

## Caleb M Fundanga: Banking in Zambia and the Kwacha appreciation

Speech by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the German Ambassador's working lunch, Lusaka, 7 June 2006.

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- Your Excellency, the Germany Ambassador to Zambia, Dr. Ireen Hinrichsen;
- Representatives of German Banks in South Africa;
- The German Business Community;
- Representatives of Local Banks;
- Distinguished Ladies and Gentlemen.

On behalf of the Zambian people and indeed on my own behalf, it gives me great pleasure to welcome our German visitors to Zambia. I am deeply humbled to be invited for this business luncheon hosted by Your Excellency. This interaction, Distinguished Ladies and Gentlemen, is very important to foster and enhance mutual co-operation between our two great nations.

Your Excellency, with your permission, I will begin my address by discussing banking in Zambia and then proceed to give some highlights on the recent economic developments in the country.

Distinguished Ladies and Gentlemen, in the early 1990s, Zambia embarked on economic liberalisation, of which reforming the financial sector was a major part. Specific measures which were undertaken included, among others, the removal of all restrictions on interest rates and elimination of controls on foreign exchange rates. Interest and exchange rates are now market determined, principally based on demand and supply.

A Bank of Zambia review of interest rates determination in 2003, nonetheless, showed that the key determinants of commercial banks' interest rates, particularly the lending rate, were the yield rates on Government securities, level of statutory reserve requirements, inflation, weak policy credibility and high default risks on loans obtained.

To enhance the role of the market in the determination of exchange rates, the Interbank Foreign Exchange Market (IFEM) trading system was introduced in July 2003. The entrenchment of the IFEM trading system has been characterised by increased interbank foreign exchange liquidity flows, particularly from mineral exporters.

The financial sector reforms were aimed at improving the efficiency and intermediation of the banking system and also at enhancing competition amongst the players. The reforms entailed opening up entry of participants into the banking sector.

With the liberalisation of the financial sector, several bank and non-bank financial institutions were established. The financial sector has expanded remarkably over time and the services provided have been improved.

- The number of commercial banks has more than doubled to 13 from 4 banks prior to 1990. Currently, the banking system is made up of the Bank of Zambia, which is the central bank, and 13 commercial banks, with a branch network of 159 as at end-December 2005 compared to 123 in 1990.
- Commercial banks have improved the range of products offered to customers, in line with global innovations. These include Automated Teller Machines (ATMs), foreign exchange accounts, Visa, mortgages, and leasing services. In 2005, 4 commercial banks launched the E-switch facility to allow their customers to share their ATMs and other payment delivery channels, like point of sale terminals. These services were unheard of before the reforms and were supported by the international community.
- Commercial banks have also embarked on other initiatives including expansion programmes based on the community banking concept. This is consistent with the rural banking concept and is intended to provide financial services to those sectors of the community that are not currently serviced by the banking sector.

Your Excellency, to meet the challenges which come with an expanded banking sector and in our desire to continue modernising the overall financial sector, it has been imperative to strengthen the prudential and supervisory mandate of the Bank of Zambia. In this regard, the key initiatives that have been endorsed, with an ultimate goal of promoting safe, sound and efficient operations have included:

- The enactment and amendment of the Banking and Financial Services Acts in 1994 and 2000, respectively.
- The implementation of the Banking Supervision Application Project, aimed at supporting banking supervision and providing a framework for supervision with the view of having a safer financial sector

Distinguished Ladies and Gentlemen, in order to promote greater access by the population to banking and financial services, the following have been implemented:

- Establishment of an automated electronic clearing house in 1999, (to speed up processing cheques from 4-10 days for local and country checks, to 2-5 days, respectively), enhancing the security of cheques and introducing machine-readable cheques.
- Establishment of a direct debt and credit clearing system (DDACC) and a realtime gross settlement system (RTGS) called *Zambian Interbank Payment and Settlement System (ZIPSS)* in October 2001 and June 2004. The DDACC system has facilitated the transfer of money by electronic means for payment of bills and salaries while RTGS allows a speedy, safer and large value clearing facility. Commercial banks have also set up a foreign currency cheque clearing system.
- The adoption of the Financial Sector Development Plan (FSDP). This is a framework which aims to promote the development of a stable, sound and market-based financial system that would support efficient resource mobilisation necessary for economic diversification, sustainable growth and poverty reduction. Currently, key recommendations of the FSDP are under implementation. For example, the creation of a Credit Reference Bureau will improve the information available to credit providers in order to enable them to make better credit decisions.

Your Excellency, the *Zambian Government* recognises the importance of expanding financial services to our rural areas, as part of its overall strategy to reduce poverty. The importance of the agricultural sector to the economy, in general, and small-scale farmers in particular, has made provision of financial services to rural areas a priority on the *Government's* agenda. The need to improve financial services in economically disadvantaged areas also comes in light of the reduction in the presence of a number of banks in these areas over the last ten years. These areas need banking services from both commercial banks and non-bank financial institutions.

Distinguished Ladies and Gentlemen, although this has been the case, the *Microfinance Institutions (MFIs)* have risen to the occasion to fill-up the gap in the provision of financial services such as small loans and savings facilities in the periurban and rural areas. In addition, the *National Savings and Credit Bank (NSCB)*, formerly known as *Postal Bank*, which has a rural network has been providing financial services to the remote parts of the country.

Your Excellency, coming to economic developments, I wish to state that the *Zambian economy* has performed relatively well in recent years. Inflation and interest rates have been coming down while the exchange rate of the *Kwacha* against major currencies has relatively stabilised, following a steep appreciation in 2005.

Distinguished Ladies and Gentlemen, in 2005, the economy registered growth of 5.0% in real terms, marking the seventh consecutive year of positive real growth in output. This growth was largely due to the expansion in construction, driven by a robust demand for housing as well as large-scale investment which led to a marked pick-up in mineral production, particularly of copper. Other sectors such as tourism as well as transport, storage and communications also contributed to the overall economic growth.

Inflation declined to 15.9% at the end of December 2005 from 17.5% at the end of December 2004 despite several setbacks. These included the partial drought that significantly reduced food supply and high prices of oil and petroleum products. Attainment of single digit inflation has been *Government's* goal for a long time. It is, therefore, encouraging to see inflation coming down in recent months, reaching a single digit level of 9.4%, in April 2006 and dropping further to 8.6% in May 2006.

Ladies and Gentlemen, accounting for this favourable out-turn in inflation was appropriately tight monetary policy, aided by prudent fiscal policy and the relative strengthening of the Kwacha. The bumper maize harvest this season has helped to ease pressure on food prices and to keep food inflation and thus overall inflation low. To ensure that inflation remains low and stable, it is imperative to continue maintaining a tight monetary policy, prudent fiscal policy and a relatively stable exchange rate.

In the Government securities market, developments in yield rates were mixed in 2005. Overall, the composite weighted average Treasury bill yield rate stood at 16.2% in 2005, down from 17.8% recorded in 2004. In contrast, the composite yield rate on Government bonds stood at 23.0%, up from 20.9% registered in 2004. As at May 29, 2006, the composite weighted average Treasury bill yield rate came down sharply to 6.5% while the composite yield rate on Government bonds declined to 11.0%. The sharp reduction in yield rates on Government securities has been due to low inflation expectations, coupled with high demand for these securities by Banks, the non-bank Private and Public financial institutions, and foreign portfolio investors.

You may wish to know, Your Excellency, that there are no restrictions with regard to foreign participation in the Government securities market. With continued improvements in the macroeconomic environment, investor confidence is heightened with foreign portfolio investment in Government securities recording appreciable growth. Foreign portfolio investments in Government securities increased to K400 billion at end-December 2005 from K5.6 billion at end-July 2005.

Distinguished Ladies and Gentlemen, with respect to developments in the money market, commercial banks lending rates have also been coming down, though not as fast as the decline in inflation and Treasury bills rates. Commercial banks nominal weighted average lending base rate declined from 29.8% in 2004 to 27.6 % in 2005. As at May 30, 2006, the weighted average lending base rates stood at 22.5%. Clearly, there is a need for commercial banks to do more to reduce lending rates in order to influence a substantial expansion of private sector credit. Lower lending rates will contribute to the reduction in the cost of doing business in Zambia. Sustainable lowering of lending rates by commercial banks should occur in the current environment of low inflation.

Your Excellency, the next issue I would like to address is that of the appreciation of the Kwacha against major currencies. The appreciation has occurred mainly due to the higher supply of foreign exchange on the market than demand. The key factors underlying the increased foreign exchange supply include:

- increased copper output and exports as well as record high prices of the commodity. Copper exports volume has in recent years registered sustained growth, increasing from 353,000 metric tons in 2003 to 423,000 metric tons in 2005. The price of copper rose to US \$4,572.0 per tonne in December 2005 from US \$3,134.79 per tonne in December 2004. The price of copper has since increased sharply and had risen to over US \$8,000 per metric ton by May 2006,
- increased non-traditional export earnings, from US \$410 million in 2003 to US \$576.7 million in 2005;
- improved economic confidence following the attainment of the enhanced HIPC Initiative Completion Point in April 2005, which resulted in reduced external debt service obligations; and
- increased foreign direct and portfolio investments, reflecting increased market confidence in the economy occasioned by the greatly improved prospects for the copper sector, the cancellation of the bulk of Zambia's external debt, and anticipated continued commitment to implementation of prudent fiscal and monetary policies.

Your Excellency, from this, it is clear that the current strengthening of the Kwacha has been caused mostly by changes in economic fundamentals. I recognise the concerns by some of our exporters of non-traditional commodities that they are losing external competitiveness. I wish to point out that not all has been lost as a result of the appreciation of the Kwacha. Some non-traditional exporters have benefited through, among other things, the reduction in the cost of capital goods and imported raw materials. In addition, may I mention the fact that the exchange rate alone does not determine external competitiveness of exports. Exporters should look at those areas in their production processes where they can attain efficiency gains and improve productivity. These efforts need to be complemented by Government through directing investment in infrastructure and structural reforms, including labour

laws, so as to reduce the cost of doing business in Zambia. On its part, the Bank of Zambia will carry out its function of smoothing the movements in the exchange rate in a way that would not compromise the low inflation objective.

At this point, Your Excellency, Distinguished Ladies and Gentlemen, allow me to humbly say once again that I am deeply honoured to be invited to address you on this occasion.

I thank you for your attention.