeship Program

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1. BACKGROUND

The Zimbabwean economy is currently in a crisis, with inflation at 231 million percent as at end July 2008 - the highest in the world and very unusual for a country not at war. Inflation is, in large part, fuelled by high levels of money supply growth and speculative activities. Fiscal deficits have been largely financed through inflationary bank sources.

The deterioration in the balance of payments position of the country culminated in severe foreign currency shortages leading to external payment arrears. Efforts to arrest the economic decline met with very little success, despite the adoption of an International Monetary Fund (IMF) supported adjustment program in 1991, and subsequent numerous reform programs. Fiscal slippages are largely to blame for the failure by government, to restore macro-economic stability. It is imperative that the country adopts credible and consistent economic recovery measures to arrest the economic decline.

This paper examines the various economic policies Zimbabwe can adopt, in a constant framework, to achieve and maintain macro-economic stability and hence contribute to the goal of rapid and sustained growth. The role of financial programming as a policy management tool is alluded to.

2. AN OVERVIEW OF FINANCIAL PROGRAMMING

2.1 Definition and Significance of Financial Programming

A financial program is a comprehensive set of policy measures designed to achieve a given set of macroeconomic goals in the short term. It seeks "to achieve an orderly adjustment, through the early adoption of corrective policy measures, and through the provision of appropriate amounts of external financing" (Barth and Hempill, 2000). As Rajcoomar, Bell, Karlik, Martin and Sisson (1996) point out, "It is important to aim at minimising output losses and unemployment in the initial stages of adjustment and at the same time creating conditions conducive to a sustainable balance of payments position".

A country can aim at maintaining its current level of

economic performance or more often, restore equilibrium between aggregate supply and aggregate demand. The achievement of a better balance between aggregate supply and aggregate demand or more specifically, the elimination of internal and external imbalances can be achieved through stabilisation policies, encompassing a consistency framework.

The output of a financial program is a set of specific targets for fiscal and monetary policy for the next 12 to 18 months, normally on a quarterly basis - consistent with the designated macroeconomic objectives. A financial program should be consistent with adequate growth, price stability and the country's ability to meet external payment obligations. It should also be set in a forward-looking time frame.

The sustainability of using financial programming as a policy tool depends to a large extent on its institutionalisation as a standard element of macroeconomic management. The institutionalisation of financial programming should include high frequency technical cooperation between economists from the Central Bank and the Ministry of Finance.

2.2 The Framework for Financial Programming

A financial program is based on an integrated system of macroeconomic accounts, which include the national accounts, balance of payments, government finance statistics, and money and financial statistics. These macro-economic accounts provide basic information needed to assess the performance of the economy and the extent of policy adjustment required. The relationships between the key macro-economic accounts also provide a framework for consistency checks. The interrelationship among macro-economic accounts further highlight the fact that, any sector that spends beyond its income must be financed by the savings of other sectors. Thus, excess spending by the whole economy, is only possible when there is external financing.



The accounting framework is complemented by behavioral equations, which typically indicate the reaction or response of some of the variables included in the accounting framework, to changes in other variables, for example, impact of different levels of income and taxation on private sector spending.

The consistency framework is based on the four basic identities:

a) The savings gap constraint:

$$\begin{aligned} \text{GDP} &= C + I + (X - M) = A + (X - M) \\ \text{GNI} &= \text{GDP} + Y_f = C + I + (X - M + Y_f) \\ &= A + (X - M + Y_f) \\ \text{GNDI} &= \text{GNI} + \text{TRf} \\ &= C + I + (X - M + Y_f + \text{TRf}) \\ &= A + (X - M + Y_f) \\ \text{Or GNDI} - A &= (X - M + Y_f + \text{TRf}) \\ \text{Since GNDI} - C &= S \text{ by definition,} \\ \text{GNDI} - C = I + (X - M + Y_f + \text{TRf}) &= S \\ S - I &= (X - M + Y_f + \text{TRf}) = \text{CAB} \end{aligned}$$

Where

A = Absorption
 X = Exports of goods and non- factor services
 M = Imports of goods and non- factor services
 Y_f = Net factor income from abroad
 TR_f = Net transfers from abroad
 C = Final consumption
 S = Gross national savings
 I = investment

b) The monetary survey:

$$\begin{aligned} M &= \text{NFA} + \text{NDC} + \text{OIN} \\ \Delta M &= \Delta \text{NFA} + \Delta \text{NDC} + \Delta \text{OIN} \end{aligned}$$

Where

NFA = Net foreign assets of banking system
 NDC = Net domestic credit of banking system
 = Net credit to gvt (NDC_g) + net credit to parastatals + credit to private sector
 NDA = Net domestic assets
 M = Broad money
 OIN = Other items net
 BD = Budget deficit
 NBB = Net bank borrowing
 EF = External Financing

c) The government budget constraint:

$$\begin{aligned} \text{BDig} &= \text{TE} - (\text{REV} + \text{GRNT}) = \text{NDCg} + \text{NFF} \\ \text{PBALxg} &= (\text{TE} - \text{INT}) - \text{REV} \end{aligned}$$

Where

BDig = Budget deficit including grants
 PBALxg = Budget balance excluding grants
 DPBALxg = Primary domestic balance
 TE = Total expenditure
 GRNT = Grants
 NFF = Net foreign financing
 INT = Interest payments
 NDCg = Net domestic credit to government

d) The BOP constraint:

$$\begin{aligned} \text{BOP} = \Delta \text{NFA} &= -(\text{CAPBAL} + \text{CURBAL}) \\ &= -(\text{NOFF} + \text{NPCF} + \text{NSTCF}) - (\text{BOT} + \text{NFP} + \text{NTRAN}) \end{aligned}$$

Where

Δ NFA = Change in net foreign assets
 CAPBAL = Capital account balance
 CURBAL = Current account balance
 NOFF = Net official foreign financing
 NPCF = Net private capital flows
 NSTCF = Net short term capital flows
 BOT = Balance of trade in goods and services
 NFP = Net factor payments
 NTRAN = Net transfers

2.3 Steps in a Financial Programming Exercise

The starting point in any financial programming exercise is the baseline scenario. In the baseline scenario, forecasts are made of the main macroeconomic variables assuming that no policy changes are undertaken. The baseline scenario allows for the setting of reasonable objectives and determination of the policy focus. It thus gives the general policy direction.

An assessment of economic problems vis-a vis national objectives is required in preparing a financial program. It is important that a consistent set of policy instruments, necessary for effecting the adjustment required, is identified and quantified through the analysis of the major macroeconomic accounts. The feasibility of the various policy packages should be assessed. A financial programming exercise can be carried out in steps as follows:

2.3.1 Evaluating economic problems

"An understanding of a country's economic, institutional and socio-political structures, recent economic developments and available policy instruments is essential to forecasting and policy analysis." (Rajcoomar, Bell, Karlik, Martin and Sisson, 1996). It is essential to understand the nature, source and severity of the economic imbalances.

2.3.2 Identifying exogenous factors

The impact on key variables, which the authorities have no control over, should be taken into consideration in any financial programming exercise. Of particular significance are external sector forecasts, which entail relationships with the rest of the world. Global economic developments, therefore, need to be taken into account.



2.3.3 Quantifying objectives, setting preliminary targets and developing policy package

The overall objective of achieving either internal or external balance has to be translated into specific targets. Examples of targets could be the overall balance of payments position, current account balance, prices or output. The setting of specific targets sets the stage for the development of the appropriate policy package.

2.3.4 Preparing sectoral forecasts

Not a single starting point can be recommended for the development of projection scenarios. One could start with a preliminary price and output projection, followed by forecasts for the balance of payments, the fiscal sector and finally the monetary sector. Alterations will, however, be required at various stages to ensure accounting and behavioural consistency.

2.4 POLICIES AND FINANCING OPTIONS

Policy options are centred around two identities, namely:

a) $GNDI - (C + I) = CAB$: gross national disposable income less domestic absorption equals current account balance

b) $CAB + \bullet FI = \bullet R$: the current account balance plus net capital inflows equals the change in net official international reserves.

where

CAB = external current account balance

$\bullet FI$ = net capital inflows

$\bullet R$ = the net change in official international reserves.

From the first identity - improvement in the external balance can be a result of increase in output or reduction in expenditure. Accordingly, adjustment policies may aim to increase a country's output or reduce domestic expenditure.

From the second identity, which is the balance of payments identity, any excess expenditure over income as reflected in a current account deficit must be financed by either capital inflows or a draw down of reserves.

2.4.1 Demand management policies

These are primarily aimed at reducing domestic demand in order to narrow the external current account deficit and to lower inflation. Demand management policies can be monetary, fiscal or incomes policies. In a case where public expenditure is the source of excess demand, a corrective policy stance would be a combination of reduction in public sector outlays, coupled with increased revenue collection. Domestic absorption can also be reduced, by introducing measures that control monetary expansion. In cases where fiscal deficits are monetised a reduction in fiscal expenditure can restrain monetary growth. Growth in credit to the private sector might also have to be reduced.

2.4.2 Expenditure switching

This involves the redirecting of expenditure from either domestic goods to imported products or vice-versa. Exchange rate devaluation, for example, can result in a global increase in demand for domestic goods and consequently a reduction in the demand for imported goods. Expenditure switching policy can complement the reduction in domestic absorption.

2.4.3 Structural policies

These are policies aimed at enhancing supply and thus close the gap between domestic expenditure and output. Structural policies become important where there is evidence that current account imbalances are not simply caused by short-term factors. They can be designed to raise output by a more efficient allocation of resources or to enable the economy to expand its productive capacity. Efficiency in the allocation of resources can be achieved by the removal of distortions caused by price controls, imperfect competition, exchange control restrictions and in some cases subsidies and distortionary tax systems. Output can be raised by the implementation of policies that encourage savings and investment.

2.5 Problems and Difficulties in Program Design

Program design is fraught with many uncertainties and difficulties. Behavioural relationships, for example, may be difficult to specify and estimate with precision, as variations occur across countries, depending on political and institutional factors. When governments institute major policy shifts and structural reforms, behaviour in the post reform period may significantly differ from expectations. The

success of a reform program also depends on the credibility of the implementing authorities. Assumptions on the expected response of exogenous variables to new policies may prove to be incorrect.

3. FINANCIAL PROGRAMMING IN ZIMBABWE

The use of financial programming in economic policy analysis and management began in earnest in 1992, after Zimbabwe adopted an IMF supported structural adjustment program. A Technical Memorandum of Economic and Financial Policies (TMEFP), for the period January 1992 to December 1994, was agreed upon between the IMF and the Zimbabwean authorities (Reserve Bank of Zimbabwe and the Ministry of Finance Economic Planning and Development). The TMEFP outlined the policies that the government of Zimbabwe undertook to pursue, in order to achieve targets agreed upon with the International Monetary Fund (IMF).

The practical application of financial programming was, however, abandoned at the end of the first phase of economic reforms in 1995. The country failed to achieve the quantitative and structural criteria, it had agreed with the IMF. The IMF then suspended balance of payments support for the country and placed it on a "shadow program".

Zimbabwe designed and adopted numerous other successive reform programs which did not succeed largely due to piecemeal implementation.

4. POLICY COORDINATION IN FINANCIAL PROGRAMMING: THE CASE OF UGANDA AND TANZANIA

The success of policies implemented in any economy depends, to a large extent, on the commitment of policy makers. It also requires commitment from the highest political office in the land. Likewise, success in application of financial programming as a policy tool depends on the level of coordination between the major players, namely, politicians, the Central Bank and the Finance and Economic Planning Ministries.

In Uganda, policy coordination involves the highest political office, the decision makers at the central bank and treasury. Formal committees exist at both technical and policy - making levels and they meet on a regular basis, to formulate new policy and review progress in the implementation of existing policy.

The Bank of Uganda (BOU) works very closely with the Ministry of Finance Economic Planning and Development (MFEPP) in ensuring that there is consistency between fiscal developments and the Reserve Money Program, monitored at the Bank of Uganda. In this respect, the BOU and MFEPP officials meet at technical level to agree on fiscal expenditure levels consistent with the targeted reserve money growth. The desired reserve money growth is derived from the country's inflation objective.

From the very beginning, both BOU (monetary authority) and MFEPP (the fiscal authority) have worked together to formulate a program that is workable and realistic. Not only are GDP growth and inflation targets agreed upon, but also other key variables like net international reserves build-up, the appropriate levels of net credit to government and private sector credit growth, consistent with growth targets.

In Tanzania, monetary policy is reviewed by a Monetary Policy Committee (MPC), which meets regularly. The MPC is made up of senior representatives from the Ministry of Finance (The Union Government and Zanzibar Government) and the Bank of Tanzania. The macroeconomic consistency framework, which forms the basis for the government budget, and other macroeconomic policy targets is prepared by the Planning Commission, in consultation with the Ministry of Finance and the Bank of Tanzania. Implementation of fiscal policy is monitored, on a regular basis, by a committee, which reviews performance of the government, relative to the budget and set expenditure ceilings.

5. A FINANCIAL PROGRAM FOR ZIMBABWE

5.1 Introduction

2008 is the baseline for the Zimbabwe financial program, while 2009 represents the program scenario. The financial program is based on information that was available when the exercise was carried out.

5.2 The Baseline Scenario

The baseline scenario is represented by the year 2008.

5.2.1 Assumptions

The baseline scenario is based on the following



assumptions:

- Real GDP growth rate of -10%.
- End period inflation of 20.8 billion percent
- M3 growth (end period) of 36.3 billion percent

The major assumptions underlying the projected economic performance for the baseline scenario are as follows:

- Weak domestic and export demand due to the following factors:
 - Declining real disposable incomes;
 - Weak global economic conditions;
 - Real exchange rate appreciation;
- Loss of export competitiveness due to poor quality of goods, lower costs of production elsewhere and an overvalued exchange rate;
- Foreign exchange shortages;
- High inflation and rising production costs;
- Fuel and electricity shortages;

Owing to the above adverse effects, major sectors of the economy are projected to decline, with the exception of agriculture. Real GDP is estimated to decline by 10.5%.

5.2.2 Implications of the Baseline Scenario

The size of the fiscal deficit implied by the baseline scenario, means that the central bank has to increase accommodation to banks, in order to enable them to hold large volumes of government debt. Domestic banks will, however, not be interested in procuring such a large volume of new government debt without obtaining very high interest rates. Furthermore, the decline in economic activity has reduced the capacity of banks to mobilise sufficient deposits from which to lend to government. In an endeavor to augment this capacity, increased central bank lending to banks will fuel money supply growth and, weaken the effectiveness of monetary policy.

The fact that more than 100% of the deficit financing requirements has to come from the banking system implies that there will be significant crowding out of the private sector. Large fiscal deficits, financed from the banking system, directly compete with the private sector, resulting in a fall in investment, which will further worsen economic decline.

5.3 The Program Scenario

5.3.1 Introduction

The program scenario envisages that the country adopts a disinflation program in an overall macro-economic consistency framework, underpinned by complementary, and tight fiscal and monetary policy. It is premised upon the restoration of confidence in the economy through the normalisation of relations with the international community.

The negative perception by the international community about the breakdown in the rule of law and deepening bad governance, coupled with the suspension of Zimbabwe's voting rights by the IMF have severely eroded investor confidence-critical for the achievement of sustained growth.

The success of the program will entirely depend upon the support the country gets from the international community, as well as, the commitment of the new Government to the disinflation program.

This program - a medium term framework for long term growth. The program takes cognisance of the difficulty in reducing expenditure in a high inflation environment. Increase in fiscal expenditure is, therefore, allowed in nominal terms. Allowing nominal growth in fiscal expenditures implies that there has to be sustained fiscal restraint, coupled with the implementation of new revenue generating measures. This is going to be difficult but not impossible. The program, will lead to macro-economic stability if implemented as a wholesome package. The piecemeal implementation of programs does not work.

5.3.2 Assumptions for the Program Scenario

	Macro and Policy Targets	
	2008 Baseline	2009 Program
End period inflation	20.9 billion %	1 303.9%
Real GDP growth	-10%	5%
Reserves (months of imp. cover)	0.5	0.7
M3 growth (end period)	36.3 billion%	1 523.1%
Fiscal deficit (% GDP)	38%	5%

The program scenario is based on the following assumptions:



a) Liberalised exchange rates regime

It is assumed that the liberalised exchange rate regime will be sustained.

b) Confidence building

It is assumed that the country will normalise its relations with the international community – to restore confidence in the economy and ensure that the country gets funds for budget financing and balance of payment support.

c) Tight Monetary Stance

The growth in money supply will be drastically curtailed to support the liberalised exchange rate. The monetisation of deficits will be halted. Quasi-fiscal activities of the central bank will be stopped with the outstanding balance being transferred to the fiscus.

d) Structural reforms

The success of the program must be complementary to other measures and structural reforms. Structural reforms are therefore a fundamental component of the reform package.

e) Political Commitment

It is assumed that the program will have the commitment of the highest political office in the country.

5.3.3 Structural Reforms in the Program Scenario

The program scenario calls for the authorities to simultaneously institute the following structural reforms:

- Moving away from price controls to increase business viability, and restore formal sector activity, boosting the fiscal revenue base.
- Boosting the fiscal revenue collection base by implementing measures to collect mining royalties and rental income taxes.
- Establishing a pre and post shipment inspection scheme to account for all imports and exports in a bid to reduce transfer pricing;
- Doing away with quasi-fiscal operations through commercialisation and eventual privatisation of public enterprises, to reduce their burden on the budget.
- Civil service reform.

5.3.4 What is crucial in the Program Scenario? (Main Policy adjustments)

The success of the program depends upon the commitment by the authorities to restore confidence in the economy as well as normalise relations with the international community - critical for the mobilisation of external financing. The availability of external financing for both budget and balance of payment support plays a pivotal role in the program scenario.

Further exchange rate adjustments on the official market, are required to arrest the erosion of external sector competitiveness. The size of the exchange rate adjustment has to be sufficient enough to match the scale of the currency's over-valuation. Devaluation will, however, have to be coordinated with sufficient monetary restraint to avoid a situation where, because of high inflation, the real exchange rate eventually resumes its upward trend. In addition, there is need for unifying the exchange rate, liberalising the exchange system and eventually removing surrender requirements. This will restore confidence in the foreign exchange market and discourage firms from engaging in transfer pricing.

The program calls for the restoration of fiscal discipline and the abolition of quasi-fiscal operations. Fiscal policy has been over-expansionary, against the background of a narrow tax base and poor performance of public enterprises. Government will have to allow public enterprises to charge economically viable prices for their products and hence do away with the need to subsidise them.

Monetary policy will need to be decisively tightened to reign in inflation and build policy credibility. In this respect, the concessional lending facilities extended to producers by the Reserve Bank of Zimbabwe (RBZ) through banks - a significant source of rapid monetary expansion, must be abolished. The RBZ should contribute to the fight against inflation by reviewing its accommodation policy. Overnight accommodation must only reflect the function of the central bank as the genuine lender of last resort.

Interest rates should be allowed to increase gradually, given increasingly high negative real rates as inflation continues to rise. The liberalisation of the money market should be the ultimate goal.

The program scenario calls for close cooperation between the RBZ and the Ministry of Finance as well as the Ministry of Economic Development - the



institutions responsible for the design and execution of monetary and fiscal policy, respectively. Close cooperation between the RBZ and the above ministries will ensure that fiscal operations of government do not derail monetary growth objectives. It will effectively remove the fiscal dominance characteristic of current policy management in Zimbabwe.

6. SUMMARY AND CONCLUSIONS

The use of financial programming as a macroeconomic policy management tool can only be effective in the context of a macroeconomic consistency framework. A financial program seeks an orderly adjustment through use of monetary, fiscal and exchange rate policies to correct internal and external imbalances in an economy. As Bolnick (1999) observed, "financial programming, in essence, is a quantitative framework for determining policy targets which are consistent with a designated set of macroeconomic objectives. Thus, some approach of this sort would be required as a central tool for ensuring macroeconomic stability even if IMF conditionality had never been invented". Financial programming should thus not be synonymous with the IMF.

6.1 Financial Programming Instils Fiscal and Monetary Discipline

By setting specific targets on revenue and ceilings on expenditure, yielding a specific fiscal deficit, consistent with other targets, financial programming ensures fiscal discipline on the part of government. On the other hand, monetary authorities are compelled to work within specified domestic credit limits, consistent with desired growth in money supply and hence the inflation target. This effectively restrains the central bank from extending credit to the banking system and to government beyond certain limits.

6.2 Potential to Build Investor Confidence

The adoption of a financial program signals that authorities are serious about restoring macroeconomic stability in an economy and can boost investor confidence. In Zimbabwe, for example, economic agents lack confidence in the economy because of the apparent lack of clarity on the policy direction government intends to take. The restoration of investor confidence is key to the success of any stabilisation program.

6.3 The Basis for Assistance

The adoption of a financial program forms the basis upon which multilateral agencies such as the IMF, the World Bank and even other bilateral sources give assistance to those countries in need. In principle, a financial program ensures that funds are utilised for the intended purpose and that disbursements can be stopped if agreed quantitative criterion is not achieved. Monitoring of progress under the reforms is much easier if there are program targets to be met.

6.4 The Importance of Technical Capacity in Financial Programming

The lack of technical capacity to negotiate with the IMF as well as to implement financial programs to a large extent explains the failure of reform programs in many developing countries. The problem starts as early as the negotiation stage in the setting of targets. The IMF always advocates for austerity measures, which in some cases might lead to social unrest, for example, drastic cuts in social services or retrenchments. Some measures may unfortunately stifle growth, for example, drastic cuts in private sector credit. There is thus need for local capacity with a deep understanding of the macroeconomic framework so that "authorities can ensure that the structural assumptions and balance of risk adequately embody local judgments" (Bolnick, 1999).

The assumptions underlying the Fund designed adjustment programs should be sufficiently analysed by government negotiators and a case for modifications made if necessary, taking into account reality on the ground. If government technocrats do not have the necessary capacity to sufficiently scrutinize the technical options, full control of the technical analysis is consequently, left with the IMF and this might result in the adoption of unrealistic targets. This leads to failure to achieve targets on the part of the authorities.

6.5 Rapid Inflation reduction is achievable

Zimbabwe can reduce inflation from eleven digits to double digit levels within a year if a comprehensive economic reform program is implemented.

The success of the economic reform program will, however, largely depend on the commitment of the authorities in implementing the economic recovery program as a package. Normalisation of relations with the international community is also of critical importance.



6.6 Integration of Financial Programming into Policy Management

The integration of financial programming into the policy management process provides authorities with an organised policy formulation and implementation platform for achieving macroeconomic stability. Effective implementation of financial programming, for policy management, however, requires that "public and private institutions be restructured to create an environment in which capable people work effectively, and that political leadership be committed to nurturing those institutions, not politicising them for narrow objectives" (World Bank, 1994).

As Bolnick (1999) also observed, "on the technical side, it also requires serious attention to database development; adoption of new procedures and assignments within the central bank; the establishment of close operational links with liquidity managers in the central bank and budget managers at Treasury; and technical training to ensure that the methodology is deeply understood by economists involved in the process".

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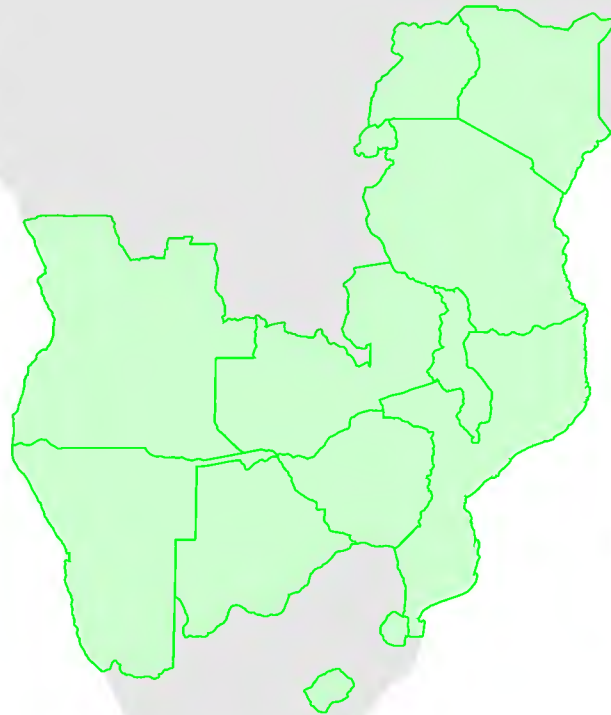
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Building Sustainable Capacity

Fostering Best Practices

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