Chapter 19

Sub-Saharan Africa
Zimbabwe

A centrally prescribed and unsustainable credit market succumbs to political and economic turmoil.

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Lessons

Although Zimbabwe neighbors South Africa, its recent experience in local government borrowing is very different from that country's. In Zimbabwe local government borrowing has been premised on a policy and regulatory regime—most evident in central government guarantees and prescribed assets for institutional investors—that is inimical to the development of sustainable municipal credit markets. The country's two largest cities have been able to successfully issue a limited volume of securities for many years, but this has come at the cost of accumulating liabilities for the central government and significant financial losses for investors. When a default by Harare in 1998 prompted the government to withdraw its implicit guarantee of local bond issues, interest rates immediately jumped, making local government borrowing prohibitively expensive. Not until 2001 did the central government again begin to underwrite mu-

nicipal debt issues, this time explicitly. Moral hazard has thus become embedded in the subnational lending system.

The economic and political crisis that Zimbabwe now confronts makes it difficult to talk about prospects for sustainable subnational borrowing in the country. The most recent bond issues suggest that borrowing has ceased to be an affordable source of funding for long-term investment programs. The policy and regulatory environment for subnational borrowing in Zimbabwe has fostered a "false" municipal bond market in which investors rely on the financial position of the central government rather than the creditworthiness of the municipal issuer. The sustainability problems that this has created have been greatly exacerbated by the deterioration in the country's economic and political climate.

Starting in early 2001 economic and political conditions in Zimbabwe began to deteriorate dramatically. In February 2002 the official annualized inflation rate stood at around 110 percent, GDP had shrunk by 5 percent over the previous year, and one in four jobs in the formal economy had disappeared. Under conditions such as these, the prospects for sustainable, cost-effective subnational borrowing are remote. Whether the municipal finance market will regain any of the momentum it began to show in the 1990s—though in a problematic policy environment—remains unclear.

Institutional Framework for the Financial Sector

Until recently Zimbabwe had a relatively stable financial system based on a long tradition of high savings and a well-diversified financial sector. Complementing the substantial and relatively sophisticated banking system are near-banks (nonbank financial institutions), insurance and pension funds, a well-established stock market, and a range of other market participants. The system has become increasingly competitive, though with a growing amount of risk. The government's National Economic Structural Adjustment Program, implemented in the early 1990s, introduced some econom-

ic deregulation, enhancing competition, allowing market conditions to influence financial prices, and increasing the diversity of market participants and financial services (World Bank 1998). During the 1990s assets held by deposit-taking institutions grew significantly in real terms (table 19.1).

Financial Institutions and Instruments

The financial sector remains segmented, with legal restrictions on the kinds of transactions that different types of institutions can undertake.

- *Commercial banks.* The seven commercial banks in operation in 1999 were the largest institutions in the banking system. At that time they held 32 percent of the assets in the financial system and 60 percent of loans and advances, and 49 percent of deposits, in the banking system. Permitted to undertake most types of financial intermediation (except financial leasing and hire purchase), commercial banks are important lenders to subnational governments for short-term facilities, such as overdrafts and bridge financing.
- *Merchant banks.* With six existing in 1999, merchant banks perform the second largest volume of financial intermediation but cannot offer checking accounts. They tend to cater to larger enterprises by providing tailored services and trade financing.
- *Discount houses.* There were six discount houses in 1999. Their primary role is to act as a market maker for commercial and merchant bank liquidity and as the main receiver and dealer of treasury bills from the central bank, the Reserve Bank of Zimbabwe. (Until 1999 dis-

Table 19.1. Assets of Deposit-Taking Institutions, Zimbabwe, 1992–97 (millions of Zimbabwe dollars)

Type of institution	1992	1993	1994	1995	1996	1997 (Sept.)
Commercial banks	8,062	14,900	20,275	24,669	32,648	40,533
Merchant banks	1,961	6,126	7,756	10,361	17,051	18,349
Discount houses	716	1,347	1,674	3,781	3,161	2,958
Finance houses	1,491	1,498	1,908	2,866	4,270	5,420
Building societies	2,916	3,892	5,808	10,088	13,843	15,666
Post Office Savings Bank	2,315	2,977	3,662	4,466	6,227	6,927
Total	17,460	30,740	41,082	56,230	77,200	89,852

Source: Reserve Bank of Zimbabwe 1997.

count houses had exclusive access to the Reserve Bank and would purchase treasury bills and rediscount them into the rest of the financial market. Now, however, all financial institutions have access to the Reserve Bank.) The discount houses play an important market-making role in the municipal finance market, assisting subnational governments in issuing long-term bonds for capital development. In 2001 one of the discount houses was licensed to assist local authorities in seeking funding for infrastructure and to create a market for local government securities (such as municipal bonds and municipal treasury bills). Discount houses held around 3.3 percent of the assets of deposit-taking institutions in 1997.

- *Finance houses*. The four finance houses existing in 1999 function largely as fixed asset financing arms of commercial banks, financing equipment and vehicle loans and collateralized lending. The finance houses hold about 3.1 percent of the assets in the financial system (excluding the Reserve Bank of Zimbabwe).
- *Building societies*. There were five building societies in 1999. These institutions accept share, savings, and fixed deposits and negotiable certificates of deposit. They lend for residential and commercial mortgages, purchase treasury bills, provide other loans to the government, place funds in the money market, and finance low-income housing projects. In 1997 they held approximately 17 percent of the assets in deposit-taking institutions.
- *Post Office Savings Bank*. A government-owned institution, the Post Office Savings Bank mobilizes funds from small savers throughout the country and offers both savings and fixed deposit facilities. In 1997 it held 7.7 percent of the assets in deposit-taking institutions.
- *Development finance corporations*. The development finance corporations specialize in term financing, often with support from the government or donors. These include the Agricultural Finance Corporation, Zimbabwe Development Bank, and Small Enterprises Development Corporation.

Instruments traded in the market include treasury bills and government bonds, bank acceptances, certificates of deposit, and a limited amount of commercial paper. Treasury bills dominate the market and have had a crowding-out effect on competing investments. Maturities range from 30 to 91 days for treasury bills and from 1 to 16 years for fixed-income debt stock.

Prescribed Assets Regime

The government of Zimbabwe, to regulate interest rates in its favor, has maintained a "prescribed assets" regime. Institutional investors (pension funds and insurance companies) in Zimbabwe are required to keep 45 percent of their holdings in prescribed assets, which have generally included long-term bonds (with maturities of more than six years) of the central government, parastatals, and local governments (this share has been reduced from 55 percent in 1997 and 65 percent before that).[1] This requirement originally had some validity, as a way to ensure safe investments by financial institutions. However, its continued use guarantees the public sector preferential access to domestic financial markets.

Throughout the 1990s there were insufficient prescribed assets in the market to satisfy the statutory requirements. This, coupled with the government guarantee implicit in the prescribed asset requirements, has made pricing these assets difficult. A recent World Bank (1998) review of the financial sector concluded that

> . . . [T]he contradiction between investors holding fewer prescribed assets than required and the inability of [the] Government to place long-term stock suggests that market participants are reticent to hold long-term instruments except at very high yields and [that the] Government is reticent to pay such a premium for long-term funds.

The availability of prescribed assets has tended to fluctuate. During shortages municipal bonds, for example, have often been oversubscribed when first issued, depressing interest rates (Phelps 1997). There is no secondary bond market in Zimbabwe because most institutional investors find it difficult to meet the required 45 percent share for prescribed assets and therefore adopt a "buy-and-hold" strategy.

Intergovernmental Structure

Zimbabwe has a two-tier system of elected government: the central government (with line functions devolved to both the provincial and the district level) and local governments. The local governments consist of 57 rural district councils and 23 urban councils—city and town councils, town boards, and local boards.

The councils are elected on the basis of ward constituencies, with all adults having the right to vote. Their functions and responsibilities are set

out in the Rural District Councils Act and the Urban Councils Act. Local governments are responsible for administering the areas under their jurisdiction. However, the central government maintains strategic control of boundaries and the hiring and firing of local government senior staff.

The urban councils have a broad range of responsibilities—street lighting, street cleaning, physical planning, emergency services, municipal police, low-cost housing, primary education, primary health care, solid waste management, road maintenance and expansion, and water and sewerage services. They also operate enterprises, including farms and beer gardens.

Subnational Funding Sources

Local authorities have three main sources of funds for financing current and capital expenditure: internal revenues, external revenues, and borrowing.

Internal Revenues

Local governments derive internal revenues primarily from taxes and service charges. They do not have complete autonomy over these revenue sources: to increase taxes, property assessments, and service charges for low-income areas, local governments must obtain the approval of the minister of local government, whose ministry oversees their operations on behalf of the central government.

- *Assessment rates and supplementary charges.* Assessment rates, applied to the ratable value of property within the municipal boundaries, are levied on commercial properties and on residential properties in high-income areas. Flat unit charges on properties (known as "supplementary charges") are levied on residential properties in low-income areas. Any increases of more than 20 percent in either of the charges must receive prior approval by the minister of local government, often leading to delays that result in revenue shortfalls. Assessment rates and supplementary charges account for around 20 percent of subnational income.
- *General service revenue.* Local authorities generate increasing revenues from charges for "economically viable" services, such as sewerage and refuse collection. Sewerage contributes around 7 percent of subnational income, refuse removal and housing income around 6 percent each, and income from health and welfare and other general services around 24 percent.

- *Trading income*. Profits from water distribution are by far the largest source of trading income. Some councils also run such trading operations as farms and beer gardens, although these typically contribute only a minor share of budgets.
- *Other internal revenue sources*. From time to time local authorities also derive income from the sale of fixed property, primarily land.

External Revenues

External revenues come through intergovernmental transfers, which have recently declined precipitously to insignificant levels (table 19.2). In transferring responsibility for health care services to local authorities, for example, the central government initially agreed to fund a share of the salary costs through grants. Within a year, however, these grants had ceased to flow, and the health funds of local authorities now operate at significant deficits.

In general, intergovernmental transfers are a much less important source of revenue for larger, urban councils than for rural councils. Harare, for example, received no intergovernmental transfers in 1995–97, and for Kwekwe such transfers accounted for less than 1 percent of revenue during that time.

Borrowing

Local authorities can turn to three main sources for borrowing:

- *Government loans*. Government loans have accounted for around 90 percent of local authorities' total borrowing for capital development over the past two decades. The funds for these loans have been obtained mostly from aid agencies, then on-lent to local authorities at

Table 19.2. Local Government Revenues by Source, Zimbabwe, 1995–98 (percentage of total)

Revenue source	1995	1996	1997	1998
Assessment rates and supplementary charges	24	25	22	31
General services	35	44	36	56
Trading income	22	7	6	8
Intergovernmental transfers	18	24	35	6

Source: Zimbabwe Central Statistical Office accounts.

concessional rates through the General Loan Development Fund and National Housing Fund.

- *Bank overdrafts and short-term loan finance.* Overdrafts and short-term borrowings are capped at the local authority's income from rates in the previous year (unless otherwise authorized by the minister of local government) and are intended to be temporary. These funds may be used for capital expenditure only if borrowing power for that expenditure has been obtained from both the Ministry of Finance and the Ministry of Local Government. Between 1994 and 1997 subnational revenue grew by 26 percent while outstanding debt grew by 78 percent. Much of this deficit is being financed by overdraft facilities.
- *Long-term finance.* Local authorities can raise long-term finance from private investors by issuing bonds or by borrowing directly from financial intermediaries, including the Local Authorities Pension Fund.

Local Government Borrowing

The Urban Councils Act and Rural District Councils Act provide broad borrowing powers to local governments. Local governments are permitted to borrow for capital works or improvements, acquisition of fixed property, certain kinds of advances, payment of compensation (excluding that for permanent employees), liquidation of previous loans, relief of general distress (caused by a natural disaster, for example), and acquisition of plant, equipment, and vehicles.

Regulation and Oversight

Before a local government can borrow, however, the local council must pass a formal resolution of its intention to borrow, give public notice of its intention, including the purpose for which the borrowed funds will be used, and invite comments from its constituents. Before borrowing from the central government, the Local Authorities Pension Fund, a municipal provident fund, a medical aid society, or another local authority, the council must obtain permission from the Ministries of Local Government, Public Construction, and National Housing. If the council intends to issue bonds, stock, or debentures, it must obtain authority from the Ministries of Finance and Local Government. Four of Zimbabwe's five major cities—Harare, Bulawayo, Gweru, and Kwekwe—have issued bonds in local capital markets. Indeed, Harare and Bulawayo have been raising bond finance since the late 1960s or early 1970s. By contrast, short-term overdraft facili-

ties require central government approval if they exceed the previous year's income from rates.

The requirement for central government approval, along with the prescribed assets regime, has provided a foundation for the primary market for municipal debt in Zimbabwe because it has led to a market assumption of an implicit central government guarantee of such debt. The phrasing of issues has often reinforced this impression. For example, the prospectus prepared by Kwekwe for its 1998 issue stated that "[w]hile the Government does not explicitly guarantee this stock issue, it has the moral responsibility to ensure that the local authority meets its external obligations." Prud'homme (1999, p. 14) has argued that the local government bond market in Zimbabwe is really a "false" market in which "[f]or all practical purposes, municipal bonds . . . are basically a variety of central government bonds, and are seen as such by the financial community."

Borrowing Trends

Faced with deteriorating revenue bases and increasingly unfunded mandates in the social sectors, local governments have been forced to increase their debt over time (table 19.3). Of the total debt, an average of 47 percent is held in bond issues in the domestic markets (registered stock) and 53 percent is from other sources (including the central government and private sources, such as the Local Government Pension Fund). Long-term borrowing from private financial institutions is therefore an important source of finance, particularly for the five largest councils (table 19.4).

Table 19.3. Gross Public Debt of Local Authorities, Zimbabwe, 1994–97 (millions of Zimbabwe dollars)

	1994	1995	1996	1997
Long-term borrowing	1,376.7	1,559.4	1,767.5	2,293.4
Registered bonds	553.5	543.5	629.5	815.6
Central government	713.4	871.1	945.6	1,287.4
Private	109.7	144.8	192.4	190.4
Short-term borrowing	4.8	50.7	43.8	169.5
Total	1,381.5	1,610.1	1,811.3	2,462.9

Source: Zimbabwe Central Statistical Office 1999.

Table 19.4. Bond Issues by Local Governments, Zimbabwe, 1990–2001

Year	City	Issues	Total amount (millions of Zimbabwe dollars)	Total amount (millions of U.S. dollars)	Coupon rate (percent)	Inflation rate (percent)	Term (years)
1990	Harare	1	46	17	15.3		19
1991	Bulawayo	1	10	1.98	17		10
1993	Harare	1	90	12.98	32	27.6	5
1994	Harare	1	120	14.30	17	22.3	7
1994	Bulawayo	1	100	1.92	18	22.3	10
1996	Harare	1	100	9.93	18	21.4	17
1996	Bulawayo	1	100	9.93	20	21.4	10
1997	Bulawayo	1	100	8.04	14	18.9	15
1998	Kwekwe	1	28	1.15	28	30	10
1998	Gweru	1	50	2.05	23	30	10
2001	Harare[a]	10	249	1.84	13.4–18	60.8–112.4	1–13
2001	Bulawayo	2	250	1.388	28–32	60.8–112.4	

a. All these bonds carried an explicit government guarantee. The official Zimbabwe dollar–U.S. dollar exchange rate was pegged in January 2001. The U.S. dollar figures here reflect the parallel market rate.

Source: Reserve Bank of Zimbabwe.

According to data collected from the local authorities and one of the discount houses, local government bonds in issue in September 2001 stood as follows:

City	*Millions of Zimbabwe dollars*
Harare	539
Bulawayo	630
Gweru	50
Kwekwe	36
	1,255

However, municipal bonds constitute a very small share of the instrument base of the lending institutions (about 5 percent of their portfolios), and the instruments are rarely traded. The secondary trades that have occurred have been transacted at significant discounts, probably reflecting the market risk perception of municipal bonds. Nearly all the bonds are held by pension funds, with banks preferring a short-term investment horizon. As a result, it has become extremely difficult to price existing stocks and to compute the cost of funds for new issues.

The implicit government guarantee has always ensured a lower cost of borrowing for local governments compared with the yield curve. This has been changing, particularly since a much-publicized default by Harare on the redemption of locally registered bonds in August 1998.

Most financial market participants have access to very little information on municipal bonds or securities in issue and consequently have very little information on the operations and performance of urban councils. This lack of information limits the market's capacity to price municipal securities and, more important, limits the financial sector's ability to design and offer services to the municipal sector. There is interest in developing loans for urban councils, but municipal bonds account for only about 3 percent of institutional investors' portfolios on average (PADCO and Techfin Research 1999).

Design of Municipal Debt

The Urban Councils Act and Rural District Councils Act specify that "all loans made by authorities are secured and charged upon the assets of the Council and all securities granted by the Council in respect of such loans shall rank equally without priority." This pledge is similar to the security for general obligation bonds in the United States. However, this statutory language appears to prevent the issue of revenue bonds in Zimbabwe—bonds for which the issuer pledges a particular revenue source. Nor do the acts anticipate the use of innovative security structures that would dedicate a separate revenue stream to an escrow account for future debt offerings (Johnson and Kimberley 1999). Even so, this type of security enhancement is under review by Harare, where potential investors in a proposed bond offering are suggesting that the water fees of the 20 largest users be paid directly to an escrow agent as security for payment of the debt service on the new bonds.

The general pledge or parity bond provision is modified by other provisions of the Urban Councils Act relating to the creation of separate estate and parking accounts into which a council's income from specified sources flows. Money in these accounts can be directed only to specified costs and expenditures. Although these accounts may be considered dedicated income streams for purposes of a revenue bond financing, there is no case law to support this conclusion or the conclusion that these accounts are assets of the council and therefore subject to the general pledge provision (Johnson and Kimberley 1999).

In some cases, however, a dedicated revenue stream other than property taxes (for example, revenue from water fees) might be more attractive to in-

vestors than a general obligation pledge of the local government. Moreover, given the decline in the general balance sheets of local governments, a project investment financed from a dedicated revenue stream might be more acceptable to investors than the general obligation bonds now authorized. Revenue bonds have therefore attracted growing interest from local governments, though no such bonds have been issued yet. All bonds have been for general development purposes, issued on a pari passu basis (with a ranking equal to that of all others).

The legislation allows subnational governments to establish and operate a consolidated loan fund, used to separately account for all money borrowed and principal and interest payments made. Only Harare has established such a fund; other local governments use sinking funds to repay loans. They pay annual installments into the sinking fund, sufficient to pay off the debt over the period for which the money was borrowed, and then use the fund for final (bullet) redemption.

The amount of issues is usually lower than the amount authorized by the Ministries of Local Government and Finance. The authorizations usually remain valid for several years (in principle, for an unspecified number of years). A local government then can opt to use up only part of its right to issue bonds, either because it does not want to run the risk of failing to sell all its bonds or because it does not want to commit itself to excessively high interest payments in the coming years. For example, Kwekwe, which obtained authorization to float bonds for 55 million Zimbabwe dollars (Z$) in 1998, chose to go to the market for only Z$28 million that year and planned to go to the market for the rest at a later date.

Bond Issuance and Trading

Local governments that have issued bonds prepare the issue in-house or have discount houses assist them by drawing up the prospectus, undertaking the initial canvassing, and processing the initial public offering. Trading takes place mainly over the telephone, and settlement is conducted on the same trading day. There is no central depository, nor is there a well-defined settlement system. Because of liquidity problems, some financial institutions have encountered situations in which transactions have been confirmed only after funds have been cleared.

In principle, bonds are allocated to prospective investors through bidding. Interested investors fill in a stock auction application form indicating the price they are prepared to pay for the bonds of a nominal value of US$100 and the number of bonds they want, enclosing a check for the ap-

propriate amount. The bonds are then allocated to those offering the highest price. In practice, the prices offered appear to be very close to the nominal value of the issue. The Kwekwe issue of Z$28 million, for example, sold for Z$28.92 million. Most bond issues have reportedly closed at somewhat below par, at about 95 to 97 percent.

The prospectus for a bond issue states the purpose of the issue, the amount to be raised, the interest rate, the issue price, the opening and closing dates for applications, and the maturity date. It explains where, when, and how to file applications. Payment is often 10 percent on application, and the balance three months later. The prospectus also gives details about the allocation of bonds and any refunds of payments made on application. Interest is normally calculated on a daily basis at the stated rate and paid semiannually. The prospectus states the redemption date, on which payment is made against surrender of the bond certificate. The prospectus expressly states that the debt will rank pari passu (equal) with all existing debt and form a charge on the rents, rates, and general revenue of the local authority and that it will be further secured on all its assets.

The level of disclosure in a typical prospectus (generally four to five pages long) for a local authority bond offering in Zimbabwe falls far short of international norms and often fails to meet listing requirements of the Zimbabwe Stock Exchange. The quality of prospectuses reflects an underlying assumption by investors that the creditworthiness of the issuer is immaterial because of the sovereign guarantee implicit in the prescribed assets regime and approval requirements for borrowing. Moreover, in Zimbabwe there is no authority that verifies the facts provided in prospectuses.

No bonds issued in Zimbabwe have been supported by an independent credit rating. Indeed, with the central government guarantee, there has been no need to verify the financial information. In 1999–2002, 17 of the urban councils were independently rated. Contrary to expectations, the rating agency Duff & Phelps (1999) found that some of the smaller local governments "reflect lower costs structures, more efficient collection procedures, and more pragmatic financial planning than their large counterparts." The rated councils have used the associated management reports as guides for improving their internal operating efficiency.

Even though all local municipal long-term bonds are listed on the Zimbabwe Stock Exchange, there is virtually no trading. The Stock Exchange and its members tend to ignore municipal bonds. If secondary trading in local debt securities develops, there will be a need for continuing disclosure

to allow the market to reassess the value of securities on the basis of developments since the initial prospectus. Even an initial prospectus that properly and fully disclosed relevant information would not contain information relevant to investors years after the bonds were first sold. Just as for initial disclosure, standards for continuing disclosure do not need to be established by statute.

Assessment and Prospects

Toward the end of the 1990s and through 2001 central government funding of local authorities in Zimbabwe began to decline precipitously. Grants fell both because of policy decisions by the government and because of its increasingly strained fiscal position. Public sector loans declined mainly as a result of the closure of donor-funded projects that had been the source of the intergovernmental loans and because of the diminished donor interest in the country. Moreover, while no accurate data are available on the repayment performance of local authorities, there have been reports of an increasing number of effective defaults on public sector loan obligations—a common phenomenon in Africa and indeed globally.

Under these circumstances—and given the advantages of the policy environment for local borrowers due to the prescribed assets regime and central guarantees—it might have been expected that local governments would make greater recourse to the bond market. However, this has not occurred. Real borrowing in 1998–2001 was substantially lower than in the 1980s and early 1990s. This decline probably reflects the deterioration of the financial sector's position resulting from the deterioration in the wider economy as well as the central government's difficulties in fully enforcing its prescribed assets policy. It probably also reflects factors specific to the municipal bond sector, such as the fallout from the Harare default in 1998. It is impossible to disentangle these effects and weigh their relative importance. Moreover, attempting to establish what would have happened in the municipal debt market if Zimbabwe's macroeconomic situation had not deteriorated would be a largely speculative exercise.

Only a small number of local governments have floated bonds in Zimbabwe, and until 1997 only Harare and Bulawayo had done so. The value of bonds in issue constitutes a relatively small share of capital investment financing by local governments. For example, Prud'homme (1999) has calculated that in 1990–96 bonds accounted for only around 20 percent of capital investment by local governments. During this period subnational

governments made capital investments amounting to US$298 million while issuing US$60 million in bonds.

This amount seems relatively small when compared with the reported investment needs of local governments—around US$55 million a year (PADCO and Techfin Research 1999). A World Bank–funded program financing infrastructure investments in all 23 urban centers in Zimbabwe disbursed a similar amount (also around US$60 million) in 1994–98, so the nascent municipal finance market in Zimbabwe was able to match this large public sector program in dollars invested.

The domestic financial market has the potential to make significant financing available for the investment needs of local governments, but current stocks of municipal bonds have been acquired largely on the back of government guarantees and the prescribed assets regime. Private investors have shown a reluctance to take municipal paper on its own merits. Further development of the municipal finance market in Zimbabwe (feasible only when macroeconomic stability is recovered) would depend on a number of measures, including introducing a more transparent and predictable intergovernmental fiscal transfer system, amending the legislation to allow for the ring-fencing of infrastructure projects through the issuance of dedicated revenue bonds, introducing credit enhancement measures such as municipal bond insurance, and strengthening financial management and disclosure by local governments.

A False Municipal Bond Market

As Prud'homme (1999) has argued, the central authorization, central guarantee, and prescribed assets policies that have provided the foundation for private lending to local governments have created a "false" municipal bond market in Zimbabwe: investors have lent on the basis of these policies rather than on the basis of the risk presented by a local authority. The importance and impact of this policy environment became clear in the Harare default of 1998. The central government did not make good on its implicit guarantee, with the consequence that all Harare bond issues since then have had to carry its explicit guarantee. The only other city that has been able to raise bond finance since that time (Bulawayo) had to pay a large premium for the privilege and commit to special arrangements that may or may not be replicable.

Broader economic circumstances aside, the policy regime governing subsovereign borrowing in Zimbabwe has created an unsustainable situation. Prescribed assets have created general problems for the financial sector. Ac-

tions by the central government aimed at strengthening the municipal finance sector (authorizations and implicit and explicit guarantees) have increased rather than diminished the government's liabilities while making it almost impossible to price municipal risk. Even if the macroeconomic situation in Zimbabwe improves dramatically, this policy environment needs to be fundamentally reformed if a sustainable municipal debt market is to emerge.

Market Discipline

The policy regime also appears to have contributed to a decline in the quality of local financial management and budgetary discipline. The period 1996–98 was characterized both by fairly high levels of borrowing from the public and private sectors and by deteriorating financial positions of many larger urban councils and growing local fiscal deficits, funded by short- and long-term debt.[2] In 1995–97, for example, Kwekwe's annual budget deficit grew from Z$1.7 million to Z$13.8 million, and its aggregate debt burden from Z$2.3 million to Z$17.8 million (Steffenson and Trollegaard 2000). Harare has consistently been both the most active local borrower and the one with the worst financial record (Prud'homme 1999).[3]

Thus in a regulatory environment where the ability of a local authority to borrow on the markets has been determined by the actions and financial position of the central government rather than the soundness of the authority's own financial position, access to debt finance has failed to exert a disciplinary effect on local government borrowers. As Prud'homme (1999) has noted, "Recourse to the bond market does not seem to have been [driven by] financial wisdom and discipline. [Nor has] the ability of a city to go to the market [been] constrained by the soundness of its financial position and the existence of healthy accounts."

Bond Issues and Inflation

Until 1998, as a result of the prescribed assets regime, local governments were generally able to access the market at interest rates close to or below the inflation rate, borrowing at zero or negative interest rates and thereby benefiting from a hidden tax on financial institutions. Interest rates rose sharply on new issues after the 1998 Harare default. Once again in 2001, when the central government reduced and strictly regulated interest rates in an effort to contain its own soaring domestic debt, local governments benefited substantially from the spread between the real cost of money and the rates on their bond issues.[4] Prud'homme (1999) has calculated that in

real terms, with an annual inflation rate of 20 percent, a 15-year bond of US$100 is reimbursed for about US$6.

This is clearly not a sustainable situation for financial institutions in the long term. Of course, the policy of prescribing financial assets is a concern that extends beyond the municipal sector. However, like many other monetary and fiscal policy questions, it requires serious attention if a sustainable municipal debt market is to emerge in Zimbabwe. Only after fundamental reforms in the overall policy environment will it be possible to address the issues that relate specifically to municipal borrowing: the intergovernmental fiscal structure, the powers of local governments to budget and issue debt, the regulation of market participants, and procedures in the event of default. Serious and detailed reform in all these areas is essential before a sustainable debt market can emerge in Zimbabwe, but under today's circumstances this is unlikely to happen in the short or even the medium term.

Notes

1. These long-term bonds are known as "registered stocks" in Zimbabwe.

2. An analysis of the financial statements of 13 of the largest urban councils for fiscal 1998 confirmed the weak financial position of most of the councils. Of the 13 assessed, only 2 reported (modest) surpluses in fiscal 1998. Of the 11 councils in deficit, 4 were carrying deficits of more than Z$20 million.

3. In June 1999 the entire Harare council was dismissed by the central government on the basis of an extremely adverse report on the city's financial position by Deloitte and Touche.

4. For example, in January 2002 interest on 90-day negotiable certificates of deposit was 23 percent, while the annualized inflation rate was 112.4 percent.