Caleb M Fundanga: The role of financial systems in capital markets development?

Keynote address by Mr Caleb M Fundanga, Governor of the Bank of Zambia, at the African Securities Exchange Association (ASEA) conference on "The Role of Financial Systems in Capital Markets Development?", Livingstone, 11 November 2010.

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- ***The Minister of Finance and National Planning, Hon Situmbeko Musokotwane M.P;***
- ***The Chief Executive Officer of the Securities and Exchange Commission, Mr Clement Sichembe;***
- ***The Chief Executive Officer of the Lusaka Stock Exchange, Mrs Beatrice Nkanza;***
- ***Members of the African Securities Exchange Association;***
- ***Distinguished Resource Persons;***
- ***Members of the Press;***
- ***Ladies and Gentlemen.***

Let me begin by welcoming you all to this conference and on behalf of my fellow Zambians extend a warm welcome to our visiting colleagues from outside Zambia, to Livingstone.

Allow me Chairperson to take this opportunity to commend LUSE and ASEA (African Securities Exchange Association) for organising this seminar and the tremendous efforts made in enhancing functions of the regional securities exchanges. As our countries continue to recover from the recent global financial crisis, the continent requires financial platforms that will facilitate the recovery efforts and provide an enabling environment to meet the various developmental challenges that the continent faces.

I am greatly honoured to have this privilege to share some thoughts on ***"The Role of Financial Systems in Capital Markets development"***. The importance of financial systems has indeed been highlighted during the recent global financial crisis in which markets without properly functioning financial systems were affected more severely than those that had a semblance of well functioning systems. Evidently, from the theme of your conference, ***"Integration of African Capital Markets through technology"*** we can see the importance the interrelationships of financial systems and other sectors of the economy.

Ladies and Gentlemen, economists and market players have long recognized the importance of the financial system. During each financial crisis including the recent global financial crisis, we have increasingly heard that the financial system was one of the main causes of the crisis, and that the financial system needs to be reformed in order to resolve the crisis. Many of these discussions treat the financial system in isolation or link it superficially to the macro-economy, however to put these issues in perspective let us first look at the importance and limitations of financial markets.

The importance and limitations of financial markets

I would like to begin by discussing the role of the financial system and why it is different from other sectors of the economy. Individual entrepreneurs rarely have enough of their own capital to undertake investments themselves. Individual savers, without pooling their money, would not be able to take advantage of the potential increasing returns to scale of their investments, and would face a large degree of risk with little liquidity. The financial system – including banks and other financial intermediaries, equity markets, and debt markets, solves these problems by *agglomerating* capital from many smaller savers, *allocating* capital to the

most important uses, and *monitoring* to ensure that it is being used well. At the same time, the financial system transfers, pools, and reduces risk, increases liquidity, and conveys information.

Ladies and Gentlemen, let me also highlight the importance of financial markets and how they inter-relate with firms and contribute to economic growth and enhance social welfare. Whether financial systems are relatively simple or highly complex, they perform the same broad functions and share the same key characteristics. Their primary role in any economy is to mobilize resources for productive investment. An efficient financial system channels resources to activities that will provide the highest rate of return for investors. These resources stimulate economic growth, provide enterprises with the ability to become more productive and generate new jobs.

Clearly effective financial markets are indispensable to the pursuit of sustained, broad-based economic growth. Unfortunately, financial markets development is one of the most complex areas in the development field. Every economy needs to find modalities that facilitate financial markets development and provide a policy and regulatory environment that encourages the appearance of competitive forces, the use of a variety of debt and equity instruments, and promotes the growth of different kinds of institutions and systems that offer a wide range of financial instruments and services and protects the interests of savers by reducing their risks.

In protecting the interests of market players, financial systems, i.e. financial intermediaries and financial markets, channel funds from those who have savings to those who have more productive uses for them. They perform two main types of financial service that reduce the costs of moving funds between borrowers and lenders, leading to a more efficient allocation of resources and faster economic growth. The two services are basically the provision of liquidity and the transformation of the risk characteristics of assets.

Role of capital in financial markets and development

The efficiency with which financial markets contribute to economic growth largely depends on the availability of affordable capital and its efficient allocation to productive sectors of the economy. Efficient capital allocation means that funds are channelled to investment projects or firms that bring the most value to the economy. Therefore, there is an intimate relationship between capital on one hand, and economic development on the other. In order to promote economic growth, financial institutions have the primary responsibility of ensuring that capital is allocated to the most productive projects which assure the highest return possible. Thus, the main mechanisms of growth stem from the improvements in the functioning of financial markets, and the effect this has on transforming risks and maturity of assets and liabilities of which capital markets development plays an important role.

Ladies and Gentlemen, even as the private sector takes centre stage in this process, the government also has an important role to play. The absence of government means that financial markets operate without proper regulatory structures. Without a formally regulated financial system, informal financial markets tend to fill in the gap but at sub-optimal levels with high transactions and other related costs. As a result, there is less efficient allocation of capital which in turn translates into low levels of economic growth as investment funding is limited by the cost of transactions.

Therefore, efficient capital allocation relies chiefly on a properly functioning financial system, which enables firms and households to share risks and also facilitates the transformation of more liquid liabilities into illiquid but productive investments.

Instruments and the structure of capital markets

Distinguished ladies and gentlemen: Looking at the objective of every economy, it is clear that all countries develop the depth and breadth of their financial markets to meet the needs of the real economy. This includes making a wide range of choices available to investors and issuers of securities in fixed-income and equity markets. Bond issuers, for example, would ideally be able to issue a variety of maturities with both variable and fixed rates.

Money markets: The market for securities of less than one year includes government and central bank bills, repurchase agreements of government paper (repos), commercial bank certificates of deposit, corporate commercial paper and trade finance instruments such as bankers' acceptances. These markets, in their inter-bank or over-the-counter (OTC) form, have been in existence for a long time in many countries. A newer phenomenon, however, has been for these instruments to be listed on organized stock exchanges and for central banks to increasingly conduct monetary policy through open market operations in these instruments.

Ladies and Gentlemen, in developing economies debt markets which include public entities (ministries of finance, central banks and specialized government agencies for housing, agriculture, export and industry), are the most creditworthy borrowers and generally dominate the issue of local currency debt. However, we are seeing an increasing ability to issue corporate obligations beyond one year in local bond markets. The maturity structure (yield curve), however, generally does not extend beyond two or three years, and the central problem for both government and corporate borrowers is to push out maturities as far as is possible.

Equity Markets which are organized stock exchanges in emerging economies have been slow to develop because of the traditional reluctance of closely-held firms to divulge information to the public or an unwillingness to dilute voting power and control of the firm. For these reasons, closely-held private placements have historically been more important.

Another important group of investors in capital markets are Institutional Money Managers. These include insurance companies, mutual funds and pension funds which achieve important economies of scale through pooling small savings, diversifying investments and monitoring market information. Institutional investors raise the level of professionalism within markets through requiring better information and increased transparency.

Financial infrastructure: Capital market participants nearly unanimously agree that they should not engage in underwriting, trading or asset management activities in the absence of a secure legal and regulatory environment. Foreign investment funds usually cannot go into a market that lacks adequate legislation and oversight.

Ladies and Gentlemen, many organized exchanges operate as self-regulatory organizations (SROs) that sometimes do not meet internationally recognized norms for transparency and disclosure. Although exchanges perform a self-regulatory function, most developed financial systems additionally have a securities exchange commission-type institution that provides an additional layer of oversight. Investors look to these organizations to safeguard the markets through establishing minimum standards of capitalization, registration of securities and market participants, timely and material disclosure and effective enforcement.

In addition to the legal and regulatory framework, the financial infrastructure should include a non-bank payments system for the organized exchanges. Commonly called clearance and settlement within a central securities depository, these clearing houses depend importantly on legislation enabling their establishment and on the clarification of legal concepts such as netting and the treatment of guarantees in bankruptcy for their effective operation.

Role of financial systems

Distinguished Ladies and Gentlemen, in development finance it is recognised that economic development is partially dependent on the financial system to help mediate the transfer of money to areas of the economy that need it most. The financial system has a number of key functions, which help facilitate these shifts in money that are important for sustainable economic growth. The most important of these are:

- ***Savings;***
- ***Loans;***
- ***Investments;***
- ***Business Growth and***
- ***Government Expenditure***

Responding to international capital flows

Distinguished Ladies and Gentlemen, I would like to discuss, though briefly, the role international capital flows and their effects on our economies. Many of the same principles that apply in domestic capital markets also apply in international capital markets. The probability of default is essential to understanding international capital flows and exchange rate movements. Asymmetric information, for instance between foreign and domestic investors, can have important consequences. And, as in domestic markets, there is no presumption that the market, left to itself, is efficient.

Today, developing countries are more vulnerable to international capital flows than ever before. What would have been a mistake with minor consequences in a closed economy can become magnified into a major crisis in an open economy. This is the lesson many people draw from the recent crisis which struck a number of economies in the world. Inadequate financial supervision and regulation, problems with macroeconomic management, and a general lack of transparency certainly contributed to the problems.

Ladies and Gentlemen, even with the best economic management, small open economies remain vulnerable. They are like small rowboats on a wild and open sea. Although we may not be able to predict it, the chances of eventually being broadsided by a large wave are significant no matter how well the boat is steered. Though, to be sure, bad steering probably increases the chances of a disaster, and a leaky boat makes it inevitable, even on a relatively calm day.

Ladies and Gentlemen, let's turn to the role of monetary policy and central banks

Price stability

The interaction between financial markets, economic growth and monetary policy is by no means a new issue for central bankers. However, financial market developments have brought the question to the forefront of the policy debate. The continued integration and deepening of financial markets is a significant issue for policy-makers, and particularly for central bankers, since smoothly functioning and efficient financial markets are crucial in ensuring a smooth transmission of monetary impulses.

The best contribution that monetary policy can make to the smooth functioning and integration of financial markets and to economic growth is to maintain steady medium-term price stability. Such a policy will be beneficial, as it will minimise the adverse effects of inflation and high inflation uncertainty. As we all know, price stability is beneficial in numerous ways. It not only creates a climate for higher economic activity over the medium term, but also reduces the economic and social inequalities caused by the asymmetric distribution of the costs of inflation among the various economic agents.

Financial system stability and the role of central banks in banking supervision

Ladies and Gentlemen, the design of prudential regulation plays an important role from a growth perspective. Supervision is the guardian of financial stability, which in turn crucially determines the capability of the financial system to allocate resources efficiently and absorb liquidity shocks. Financial crises can have a deep and protracted impact on economic growth, as illustrated by several episodes of financial instability that occurred in many countries. The contribution of prudential supervision to economic growth proceeds along two dimensions. From a preventive perspective, supervision has to ensure a continuous and comprehensive monitoring of all the potential threats to financial stability. The role of supervision is also crucial after the emergence of a crisis, in order to provide for a swift and ordered resolution. Supervisors can only be effective in these two respects if they are able to pay sufficient attention to systemic issues, namely the risk of contagion effects.

Policy measures aimed at development of capital markets

Ladies and Gentlemen, despite the threat of the recent global financial crisis, the Zambian financial sector is currently resilient. The level of liquidity is also high, spurred largely by tighter lending conditions as banks slowed down on lending to the private sector. However, these developments also project the improvements in regulatory and supervisory oversight which continues to be updated.

Distinguished Ladies and Gentlemen, for Zambia the vision is to become a prosperous middle income country by the year 2030. In order for us to attain this vision, there is need to improve the financial infrastructure in Zambia. Since 2004, the Government has been implementing the Financial Sector Development Plan with the view to improve the functioning of financial markets and increase accessibility to financial services by a majority of Zambians. The second phase of the FSDP is currently underway after the initial five-year plan lapsed. We cannot deny that an improved financial infrastructure will result in efficient capital and money markets which in turn will attract domestic and foreign investment in the economy.

Conclusion

In conclusion Ladies and Gentlemen I would just want to emphasise that Zambia and many of our regional counterparts are small countries in need of investment. However, the high cost of capital has hampered the increase in investment, particularly among the SMEs which continue to face enormous financing challenges. Therefore provision of appropriate financing to this category of firms is likely to lead to higher investment opportunities and more efficient methods of production. In turn, this will translate into poverty alleviation due to employment creation.

Ladies and Gentlemen you will agree with me that we have come a long way since the time when many viewed the financial system simply as a sideshow, or a passive channel that allocated scarce resources to the most efficient uses. Today, almost everyone agrees that the financial system is essential for development. Improving the financial system can lead to higher growth and reduce the likelihood and severity of crises. It is essential that we have a clear understanding of the causes of business cycles and the working of monetary policy. In thinking about financial reform, we need to treat liberalization as a means rather than an end. Instead of pushing for immediate deregulation, we should try to understand the important role authorities play in financial markets. These steps will not only result in a better and more stable allocation of domestic capital, but also help countries to develop their capital markets with the requisite financial systems.

In view of this I encourage you all to join hands with authorities in your countries in improving financial infrastructure so as to contribute to the development of our regional financial

systems and thereby improving the availability of capital. I am also encouraged by the increasing number of financial service providers in our economies. As competition intensifies, banks and other financial institutions will start to reposition themselves by lowering the cost of lending to the private sector. On the policy front, central banks should continue to conduct monetary and supervisory policies that create incentives for the financial sector to thrive so as to enable them provide better services.

Ladies and Gentlemen, with these few remarks I would like to conclude here and wish you success in the rest of your deliberations for this conference.

I thank you for your attention.