Caleb Fundanga: The cost of capital – wither the Zambian financial markets?

Keynote address by Dr Caleb Fundanga, Governor of the Bank of Zambia, at the Zambia Institute of Chartered Accountants Annual Business Conference on "Change and the Paradigm Shift in the Accounting Profession", Livingstone, 6 August 2010.

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The President of the Zambia Institute of Chartered Accountants; Mr Chintu Mulendema
The Chief Executive of the Zambia Institute of Chartered Accountants; Mr Hapenga Kabeta
Distinguished members of the Eastern, Central and Southern African Federation of Accountants
Members of the Zambia Institute of Chartered Accountants
Members of the Press
Distinguished Guests
Ladies and Gentlemen

The theme for this symposium portends an important aspect of our daily lives, either at individual or corporate level. We are all, one way or the other, affected by developments in our financial markets. The role that finance plays in an economy is certainly an important one and you do not need to go far back in history for you to appreciate that role. You only need to make reference to the recent financial crises to appreciate the potency that finance has on economic activities.

Chairperson, your choice of this topic therefore could not have been more appropriate. This topic is also timely given the current challenges that face many countries in the aftermath of the recent financial crisis, some of which seem to be just unfolding in some European countries. As you know, the crisis have arguably provided provocative questions regarding the management of financial markets, to which answers are now being actively sought.

Ladies and Gentlemen, financial markets provide the liquidity necessary to facilitate transactions in assets. By pooling resources from a myriad of savers, financial markets play a critical role in directing resources to profitable investment projects. The ability of financial markets to effectively contribute to economic development depends on the availability of affordable capital and its efficient allocation in the economy. For this reason, affordability of capital is an important input in any economy's progress. But the relevant question then is "*How Can We Make the Cost of Capital Affordable?*"

Distinguished Delegates, this question cannot be adequately answered without putting it in some historical context. Most of you will recollect that two decades ago, the Zambian Government embarked on an ambitious financial liberalisation programme and dismantled many forms of administrative controls, in general, to improve the efficiency of our economy. The expectation from this policy shift was that the economy would score efficiency gains primarily arising from increased competition in the financial system. Two decades on, it would be hard to disagree that our financial system has certainly faced increased competition. Whereas the number of commercial banks at the end of the 1990s was 14 after the failure of some insolvent banks, Zambia now boasts of 18 commercial banks who in aggregate have a total of 263 branches. In the non-bank financial subsector, growth of non-bank financial institutions offering bank-like products has also tremendously increased. As at end June 2010 there were 24 registered microfinance institutions while the number of leasing firms also increased to 12 over the years.

Ladies and Gentlemen, apart from increasing the number of financial service providers, we have also scored some successes in the availability of credit to Zambians. In the period prior to the 2008 global financial crisis, the economy was experiencing not only phenomenal growth in credit availability but also a changing pattern in the distribution of credit. Annual growth in credit peaked and averaged 131% between 2000 and 2008 before succumbing to the adverse effects of the global economic crisis. With regard to the direction of credit, it is heartening to note that bank loans, which have been largely a preserve of corporate businesses for a long time, are finally within reach of our many working Zambian individuals.

Ladies and Gentlemen, the flow of credit to individual workers has literally exploded in recent years. You may wish to know that personal loans, which stood at a paltry 6% of total bank loans at the turn of this decade now account for 26%. You may also remember the aggressive manner in which commercial banks rolled out their loan products in the period prior to the 2008 global financial crisis. Although the degree of aggression may have somewhat subsided in the aftermath of this crisis, banks are still extending loans to persons they assess as creditworthy.

Outside the banking system, credit availability by non-bank financial institutions has also increased in many forms with annual growth in direct loans disbursed by microfinance institutions and leasing finance institutions showing a significant rise.

Chairperson, although these developments are encouraging and commendable, I do not think we should be fully satisfied with them. It is not enough to merely increase the number of financial institutions, nor is it enough to concentrate on building consumer loan portfolios to salaried workers only. In my view, the real gains should arise not only from increased accessibility to financial services by more of our people, but also the cost at which such accessibility is made possible. I am sure you will readily concur with me that access to finance in Zambia is still relatively low at 37.3% as at end July 2009. This is hampered in part by the continued high cost of finance and the limited financing options available to the larger part of the Zambian business sector, particularly the small and medium enterprises (SMEs).

One can attribute this state of affairs to several factors which broadly are influenced by the macroeconomic environment as well as micro-structure and practices of our financial system. Concerning the macroeconomic environment, most of you will remember the deadly combination of high inflation rates and low or negative growth that characterised our economy from the mid-1980s way into the 2000s. Following the high levels of inflation, suppliers of finance inevitably sought to obliterate negative real returns on their investments by raising interest rates to levels of inflation and in many instances above. Furthermore, the low levels of economic growth exacerbated the adverse perception of borrower risks in the economy such that suppliers of finance only concentrated on servicing their existing small blue-chip customer base that survived the harsh economic environment. This environment, Ladies and Gentlemen, has played a very critical role in cementing the high cost of finance.

At a micro-structural level, a poor credit culture is also another venomous factor that has had its own share of supporting the high cost of credit. Bad borrowers, who regularly borrow from several institutions with little or no intention to repay their loans, have also been cited as one reason for commercial banks' relatively high non-performing loans, which in turn fuel high interest rates. Non-repayment of loans does nothing but muddying the waters for even good borrowers with profitable projects, and in order to stay afloat banks have responded by maintaining their loan rates high.

Ladies and Gentlemen, in recognition of the shortcomings in the functioning of financial markets and the obtaining high cost of finance, the Government has instituted policy measures aimed at correcting imbalances in the economy and restoring macroeconomic stability. The benefits of these measures abound. For example, the fiscal deficit has been constrained to within the allowable limits of below 3% of GDP. Lower fiscal deficit coupled with prudent monetary policy have contributed to current low and stable inflation rate. As you are aware, annual inflation stood at 9.9% at end-December 2009 and further declined to close at 8.2% at end-July 2010. The growth in the economy has also been robust, underpinning the sustainability of policy reforms. Real economic growth has averaged above 5% for most part of the past decade.

Concern has also been raised that Government borrowing competes with the private sector for scarce funds thereby pushing up interest rates and perpetuating the high cost of finance. However, in recent years, the Government has scaled down its domestic borrowing requirement in order to free resources for the private sector. On the other hand, due to banks appetite for risk free debt instruments, competition for government securities has intensified exerting a downward pressure on yield rates. Chairperson, these achievements attest to the importance Government attaches to reviving this economy and making Zambia a middle income country by the year 2030.

Distinguished Ladies and Gentlemen, part of the reason financial intermediation has been limited has been because of the inadequate supporting financial and legal infrastructure. A well developed financial infrastructure is essential for fostering investor participation and expanded access to financial services. Accordingly, since 2004, the Government has been implementing the Financial Sector Development Plan (FSDP) with a view to improving the functioning of financial markets and increasing accessibility to financial services. During the initial phase of the FSDP, numerous structural impediments to financial inclusiveness were identified and some measures have been instituted to correct them. The second phase of the FSDP is currently underway and focuses on enhancing the competitiveness of the financial services industry. It also focuses on establishing secondary trading of Government securities in an effort to enhance liquidity and price formation in the debt market. Without the liquidity provided by the secondary market, the primary or new issues market would be seriously hampered in its function of helping productive entities acquire new capital at affordable price. These measures are expected to stimulate development of the capital and money markets necessary for attracting long-term financing in the economy.

Ladies and Gentlemen, in order to improve risk assessment of the credit worthiness of Zambian borrowers, the Government also came up with relevant legal provisions for establishing the Credit Reference Bureau (CRB). I am pleased to report that the CRB is now operational and compilation of the database on borrowers has commenced. However, the progress of collating credit information on the state of the clients' financial status has been rather slow. I wish to take this opportunity to once again appeal to commercial banks and other financial service providers to expedite the process of building the data base on the borrowers' credit profile. All stakeholders stand to benefit from a rich database as credit providers will have a good basis to adequately assess the credit worthiness of their existing and potential customers with a view to providing properly priced products and services.

Chairperson, the Government has also created the Citizens Economic Empowerment Commission (CEEC) in order to enable small businesses with viable investment projects have access to finance. I would personally like to see an increased flow of credit to our SMEs which, as many of you know, have been routinely found to be a major source of growth in any market economy. This is more so as the larger part of our productive population, particularly those in the informal sector, is in fact employed in one way or the other in these SMEs. It is therefore strategic for us in the financial advisory arena to support our brothers and sisters who run these SMEs. By ensuring that credit flows in that direction, we can then be assured that more and more of our people who are engaged in SMEs will certainly have access to financial services like everybody else. In the process, growth generated from the SMEs can sustainably offer the much needed respite from mineral dependency.

Ladies and Gentlemen, for Government initiatives to be effective there is need to integrate them into the mainstream financial system. In this regard, financial reforms must continue to evolve and be dynamic in order to address the main challenges still facing the Zambian financial markets. Whilst the Government should take a leading role in creating an enabling environment and putting in place an effective regulatory framework, the financial services industry, to which you all here belong, can also make a significant contribution to the reduction in the cost of capital. I therefore wish to encourage you, through this platform, to provide accurate, reliable and high quality financial information on all business activities. The availability of firm level financial information will assist financial institutions in making informed decisions on granting capital to firms. This would in turn lead to a reduction in the level of risk premium loaded on the loan rates.

Ladies and Gentlemen, allow me to conclude by stating that Zambia is a country in urgent need of investment. However, the high cost of finance has hampered the increase in investment. Therefore provision of appropriately priced financing and policy incentives to our business firms are important triggers to investment opportunities and increased productivity. The recent survey by Government and its cooperating partners on the cost of doing business has highlighted the need to ignite the SMEs by allowing them to come out of informality and contribute to job creation and poverty reduction.

Although there are still many challenges remaining, I am particularly encouraged by the increasing number of financial service providers in the Zambian economy. This is important for competition. As competition intensifies, banks and other financial institutions would start to reposition themselves by lowering the cost of finance. On the policy front, the central bank and Government in general will continue to pursue appropriate policies that promote financial sector growth so as to enable them to reduce the cost of financial intermediation and improve the delivery of high quality financial services. On its part the Government contributes to reducing the cost of capital through lower deficit spending. This frees resources for private sector borrowing.

Chairperson, I wish to strongly encourage the accounting profession to join hands with the central bank and other Government organs in the task of reducing the cost of doing business. In answering the question: The Cost of Capital – Wither the Zambian Financial Markets? – I would say that Zambia has made significant achievements in making the financial markets as properly functioning as possible. In its current state, the banking system, being the dominant player in the financial sector, should embrace competition and offer products and services that can spun growth of the entire economy. The capital market has the challenging task of mobilising small number of participants and limited range of long-term investment products. Despite these challenges I am optimistic that working together, we can reduce the cost of finance in Zambia. The Bank of Zambia will continue to provide the required leadership and act as the catalyst for the emergence of viable and responsible markets to serve the interests of all investors.

Ladies and Gentlemen, I wish you success in the deliberations of this conference and in the rest of your endeavours for 2010.

I thank you for your attention.