Financial Sector Reform and Economic Growth in Zambia- An Overview

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Abstract:
Over the recent past financial sector reform especially in SSA has become a challenging task for policy maker, academician and practitioner. In This paper, I will attempt to review of Mahendra pal (2012) research. In his paper (Mahendra pal's), he attempts to trace the relationship between financial deepening and growth for the period of 10 year (i.e. 2001-2010). He takes Data source from Bank of Zambia and World Bank. The paper analyses the trends of GDP growth rate and financial deepening in Zambia during the reform period. The paper finds that Zambian economy has not been able to improve the level of financial deepening. However, Zambian record of economic performance during the recent past remains very impressive. He concludes that the financial system has not been able to increase an effective financial intermediation, which is reflected in terms of rising M2/GDP ratio.

Keywords: *Financial Repression; Financial Deepening; Economic Growth*

1. Zambian Macroeconomic Policy - An Overview

Financial sectors in Sub Saharan Africa (SSA) have not been able to contribute significantly to the economic growth especially in low- income countries of Africa. The financial system is shallow in African countries as compared to the size of their economies. The range of institutions is narrow and dominated by commercial banks. Limited access to basic financial services, including credit availability continues to pose a major obstacle to entrepreneurial activity and welfare movement. It is worth nothing that some progress is being made as financial system continues to reform, broaden their product base and deepen their lending and their reach. Deeper and more efficient financial systems are critical for growth prospects. The basic objective of this paper is: to evaluate the financial sector reforms in Zambia based on the research paper by Mahendra Pal.

In his research paper on Zambia (2012), he has discussed the monetary and fiscal policy, exchange rate policy, current account deficit, external debt policy of Zambia. Taking into account all the policies, he goes further to discuss the financial sector reforms. He provides detailed analysis of financial repression theory developed by Mckinnon-Shaw (pp. 155-156, 1973). The most notable feature of the study is that Mahendra Pal has applied their theoretical framework of Mckinnon-Shaw to the Zambian economy for the period of two decades. So far research methodology is concerned he has applied an analytical approach. He has used secondary data especially from IFS of the IMF and World Development Indicators. He has also given a detailed analysis of theoretical and empirical review, specially on Zambian economy.

2. Monetary and Fiscal Policy

The outlook for the Zambian economy remains favourable in the medium term, supported by the robust growth and single-digit inflation. The economy is projected to grow 6.9% in 2012, picking up to 7.3% in 2013, while inflation should remain in single digit, at 8.0% and 8.5% respectively.

The country, however, remains vulnerable to external shocks, with a sluggish global economic recovery a concern for its key mining exports. Zambia's economic growth slowed to 6.6% in 2011 from 7.6% in -2010, mainly as a result of a weaker mining sector performance. However, the medium -term economic outlook appears to be favourable, in the light of sustained expansion in agriculture, construction, manufacturing, transport and communications, and by a rebound in mining, inflation is projected to remain in single digit, reflecting prudent monetary policy.

The objective of exchange rate policy is to maintain external competitiveness. Increasing domestic revenue collection remains a priority for the medium term and large infrastructure developments will require additional resources. The Government plans to raise US $ 700 million via a bond issue in 2012 to cover a finding gap for infrastructure projects. This infrastructure investment is expected to boost growth by up to 2 percentage points per annum. Risks to the outlook include Zambia's vulnerability to exerna1 shocks and a sluggish global economic recovery which could reduce demand for exports. Moreover, maintaining investor confidence has emerged as a key issue after the Government reversed the privatization of Zambia's telecoms catchpenny. Tackling high youth unemployment and poverty remains a top priority, with as much as 60% of the population below the poverty line, although there are wide disparities between rural and urban areas. Part of this high level of poverty is due to lack of employment opportunities for youth. Table 1 reveals the current macroeconomic indicators for Zambia.

Table 1. Macroeconomic Indicators of Zambia

Year	2010	2011	2012	2013 A
Real GDP growth rate*	7.6	6.6	6.9	7.3
Real GDP per capita growth	4.8	3.7	3.9	4.2
CPI inflation**	8.5	8.7	8	8.5
Budget balance & GDP	-3	-2.6	-3.6	-3
Current account % GDP	.3.6	5.4	3.6	4

A Projected figure - * Gross Domestic Product, **Consumer Price Index Inflation
Source: African Economic Outlook. 2012

3. External Sector

The external sector remained strong in 2011, with an increase in the current account surplus to US$ 951 million equal to 5.4% of GDP, from US$ 614.7 million or 3.6%' 2010 as mining sector exports grew 15% to US$ 7 billion from JS$ 5.8 billion, accounting for more than 80% of total merchandise exports. The strong external performance increased the level of foreign exchange reserves to more than four months of import cover. In 2012, the current account surplus is expected to narrow to 3.6% of-GDP, due to possible reduction in mining earnings in view of the sluggish global economic recovery. In 2013, a recovery in the global economy will benefit metal prices and revive demand for Zambia's non-traditional products, which should boost the current account surplus back to 4.0% of GDP.

4. External Debt Policy

Zambia's risk for external debt distress remains low, mainly because of the government's cautious approach following a significant reduction in borrowings under the Heavily Indebted Poor Countries and Multilateral Debt Relief initiatives of 2005 and 2006. These initiatives significantly improved Zambia's external debt sustainability, with the debt service to exports ratio falling to less than 4% in 2011 from 11% in 2005. The government's current debt strategy focuses on limiting non-concessional borrowing to economically productive investments. In 2011 the government contracted some US$ 505 million to finance infrastructure projects, compared with debt repayments worth USD 200 million in the year. In 2012 the government plans to issue a US$ 700 million bond to cover an infrastructure finance gap estimated at US$ 500 million. This will increase Zambia's external debt but the current level of economic growth means it should be sustainable. The government is trying to improve and consolidate debt management, tightening up oversight procedures. The government has also agreed to share information with the IMP before contracting any none Concessional loans. In 2011 a debt management performance assessment made recommendations in areas needing improvement.

5. Financial Sector Reforms

Before economic reforms of the 1990s, the financial system was repressed in Zambia. Interest rates, credit allocation and exchange rates were strictly regulated. Credit allocation was in favour of preferred Sectors notably Government, agriculture and mining sector. Government organizations were given priority and received the buck of total funds. Interest rates were administered with upper ceiling; exchange rates were fixed with controls on capital movement. The system was working below market clearing level. Under this system, financial system failed to increase the level of saving and investment and ultimately economic growth. With high inflation and low deposits rates and thus negative real interest rates, all these factors were responsible for economic stagnation. Moreover, low allocative and operational efficiency were also there. Due to growing awareness of economic cost of financial repression, the Government of Zambia started a programme of financial sector reforms in 1992. The programme included interest rate liberalization and interest rate structure was made market oriented. The Government also introduced the T Bill. Bill auction system in 1993. The result of the interest rate liberalisation process was the increase in lending and deposit rates. The lending rates have become positive in real terms, but deposit rates are still negative. The higher lending rates than deposit rates have given a rise to huge interest rates spreads. In Zambia, commercial Banks have been maintaining high lending rates because of associated risks of default and high volume of non-performing assets on lending operations.

After sometime, the banking sector reforms were concentrated on the improvement of banking infrastructure, banking supervision, regulation, payment and settlement system. The Banking and Financial Act was introduced in 1994. Basel Capital-1 Accord for sound bank supervision and regulation was recommended. In 2002, Zambian Government adopted a more development oriented financial sector reforms, based on the recommendations of the IMF and World Bank's financial sector assessment report of 2002. Regional and private foreign banks also entered the economy to increase the competition and the market size.

6. Financial Deepening and Economic Growth in Zambia

Mahendra pal (2012) has conducted the research on the issue of financial deepening of economic growth in Zambia. In his paper he defines the meaning of financial deepening.

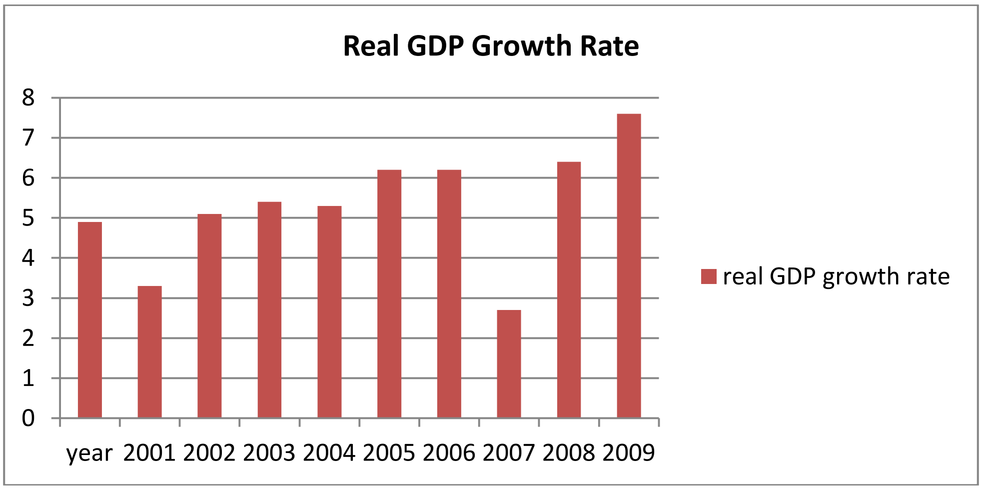
Financial deepening, as measured by, for example, the ratio M2/GDP, is an indicator of how well developed a country's financial system is. When the ratio is relatively low, the flow of loanable funds from lenders to investors is restricted. Encouragement of greater financial depth itself depends, to some extent, on the willingness of wealth holders to place saving with financial intermediaries (e.g. deposit banks, mutual funds, pension funds, life insurance companies) or to hold bonds or equity. Crucial here is the real rate of interest on, say, deposits. When this is positive, financial deepening is encouraged, but if it is negative, wealth holders will seek other less liquid means in which to hold their wealth (Pal 1997).

In his paper he shows the trends of real GDP growth rate of Zambian Economy and its financial deepening. GDP growth rate which was in very poor shape before 1990 has shown a remarkable progress during the period of financial sector reforms. However, the disappointing record of increase in financial deepening creates a problem and put a question mark on the success of financial sector reforms. If we see the record of financial deepening, it was 14.3% in 1966, it increased substantially in 1986 to about 24% and since after decline it is recovering gradually. The financial system of Zambia which includes the financial institutions, banking, money and capital market, and Government security market, has improved specially after 1991. But the real deposit rate, which is an important instrument in increasing the level of financial deepening, is still negative. It shows either high level of inflation rate or low deposit rates in banking industry of Zambia. If the Indian economy is compared with the Zambian economy in terms of level of financial deepening, a completely different picture is seen. India adopted her financial sector reform process after new economic policy of 1991, on a massive scale with a theoretical background of McKinnon-Shaw model (Pal 1997). India's level of financial deepening was more than 78% in 2009-10. Real deposite rate of interest remained positive during the last two decades.

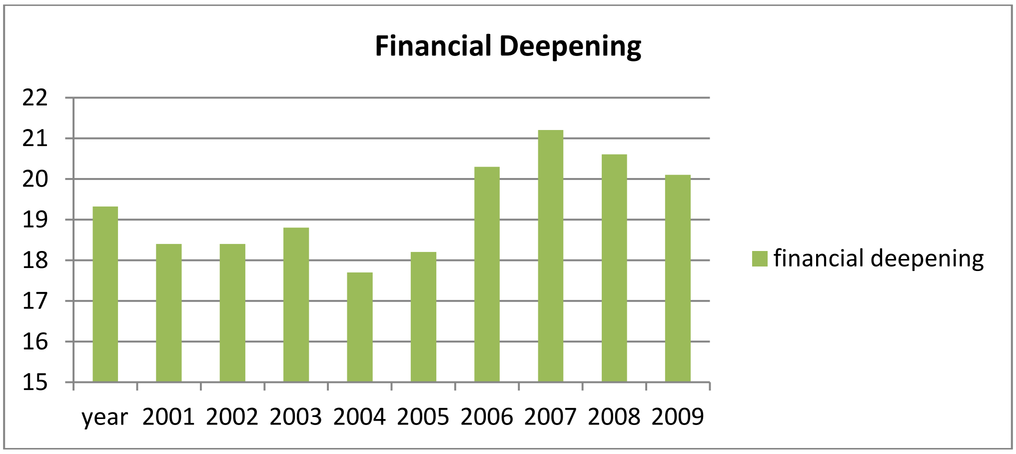
Table 2. Relationship between Real Growth Rate and Financial Deepening

Year	Real GDP Growth Rate	Financial deepening M^2/GDP (%)
2001	4.9	19.32
2002	3.3	18.4
2003	5.1	18.4
2004	5.4	18.8
2005	5.3	17.7
2006	6.2	18.2
2007	6.2	20.3
2008	2.7	21.2
2009	6.4	20.6
2010	7.6	20.1

Source: mahendra pal's calculation from Zambian data base (i.e. Bank of Zambia and World Bank)

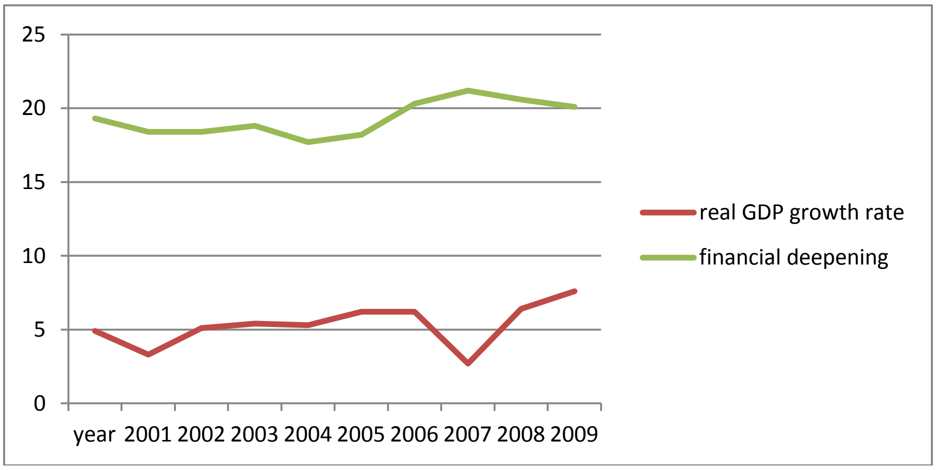


Author's calculation



Author's calculation

Relationship between Real Growth Rate and Financial Deepening



Author's calculation

Macroeconomic conditions in respect of external openness and the rate of inflation also have expected effects. Increases in the degree of external openness have positive effects on economic growth. Hence, opening up of the Zambian economy through liberalization of the current and capital accounts has contributed to increasing economic growth by significantly improving the availability of foreign exchange reserve. The country's foreign exchange reserves over the last 10 years have increased from less than two months of import cover to 5-6 months of import cover.

7. Indian Economy Compared

In his paper, pal. Mahendra (2012) has compared the progress of Zambian economy with the Indian economy, where the level of financial deepening has increased in an exponential growth after the economic liberalisation in 1991.

If we compare the Indian economy with the Zambian economy in terms of level of financial deepening, we find a complete different picture. India adopted her financial sector reforms process after new economic policy of 1991, in a massive scale with a theoretical background of Mckinnon-Shaw model (pal, mahendra. 1997). India's current level of financial deepening is more than 78% in 2009-10. Real deposit rate of interest remained positive during the last two decades. (Pal, mahendra. 2012)

It is essential to study the major bottlenecks in the smooth functioning of financial sector reforms.

1. In the area monetary policy management, it should be noted that although the economy seems to have attained relative macroeconomic stability, the rate of inflation is still high and the challenge to monetary authorities is the need to reduce current double digit inflation rates to a single digit and to achieve a relatively stable and competitive exchange rate in order to enhance confidence in the financial markets.
2. Government bonds and Treasury bills dominate the financial market in Zambia.
3. Innovative financial products such as negotiable certificates of deposits, bills of exchange and securitisation are hardly utilised in Zambia, with enterprises relying on more basic short-term financing instruments such as bank overdrafts.
4. Under developed secondary money and capital markets: The secondary trading of financial instruments in the market is very low or non-existent in some cases. The development of the

secondary market is crucial to the broadening and deepening of financial markets through increased liquidity and efficient price recovery.

5. The banking system is characterised by a number of inefficiencies which are reflected in wide interest rate spreads and high bank charges on bank services. (pal, mahendra. 2012)

8. Conclusion

In the end, in his paper the central focus is that a high level of financial deepening is a necessary condition for accelerating growth in an economy. He concludes that this is because of the central role of the financial system in mobilizing savings and allocating the same for the development process. The financial sector reforms adopted by the Zambian economy since 1991 onwards appears as based on the theoretical backdrop of McKinnon Shaw theory of liberalization. Secondly, the paper analyses the trends of GDP growth rate and financial deepening in Zambia during the reform period. Zambian economy has not been able to improve the level of financial deepening (i.e. M2/GDP ratio) which remains around 20%, Even this ratio declined in the reform period. However, Zambian record of economic performance during the recent past remains very impressive. We found from the paper that the financial system has not been able to increase an effective financial intermediation, which is reflected in terms of rising M2/GDP ratio. Thus, the regulatory framework should be strengthened and restructured to ensure good risk management, through implementation of Basel Accord which deals with high capital adequacy ratio and effective prudential norms. Even after his good efforts about the analysing of financial sector reforms, one is tempted to suggest for further investigation theoretically and empirically.

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