



2002 Annual Forum

at Glenburn Lodge, Muldersdrift

**The Need for Policy Coherence for
Financial Liberalisation in Southern
Africa: Lessons from a Small
Developing Economy**

Adelaide R. Matlanyane

University of Pretoria

TABLE OF CONTENTS

1. INTRODUCTION	1
2. SOME IMPORTANT FEATURES OF THE BANKING SECTORS IN DEVELOPING COUNTRIES	2
3. THEORETICAL OVERVIEW	3
4. AN OVERVIEW OF THE FINANCIAL SECTOR OF LESOTHO DURING AND AFTER REFORMS	6
4.1 Features of the financial sector	6
4.2 The financial sector prior to reforms	7
4.3 The financial sector after reforms	8
5. IMPORTANT LESSONS FROM LIBERALIZATION IN AN UNSTABLE FINANCIAL SYSTEM	10
6. REGIONAL EFFECTS	12
5. CONCLUDING REMARKS	13
REFERENCES	14

LIST OF TABLES

Table 1: Sectoral Distribution of Credit (in million Maloti).....	7
Table 2: Selected indicators of developments in the financial sector.....	8
Table 3: Indicators of developments in the financial sector during and after reforms	10

LIST OF ABBREVIATIONS

CMA	Common Monetary Area
CS	Commonwealth Secretariat
GATS	General Agreement on Trade in Services
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
ITC	International Trade Centre
MLAR	Minimum Local Asset Requirement
SA	South Africa
SACU	Southern African Customs Union
SADC	Southern African Development Community
WTO	World Trade Organisation

ABSTRACT

This paper looks at the policy of financial liberalisation within the context of a small developing economy that is experiencing financial sector distress. The performance and structure of the banking sector of the economy of Lesotho is in particular reviewed before, during and after the reform period. The paper also draws on the theoretical arguments for financial liberalisation in developing countries in line with distinguishing structural features of financial systems in developing countries. The implications of the analysis are extended to make an analysis of the likely effects of financial liberalisation in a group of countries that are a part of trade and monetary arrangements. Particular attention is given to the institutional arrangements that deal directly with financial issues, in this case the CMA. The primary outcome of the paper is that the economy hardly met the prerequisites for financial liberalisation at the time when the policy was implemented hence the distress in the banking sector that followed. While contagion may not be a significant problem given the size of the economy relative to its closest neighbour, South Africa, the experience nevertheless provides important lessons for economies in similar situations.

1. INTRODUCTION

In the past years trade negotiations and arrangements have placed emphasis on trade in commodities. Lately, services are increasingly becoming an essential input into the production and trade in commodities. According to the World Bank (2002:69), developing countries have experienced rapid growth rates in service trade with their share in world services increasing from 14 percent in 1985-89 to 18 percent in the period 1995-98. The development of trade in services is expected to have far-reaching positive impacts on economic growth. It is with the intent of exploiting this opportunity that the General Agreement on Trade in Services (GATS) under the auspices of WTO extended the rules governing trade in goods to trade in services by establishing a framework for liberalising trade in services (ITC and CS, 1995). Liberalisation in this regard requires countries to modify domestic regulations relating to trade in services and gradually relax restrictions on trade in service products. In the context of financial services this involves the relaxation of among others liquidity and reserve requirements, limitations on innovations of financial instruments, interest rate ceilings, government intervention in the financial markets, entry barriers in the financial system and restrictions of capital transactions with foreigners (Montiel, 1995; Agenor and Montiel, 1996; Ucer, 1998). On the other hand, the financial sector of any economy has been known to be one of the sectors that is highly fragile and vulnerable to external shocks. The experiences of Asian and Latin American countries in the 1980s provide evidence for this. This suggests that cautious liberalisation strategies have to be undertaken especially for countries that are members of multilateral and regional trade and monetary arrangements. While signs of financial stress began to show in most sub-Saharan countries including the larger economies such as Kenya and Nigeria in the 1980s, little is known of the Southern African region. Yet the region features some of the oldest regional trade and monetary arrangements such as SACU and CMA. It is interesting to assess the likely effects of liberalisation in this framework. The economy of Lesotho is the smallest in this region and has implemented financial reform strategies since the late 1980s. While contagion may not be considered a big problem because of the size of the economy, valuable lessons can be derived from the experience. This paper seeks to assess the prospects and likely costs and benefits of a small country, in this case, Lesotho of liberalising the market for financial services in the light of status of the financial sector and the macroeconomic environment. This paper begins by providing a background on some of the important features of financial markets particularly the banking sectors in developing countries in general. The theoretical foundations and implications of financial liberalisation are extensively explored in the second section. This discussion provides an understanding of the conditions under which liberalisation can be expected to be successful. An overview of and the nature developments in the financial sector of Lesotho and its assessment before, during and after the reform period follow this. On the basis of the fourth section, likelihood of successful liberalisation in Lesotho on the basis of the current status of the financial sector is assessed and important lessons are drawn from the experience. The sixth section considers the regional dimension of financial liberalisation in the context of the CMA, SACU and SADC and is followed by some concluding remarks and policy implications.

2. SOME IMPORTANT FEATURES OF THE BANKING SECTORS IN DEVELOPING COUNTRIES

Structural problems in the financial sectors of developing and transitional economies can be cited as a major factor that affects the development of the sector and its interaction with its counterparts in the international economy. A general feature of banking sectors in developing countries is that most of them have previously been dominated by oligopolistic foreign and government owned banks (Brownridge, 1998). This feature is in almost all cases coupled with high concentration levels. Because foreign banks were perceived not to have interest in national developmental interests, government owned banks were established with the aim of filling this gap. Rapid branching and segmentation of the banking sectors to serve the interests of the rural communities followed this. Government ownership also meant that banks were obliged to absorb the costs of the rapidly growing public sectors. The immediate consequence of this has been reflected in poor quality services, which are expensive, and of a limited range. As Knight (1998) notes, financial markets in developed countries are characterised by a variety of markets and products. The competition that results from the existence of these markets enhances efficiency in the financial system while it deepens it. The non-existence of a variety of instruments and institutions in the financial systems of the developing economies hinders competition and weakens the base of the system so that it becomes extremely vulnerable to external shocks. Moreover, the banking sector is overburdened with the tasks of being the major supplier of credit as well as the clearing and payments mechanism and the foreign exchange market while it also has to assess the risk and returns of private sector investment projects. In this manner the banking sector is assigned the heavy task of being the main conduit of monetary policy. However, given the level of development of the financial systems in many developing countries is at a phase in which they are more exposed to liquidity crises, it becomes difficult for them to perform these efficiently. Because of this peculiar structure, banking institutions, especially government owned banks, in developing countries are obliged to pursue government developmental interests more than traditional commercial banking practices. This structural problem ultimately manifests into insider lending, lending to high-risk borrowers and bad management practices in general. A particular example of this problem in the African context has been observed in East and West Africa. During the late 1980s signs of weakness began to show mainly in government owned banks in most sub-Saharan African countries such as Kenya and Nigeria (Mehran *et al*, 1998). These included default by large borrowers who in most cases were political borrowers. Given that the private banking sector was too small and concentrated to stand in for government banks, the survival of the financial sector was threatened.

It is common knowledge that the Asian financial crisis that started in Thailand in 1997 drove the neighbouring economies into bouts of costly recessions. Among others factors, weak regulation and supervision in the banking sector, the accumulation of non-performing loans, high foreign debt levels, corporate bankruptcies, corruption and policy changes in the areas of exchange rate management and investment co-ordination are suspected to have facilitated the reception of the crisis in these economies.¹ This shows just how large a stake prudential regulation and supervision hold in the proper functioning of the sector and its susceptibility to external shocks. It

¹ See for example, Chang, 1998; Lane, 1999; Lauridsen, 1998 and Jomo, 1998.

is common practice in developing countries to set entry requirements that are extremely below standard. This allows entry of fragile and unfit participants in the market thereby undermining the soundness of the system as a whole. Under these circumstances banking institutions may gamble for redemption and assume unhedged exposures (Eichengreen *et al.*, 1999). Moreover, it is seldom possible to detect, monitor and evaluate risky activities. With these features, the financial system is hardly in a position to withstand heavy flows of capital that result from reform either within the economy or from outside. In sub-Saharan Africa, Kenya is the most significant of the examples in which there was rapid emergence of privately owned banks that were most fragile and could not survive for long. This has been the case also in Ghana, Zimbabwe and francophone Africa (Mehran *et al.*, 1998).

Information problems of moral hazard and adverse selection are commonly known to be more intense in the financial sector. This is because of the dependence of the efficient functioning of the sector on adequate and quality information. An important feature of financial systems in developing countries that aggravates their susceptibility to both internal and external shocks is that they are both prone to the problems of moral hazards, adverse selection and herding behaviour. These problems originate from the underdeveloped nature of the markets and are known for their significant contribution to inefficient allocation of resources.

Even in the face of perfect information, the welfare improving properties of financial reforms may be frustrated by the presence of domestic distortions. In most cases trade distortions are cited as the most harmful in this respect. Brecher and Diaz-Alejandro (1977), provide an analysis particularly reflective of developing economies to show that institutions where governments have a habit of guaranteeing of subsidising foreign loans, capital inflows are encouraged through capital intensive financial institutions in labour abundant economies, hence the reduction in welfare.

Developing economies are well known for poor and unstable macroeconomic environments. One of the most important causes of financial fragility is macroeconomic instability. In a number of countries bank failures were a result of financial sector reform in the face of a fragile macroeconomic environment. In most cases this has caused contagion in neighbouring economies with equally unstable macroeconomic status. According to Brownbridge (1998), high inflation rates increase the probability that firms will make losses thereby increasing the likelihood of loan defaults. Moreover, this poses a problem of asset valuation, as asset prices become highly volatile. This involves uncertainty as to the future real value of loan security.

In general domestic and international financial liberalisation increase the probability of the occurrence of crises if not supported by robust prudential supervision and regulation as well as sound macroeconomic policies and other supporting structures such as sound legal frameworks. The sequencing of liberalisation strategies is an equally important factor that determines the final outcome of financial sector reforms (Eichengreen *et al.*, 1999).

3. THEORETICAL OVERVIEW

The occurrence and prevention of systemic problems in the financial sector has lately become a major concern of policy makers in both developed and developing countries in the 1980s and 1990s. This has led to the emergence of substantial literature on the causes and consequences of financial crises and on remedial measures to help prevent future failures. The causes range from weak macroeconomic environments, vulnerability of the banking system to sudden capital outflows, 'bad' regulation and supervision to structural characteristics of the banking sector. (Demirguc-Kunt and Detragiache, 1998; Bath *et al.*, 1999). Montiel (1995) suggests stable institutional and macroeconomic environments as prerequisites for successful liberalisation in the financial system. In turn, Knight (1998) points out that the structure of competition within the banking sector also affects the extent to which macroeconomic developments impact on the stability of the banking sector and the entire financial system. In addition, policies that promote prudential regulation and supervision play an important role in maintaining the soundness of the financial sector. While these factors have to be in place before liberalisation, the sequencing of the process of liberalisation is also crucial in determining the ultimate outcome. According to Montiel (1995), the simultaneous restoration of macroeconomic stability and the restructuring and liquidation of insolvent financial institutions should be the first phase of the process. The introduction of indirect monetary control instruments, the removal of price distortions and the establishment of supervisory guidelines is the next crucial phase. This is then followed by the opening of markets to foreign participants and the actual removal of direct monetary controls.

An overwhelming literature provides evidence of strong linkages between financial sector development and economic growth.² It has been established that the development of financial intermediation or the financial sector exerts a strong and substantial causal impact on economic growth. (Levine *et al.*, 1999; Montiel 1995, Berthelemy and Varoudakis, 1996). The development of a sound financial system is advocated as one of the necessary conditions for macroeconomic stability. This proposition is based on the realisation that banking financial intermediaries channel funds from surplus economic agents to deficit agents to facilitate trade and capital formation. (Soyibo and Adekanye, 1992). Liberalisation of trade in services is usually analysed within a similar framework as that of trade in commodities. Its success and justification is founded on the benefits thereof. As predicted by conventional trade theory, under appropriate assumptions, both large and small economies are expected to reap benefits from increased openness.

However, at a theoretical level there are basically two diverging views regarding the analysis of financial liberalisation policy. One view attests to the allocative efficiency promoting properties of liberal financial markets, which subsequently improve global welfare. On the other hand, there exists a counter view that recognises the existence of information asymmetries, distortions and other problems that face financial markets world-wide and undermine the welfare improving characteristics of liberalisation.

Although recent empirical work demonstrates that evidence in favour of trade openness has been greatly over-emphasised,³ a voluminous amount of literature provides evidence that open economies grow at a faster rate than highly protected

² See for example, Fry 1995 for a survey.

³ Rodriguez and Rodrik, 1999 find scanty evidence of a significant relationship between trade policy and economy growth.

economies because of technology and investment effects that result from more liberal policies.⁴ The channels through which economic growth is enhanced include improvement of financial intermediation, service quality and quantity, competition, efficiency in resource allocation, technology transfer and specialisation. Kono *et al*, (1998) point out that more open and efficient financial systems enhance saving and investment and hence improve the intertemporal allocation of resources.

From the classical point of view, international capital mobility that results from liberalisation allows for improved savings mobilisation and hence increased domestic investment while it makes it easy for investors to diversify their portfolios. In another dimension it tends to enhance intertemporal trade. Eichengreen (1996) provides evidence from developing countries that shows that integration and liberalisation of financial markets brings about international financial flows that are much more difficult to manage. While it is argued that capital inflows may reduced welfare by encouraging capital intensive financial innovations in labour abundant developing economies, there is also a counter view that capital flows from capital abundant countries into capital scarce countries can improve welfare in both countries in the long run. This latter proposition is based on the assumption that the marginal product of capital in capital scarce countries is higher than in capital abundant countries (Eichengreen *et al*, 1998). According to the World Bank (1997), these growth-stimulating effects of liberalization are likely to be higher in developing countries that are characterised by simple and smaller financial systems.

It is however noteworthy that the process of liberalisation involves transitional costs that cannot be undermined. According to Kono *et al*, (1998), financial institutions that were previously less efficient with high operating costs stand to suffer from competition. This can be the same for institutions and sectors that previously benefited from preferential treatment in terms of access to credit. This involves declines in output of these sectors and reallocation of resources.

It is these disturbances that invariably work to disrupt the flow of credit to economic units thereby jeopardising the functioning of the payments mechanism and restricting consumption, investment and ultimately the growth of national income. Because of the contagious nature of the financial system a well-meaning policy change tends to undermine confidence in the domestic financial system causing a decline in domestic savings and/or huge capital outflows.

For these reasons caution has to be taken in the implementation of liberalisation policies. For instance, factors such as structural rigidities, the macroeconomic environment in which they are imposed, the legal frameworks that surround the markets, the market structures as well as the sequencing of the liberalisation strategies can hinder the success of liberalisation.

In most developing countries policy makers invariably respond to these problems in the financial system by interventions including mainly bailing out failing institutions. However empirical evidence shows that government intervention in the operations of the financial market seldom achieves the intended objectives. It results in price distortions and undermines the market forces (Soyibo and Adekanye, 1992).

⁴ See for example, Marvel and Ray, 1983; Romer, 1990; Moser, 1990; Rivera-Batiz and Romer, 1991 Sachs and Warner, 1995; Francois *et al*, 1995 and 1996; Petersman, 1997; Vamvakidis, 1999.

Moreover, these rescue operations often prove to be more costly than beneficial in the medium run. For a start, they impose additional costs to the government budget. Because of distortions and hence incorrect market signals they allow operation of inefficient firms and also create the expectation of future bailouts, which reduces the incentive for financial institutions to compete for deposits and manage risk. In most cases the disease spills over to institutions that are functioning well since they are forced to adopt the liabilities of and to bear the losses of ailing institutions.

4. AN OVERVIEW OF THE FINANCIAL SECTOR OF LESOTHO DURING AND AFTER REFORMS

4.1 Features of the financial sector

The banking sector of Lesotho forms to a large extent, the core of the financial system in Lesotho given that the capital market does not exist. In terms of development, it can be placed in what Chick (1993) and Dow (1999) characterise as the second stage of development. While financial institutions play the traditional role of being an intermediary between saver and investors, credit creation has also become a vibrant activity. Because of the non-existence of an interbank market, the central bank plays the role of the lender of last resort. However, this role is rarely utilised since excess liquidity has been a dominant historical feature of the banking sector. Because of its core role in the financial system the banking sector is the main channel through which monetary policy is transmitted to address the basic objective of macroeconomic stability. In addition, the robustness of the financial system depends to a large extent on the stability of the banking sector.

Two main features of the financial sector of Lesotho make it particularly vulnerable to external shocks. Firstly, it features a dual currency system in which the South African Rand circulates alongside the local currency as legal tender at the exchange rate of one to one. However, the quantity of the Rand in circulation within the economy is unknown. Secondly, there is huge cross border trade in financial services between Lesotho and SA. Because the SA financial sector is relatively more developed and because of its close proximity, a large number of Lesotho residents perform the banking and other financial activities in SA. The unstable political climate within Lesotho towards the end of the 1990s and the absence of capital controls within the Common Monetary Area (CMA) encouraged this. In addition, strong competition for corporate lending also exists between Lesotho and SA satellite companies whose parent companies guarantee coverage against risk. Although this trade is quite significant, there is no formal record of its volume owing to the tediousness of quantifying services given the degree of integration of the financial markets of Lesotho and SA. The openness of the financial system can also be related to article 23 of the SADC protocol makes provision of services trade in developmental agenda of the SADC countries. By this agreement members undertake to implement service trade liberalisation in line with their obligations with WTO's GATS. In line with this arrangement Lesotho has made an offer to the GATS regarding the market for financial services. In general, any disturbance in the financial system whether triggered by internal policy or external factors is most likely to produce magnified repercussions.

4.2 The financial sector prior to reforms

The financial sector in Lesotho consists of the banking and insurance sub-sectors. Prior to the commencement of reforms, the banking sector consisted of one state owned commercial bank, two foreign commercial banks and two specialised banks and two development finance institutions also owned by government. The main objective of government with regard to the financial sector was to increase and channel domestic credit into local investments with particular attention on the industrial and agricultural sectors (Government of Lesotho, 1997). This objective was, however, not fully achieved. Official statistics indicate that until the early 1990s government was the largest holder of domestic credit. Households and the distributive business sector, which relies almost invariably on imports, held the next largest share (Central Bank of Lesotho, 1989; World Bank, 1990; Petersson, 1993).

Table 1: Sectoral Distribution of Credit (in million Maloti)

DOMESTIC CREDIT	1990	1991	1993	1995	1997	1999	2000
Business	146.3	183.0	319.2	403.5	559.5	319.8	338.9
Mortgages	-	-	-	86.0	89.2	82.2	67.1
Households	47.5	61.9	90.5	222.1	152.5	326.0	362.1
Total (private)	193.8	244.9	409.7	711.6	801.2	728.0	768.1
Statutory	26.2	35.9	29.3	80.5	124.3	171.4	145.3
Government	206.6	119.2	-481.7	-1140.5	-1954.2	-941.7	-733.4
Total (Public)	232.8	155.1	-452.4	-1160	-1829.9	-770.3	-588.1
Grand Total	426.6	400.0	-42.7	-448.2	-1028.7	-42.3	180.0

Source: Central bank of Lesotho Annual Reports, various issues.

Relatively free entry into the market was practised partly because most applicants have been renowned British and SA banks (Central Bank of Lesotho, 1989). It was perceived that because of cross border banking that already existed, the usual exposure to risk in the initial period of operation was minimal and that new entrants were not developing a new client base though they might have to change their policies in line with those of the new market.

The high degree of concentration in the sector resulted in very little competition among financial institutions in the country. The degree and nature of government intervention in the sector have worsened this. The tax policy exempted government owned banks from tax while their foreign counterparts were subject to tax. Although this policy seemed in favour of the financial institutions, it practically discouraged competition as it provided an uneven ground for competition while it also weakened the culprit banks' ability to compete actively in the market and limited credit to other sectors. In addition a policy of administrative determination of interest rates, which resulted in large spreads between lending and deposit rates, was practised. In setting the interest rates, the SA interest rates were used as a benchmark to limit financial price differentials.

Although the CMA allowed free capital mobility among members, capital controls were put in place. Financial institutions were required to hold at least 85 percent of local liabilities within the country and no more that 15 percent abroad. The

requirement was to ensure that financial institutions invested most of their assets locally. However, given the high risk associated with private sector lending in Lesotho, financial institutions hardly ever complied with this requirement.

Supervision was conducted largely on the basis of off-site surveillance. Inspection was carried out through monthly reports compiled by the financial institutions. Occasional on-site inspections were carried out to ascertain the accuracy and completeness of data submitted for off-site inspections and to evaluate capital adequacy, overall risk exposure, quality of management and other internal procedures (Central Bank of Lesotho, 1990). Often, inspections revealed that financial institutions hardly complied with the capital controls nor the liquidity and reserve requirements.

Evidence shows that despite capital inadequacy and failure to meet other requirements for entry into the SA financial market, local banks could not successfully compete with their SA counterparts or operate in SA because of a bad reputation of fraud incidences for which timely corrective measures had not been taken. In general the sector was backed by a weak and fragile legal system, which resulted in deficiencies in law enforcement and mismanagement.

4.3 The financial sector after reforms

Financial sector restructuring and liberalisation has been underway since the implementation of the structural adjustment programs in 1988 against a background of the deteriorating performance of the sector. At the inception of the programs, the broad objective of government towards the financial sector was to enhance financial intermediation through broadening the range of money market instruments available for policy consideration (Ministry of Economic Planning, 1997). From a broad perspective the government's objective has been to ensure closer regional and international linkages to strive to keep up with the recent changes in the global financial markets. It was envisaged that these would be achieved by adopting among others policies that would encourage and enhance cross border banking with minimum restrictions in order to stimulate competition and efficiency within the CMA, establishing a CMA payments system and reduction or elimination of capital controls.

Table 2: Selected indicators of developments in the financial sector

	MARKET SHARE OF LOCAL BANKS VERSUS FOREIGN BANKS (%)	% CONTRIBUTION OF FINANCIAL SECTOR TO GDP	FINANCIAL INTERMEDIATION RATIO(%⁵ M2/GDP)	SHARE OF BANKING SECTOR ASSETS IN GDP	CAPITAL-ASSET RATIO OF BANKING SECTOR
1990	61 ⁶	9.8	41.1	38.5	10.2
1991	64	11.3	37.3	40.9	10.0
1993	68	7.5	37.6	45.9	11.1
1995	39	6.3	31.4	35.1	10.8
1996	-	5.4	29.7	35.3	7.4

⁵ A measure of M2 includes only Maluti denominated currency.

⁶ 1985 figure

Source: Central bank of Lesotho Annual and Quarterly reports, various issues

Although improvements have been realised in other areas following the reforms, the performance of the banking sector deteriorated tremendously during and after the reforms. The contribution of financial and insurance services to domestic output had been increasing moderately to a peak in 1991. From a growth of 4 percent in 1990, the growth of the financial and insurance services sector registered 20 percent in 1991. Its share to domestic output increased from 10 percent in 1990 to 11 percent in 1991. However, since 1991 their share in output has fluctuated but with a generally declining trend. In 1992 the share of the sector to total domestic output had fallen to 8.4 percent. This trend continued to a remarkable 5 percent in 1996 showing the declining importance of the sector in total domestic output. On the other hand the market share of the local banking institutions in terms of other assets other than fixed assets has fallen from 61 percent in 1985 to 39 percent in 1995 (Lesotho Bank, 1995). Similarly the importance of commercial banks in output has been declining since 1987. From 55 percent in 1987, assets of the banking institutions as a percentage of GDP declined by almost 20 percentage points to 35 percent in 1996. The foregoing analysis shows that since the late 1980's the banking sector has drifted away from the key position that it held in terms of its contribution to output in the economy (Central bank of Lesotho, 1996).

This trend was also reflected in an accelerated series of bank failures during the reform period. In the late 1970s, the Lesotho Building Finance Corporation had suffered serious management problems that originated from bad lending practices (World Bank, 1990). This institution operated on subventions from government, a policy which government could hardly sustain. Although the corporation was capable of raising funds through deposits, that option proved to be expensive since lending rates were not at commercial rates. The government regulated lending rates while the corporation had to compete for deposits with other financial institutions. Failure to eliminate weaknesses in the control of records, which was inherited from the past, jeopardised prospects of recovery. The continuation of this trend led to a merger of LBFC with the government development bank, Lesotho Bank in 1993.

In the beginning of the 1990s, the performance of Lesotho bank also showed signs of distress that continued to the latter part of the decade. In 1990 the bank suffered a reduction in net income by 6 percent from the previous year, while the operating costs increased by 1.4 percent (Lesotho Bank, 1995). This situation was also reflected in the continuous decline of its market share.

The distress of the banking system was reflected in other local financial institutions as well. The Agricultural Development Bank was experienced similar, which led to its closure in September 1998. The poor performance of the bank was a result of high operating costs relative to net income and poor repayment record of customers. The problem was exacerbated by the relatively rapid expansion of the banks to a number of areas, some of which were not efficiently used because of the low population served by such agencies.

At the present the banking sector consists of only two foreign banking institutions. Although this symbolises the decline in government intervention in the sector in line with the privatisation and reform process and is expected to produce benefits in the

long run, it has come with costly consequences for the economy as a whole. Due to the relative openness of the economy as dictated by the CMA arrangement, loss of confidence in the banking sector and close proximity of the stronger and more developed SA financial system, the economy experienced large capital outflows despite efforts of government to keep interest rates close to that of SA. At the same time, because of the unstable political environment, investor confidence in the economy has waned. As a result, the entrance of new participants in the market following the reforms has not been experienced as had been envisaged. This is partly a result of government's effort to ensure that requirements for entry into the market are adhered to. It may also be due to an upward revision of entry requirements to discourage entry of unfit institutions. Although the existing institutions have increased the number of instruments in the market, the market is much more concentrated and lacks competition. This tends to penalise the market participants in terms of the stickiness of prices in the market. The following table shows the growth of credit to the private sector and the spread between the lending and deposit rates from 1990 to 2000.

Table 3: Indicators of developments in the financial sector during and after reforms

YEAR	GROWTH OF PRIVATE SECTOR CREDIT	INTEREST RATE SPREAD
1990	19.7	4.5
1991	33.4	7.0
1993	18.0	8.0
1995	28.6	10.35
1997	22.1	11.1
1999	-0.09	18.0
2000	5.5	17.0

Source: Central Bank of Lesotho Annual reports, 1992 and 2000

The large and growing difference between the lending and deposit rates of interest shows the extent to which agents are penalised by the market. The interest spread seems to have been particularly large in towards the end of the 1990s. This may be taken to indicate the severity of the conditions after the failure of the last and largest local bank at the end of 1998. Similar conditions are portrayed by the growth of credit to the private sector at corresponding times.

5. IMPORTANT LESSONS FROM LIBERALIZATION IN AN UNSTABLE FINANCIAL SYSTEM

As Montiel (1995) notes, in many Latin American countries liberalisation was unsuccessful because it was undertaken in unstable macroeconomic environments and under weak regulatory frameworks. Moreover, because financial instability can easily be transmitted into other countries, globalisation carries a huge amount of risk. Given that the policy is well designed and monitored it has the potential of enhancing market discipline and promoting the soundness of the market. Knight (1998) notes that currently the financial systems of developing countries are plagued by information uncertainties and inefficiencies, which present a major hindrance to successful liberalisation. Demirguc-Kunt and Detragiache (1998) verified the fact that financial liberalisation increases the probability of banking crises in a large sample of countries.

Given that the financial sector of Lesotho has been subject to costly financial distress for almost two decades, it is obviously not robust enough to withstand external shocks that come with liberalisation. In most developing countries and in the particular case of Lesotho the financial system comprises only a few commercial banks and insurance companies. The non-existence of the element of variety is a hindrance to competition and therefore provides a weak base that is susceptible to shocks. On the other hand this implies that the system is likely to be overcome by heavy flow of capital that accompanies the liberalisation and globalisation of the market. The non-existence or the malfunctioning of a key market adversely affects the ability of financial system to resist shocks. In the case of Lesotho the malfunctioning of the existing markets is mainly a result of fragile regulatory and legal frameworks. This represents a significant gap in the structure of the financial system because the banking sector is the main conduit of monetary policy. The competitiveness of the market holds a stake in determining the efficiency with which the crucial functions of credit supply, clearing and payments, foreign exchange and assessment of risk and returns for investments are performed.

In perfectly competitive markets, an individual bank can have its share of deposits at a constant cost. However, intermediation becomes costly and less efficient in imperfect and highly concentrated markets because less stock of credit is supplied at higher costs to borrowers, while depositors are offered a lower rate of interest as compared to that of the competitive case. This is precisely the case that is reflected by the financial market of Lesotho.

The foregoing analysis has two important implications. Firstly, lower levels of credit are supplied in an imperfectly competitive banking sector than in a competitive banking sector. Secondly, imperfect competition results in less efficient intermediation. This suggests that a non-competitive banking system responds to problems of non-performing loans by reducing lending while increasing the intermediation spreads. According to Knight (1998), this response tends to depress economic activity and increases the probability of banking crises.

Imprudent regulatory and supervisory systems are at the fore among the factors that have contributed to the financial crisis that the economy of Lesotho is experiencing currently. The condition was made even worse by the weak legal system. Off-site surveillance as has been used in Lesotho, can hardly be adequate as a cornerstone of monitoring a financial system, no matter how small the sector is. Through this system it is hardly possible to detect risky activities until it is too late. This has enabled banks, which are distressed to gamble for redemption and to assume unhedged exposures. Unfit financial institutions, in this particular case, specialised banking institutions were basically allowed to expand risky activities at rates that exceed their potential to manage them. The foregoing analysis therefore suggests that liberalisation can increase the risk of, or intensify financial crises in settings where it is not backed by rigorous regulatory and supervisory procedures. In addition, the external dimension of liberalisation expanded cross-border activities. This has in turn increased degree of international market dependence that requires increased vigilance since the domestic market is now vulnerable to financial disturbance originating elsewhere.

6. REGIONAL EFFECTS

The spread of financial crises beyond a country's borders poses a threat to neighbouring economies. The high probability of cross-border contagion necessitates consideration of regional effects, especially for countries that are members of regional trade agreements. This is particularly a threat to smaller economies with equally small and underdeveloped and fragile financial systems than for larger economies. A common example is the Asian financial crisis. Financial fragility that resulted from among others a weak macroeconomic conditions, weaknesses in the financial sector, failures and corruption in the corporate sector and improper sequencing of the liberalisation strategy is identified as the main element that facilitated the accommodation of the crisis into the neighbouring economies (Lane, 1999)⁷.

Lesotho is a member of a number of regional trade and monetary arrangements including SADC, SACU and CMA. The real challenge for financial systems in this setting is much more than maintaining healthy financial and macroeconomic environments in their domestic economies. The usual recommendation in this setting is stronger and closer co-operation between the members. The current wave of globalisation carries the challenge of being able to maintain an integrated financial system that keeps up with changes in the international financial markets. To avoid conflicts between regional and global arrangements requires the maintenance of effective global and regional trade rules as well as an institution to enforce them. Tiemeyer (1999) identifies three approaches available for participants in the global financial system to reap the benefits of free mobility of capital. These entail identifying sources of problems in both national and international financial systems. Co-operation in this exercise allows the authorities to create a pool of quality information that could be used to evaluate domestic and global financial conditions. This will assist in the formulation of appropriate national, regional and global regulatory and supervisory strategies. The development of and adherence to international rules and standards of practice should follow this. This will ensure that gaps in standards and codes of conduct are identified and filled timeously. Co-operation and co-ordination between national authorities and international regulatory bodies is the key to the success of this exercise. Nations should then make arrangements for consistent and co-ordinated implementation of standards by financial institutions. The effectiveness of the above strategies will require improved supervision. This therefore calls for closer co-operation between national supervisory authorities.

Though there is almost mutual agreement on the need for financial reforms, there is no standard sequence of liberalisation that guarantees favourable outcomes. This is more often blamed on lack of data on the practices of various financial regulatory and supervisory authorities as well as disclosure of information by banking institutions themselves yet the activities of banking financial institution can inhibit or promote economic development. This means that current efforts of reformations are made without much knowledge of whether or under what circumstances and to what extent they can be successful. (Bath, Caprio and Levine 1999).

⁷ See also Chang, 1998 and Lauridsen, 1998.

The frequency with which developments in the global financial markets take place warrants increased watchfulness by the supervisory and regulatory systems in both the local and the world markets. This implies that the traditional slow process of changing rules and adapting to new environments carry a risk of the economy being left behind or swept away by the tide. In the light of these developments, the emphasis on mechanistic quantitative rules seem to have been antiquated as they no longer adequately control the complex risk structures of the modern financial system. According to Artopoulos (1997), risk management provides more protection to a firm than capital adequacy. The use of capital adequacy as a tool of assessing risk needs to be complemented with non-quantifiable risk measures. This suggests that internal risk management structures have to be given more weight than other safeguard measures.

5. CONCLUDING REMARKS

Financial markets play a vital role in the development of any capitalist economy. Their role has become even more crucial given the current shift of emphasis from trade in commodities to services and the experiences of financial crises in global economy. It is therefore obvious that in a modern economy, a sound financial sector, which constitutes the banking sector in most developing countries, is a pillar of a viable macroeconomic system that has a potential to grow. This paper set out to assess the benefits and costs of financial liberalisation in the context of a small developing economy that is part of regional trade and monetary arrangements. The analysis has shown that premature implementation of financial liberalisation can prove to be detrimental to the financial sector and the economy. The developments in the global financial markets have obviously left behind the financial markets of most developing economies. A combination of these development and the problems that plague these financial markets, most of which are structural, has left them in a position of extreme distress. A partial relief to this status has been realised in some cases through liberalisation and reform processes. However, a large number of them are still unable to keep pace with the rapid changes in the global markets. This requires intensified measures to strengthen the financial systems and to create capacity for them to withstand heavy capital flows that result from policy elsewhere.

REFERENCES

- Agenor PR. and Montiel PJ 1996. *Development Macroeconomics*. Princeton University Press. New Jersey.
- Artopoulos W. 1997 'Prudential Supervision and Globalization of the Banking Sector: A National Supervisor's View' in Enoch C. and Greed JH. (eds.) *Banking Soundness and Monetary Policy, Issues and Experiences in the Global Economy*. IMF. Washington.
- Barth JR, Caprio G and Levine R. 1999. 'Financial regulation and performance' *World Bank Policy research paper 2037*. World Bank
- Berthelemy JC. and Varoudakis A. 1996. 'Models of financial development and growth: A survey of recent literature' in Hermes N. and Lensink R. (eds.) *Financial development and economic growth: theory and experiences from developing countries*. Routledge. London.
- Brecher R. and Diaz-Alejandro C. 1977. 'Tariffs, Foreign Capital and Immiserizing Growth' *Journal of International Economics*. Vol. 7 pp. 317-322
- Brownbridge M. 1988. 'The Causes of Financial Distress in Local Banks in Africa and Implications for Prudential Policy.' *UNCTAD Discussion Paper No. 132*. United Nations.
- Central Bank of Lesotho. 1986-2000. *Central Bank of Lesotho Annual and Quarterly Reports*. Central Bank of Lesotho. Maseru.
- Chang H. 1998. 'Korea: The misunderstood crisis'. *World Development*. 26(8) pp.1555-1561
- Chick V. 1993.' The evolution of the banking system and the theory of monetary policy'. In Frowen S. (eds.) *Monetary theory and monetary policy*. St. Martin's Press. New York.
- Demirguc-Kunt A. and Detragiache E. 1998. 'The Determinants of Banking Crises in Developing and Developed Countries.' *IMF Staff Papers*. Vol. 45 No. 1
- Dow S. 1999. 'The stages of banking development and the spatial evolution of financial systems' in Martin RL. (ed.) *Money and the space economy*. Wiley. Chichester.

- Eichengreen B. 1996. *Globalizing Capital*. Princeton University Press. New Jersey.
- Eichengreen B, Mussa M, Dell'Ariccia G, Detragiache E, Milesi-Ferretti GM and Tweedie A. 1998. 'Capital Account Liberalization, Theoretical and Practical Aspects.' *Occasional Paper 172*. IMF.
- _____ 1999. 'Liberalizing Capital Movements, Some Analytical Issues.' *Economic Issues 17*. IMF.
- Fry JM. 1995. *Money, Interest and Banking in Economic Development*. John Hopkins University Press. London.
- Ghosh DK. and Ortiz E. (eds.) 1997. *The Global Structure of Financial Markets, An Overview*. Routledge. London.
- IBRD. (1974). *The Economy of Lesotho*. IBRD. Washington.
- International Trade Centre (ITC) and Commonwealth Secretariat (CS). 1995. *Business Guide to the Uruguay Round*. ITC/CS. Geneva.
- Jomo KS. 1998. 'Financial liberalisation, crises, and Malaysian policy responses'. *World Development*. 26(8) pp.1563-1574
- Knight M. 1998 'Developing Countries and Globalization of Financial Markets.' *IMF Working Paper WP/98/105*. IMF.
- Kono M, Low P, Luanga M, Mattoo A, Oshikawa M and Schuknecht L. 1998. 'Opening markets in financial services and the role of the GATS' *WTO Special studies*
- Lane T. 1999. 'The Asian Financial Crisis. What Have We Learned?' *Finance and Development*. IMF.
- Lauridsen LS. 1998. 'The financial crisis of Thailand: Causes, conduct and consequences?' *World Development*. 26(8) pp. 1575-1591
- Lesotho Bank. 1990-1995. *Lesotho Bank annual reports*. Lesotho Bank. Maseru
- Levine R, Loayza N and Beck T. 1999. 'Financial Intermediation and growth, causes and causality' *World Bank Policy research paper 2059*. World Bank
- Matlanyane RA. 1999. 'Financial Liberalization and Globalization in a Fragile Financial Environment: The Case of Lesotho.' Paper presented at the 21st Southern African Universities Social Science Conference in Malawi
- McKinnon RI. 1973. *Money and Capital in Economic Development*. Brookings Institution. Washington.

- Mehran H, Ugolini P, Briffaux JP, Iden G, Lybek T, Swaray S and Hayward P. 1998. 'Financial Sector Development in Sub-Saharan African Countries' *Occasional Paper 169*. IMF.
- Ministry of Economic Planning. 1997. *Economic Options for Lesotho*. Government of Lesotho. Maseru.
- Montiel PJ. 1995. 'Financial Policies and Economic Growth: Theory, Evidence and Country-Specific Experience from Sub-Saharan Africa'. *AERC Special Paper 18*. AERC. Nairobi
- Petersson L. 1993. 'Structural Adjustment and Economic Management in a Dependent Economy: The Case of Lesotho.' in Blomstrom M. and Lundaht M. (eds.) *Economic Crisis in Africa, Perspectives on Policy Responses*. Routledge. London.
- Rodrigues F. and Rodrik D. 1999. 'Trade policy and economic growth: A skeptic's guide to the cross-national evidence.' *NBER Working paper 7081*. NBER
- Shaw ES. 1973. *Financial Deepening in Economic Development*. Oxford University Press. New York.
- Tietmeyer H. 1999. 'Evolving Cooperation and Coordination in Financial Market Surveillance.' *Finance and Development*. IMF.
- Vamvakidis A. 1999. 'Regional Trade Agreements versus Broad Liberalization: Which Path leads to a Faster Growth?' *IMF Staff Papers*, Vol. 46. No. 1.
- Wahba J. and Mohieldin M. 1998. 'Liberalizing trade in financial services: The Uruguay Round and the Arab countries'. *World Development*. 26(7) pp.1331-1348
- World Bank. 1983. *Economic Memorandum on Lesotho*. World Bank. Washington.
- World Bank. 1990. *Lesotho Financial Sector Review*. World Bank.
- World Bank. 1997. *Private Capital Flows to Developing Countries: the road to financial integration*. Oxford University Press. Oxford