Foreign portfolio investors in Africa: the case of Zambia

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1. Introduction

The rapid growth in foreign investors' exposure to African debt markets is one of the most invasive developments going on in recent times. In Zambia, foreign holdings of Government securities has rapidly risen from less than 0.5% of outstanding issues in 2005 to around 17% by the turn of 2008. Whereas benefits of foreign capital inflows in a developing economy can least be questioned, so can potential risks. We explore in this paper the growing exposure of foreign investors to the Zambian financial markets and the main reasons behind this rather phenomenal growth in exposure. We also review the nature of the exposure, and the major policy implications and challenges of this development. Although portfolio investments in a country can be far and varied across its economic sectors, we concentrate our discussion on the Government securities market for which disaggregated data is readily available.

The paper is organized as follows. A brief overview of economic policies pursued by Zambia since its independence in 1964 is highlighted in section II followed by a discussion of trends, causes and effects in the build-up and structure of the non-residents' portfolio of Government securities in section III. Section IV discusses policy implications of the increasing foreign investors' exposure to the Zambian markets while section V concludes the paper.

2. Overview of economic and financial policies

Zambia, one of Africa's dynamic economies, got its independence in 1964 with a rudimentary financial market system that was designed to facilitate colonial economic interests. Post-independence, the financial system was re-oriented mainly to support the new Government's socialist economic policies which continued way into the 1980s' decade. During this era, the economy was systematically dominated by massive parastatal structures with tentacles permeating virtually all economic activities in the country. In order to provide finance to the Government's development efforts, financial market structures were designed to facilitate direct allocation of credit to the Government's preferred sectors at non-market interest rates. In cases where public sector deficits arose, they were financed by either outright monetization or issuances of Government securities to a captive investor base, such as commercial banks and the state-owned pension system.

The results of such financial policies are now well-known. Credit was often misallocated and the preferred sectors never performed as expected. In addition, Government's consistent monetization of its deficit created a serious inflationary environment such that economic output in virtually all aspects consistently collapsed and systematically pauperized the citizenry with per capita GDP falling from an average of US$558 in the 1970s to US$369 in the 1990s (Table 1).

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Table 1

Inflation and growth

Period averages

	1970–80	1980–90	1990–00	2000–07
Inflation %, y-o-y	10.4	46.3	74.8	17.9
Real GDP Growth %, y-o-y	0.2	0.8	0.9	4.8
GDP per Capita (USD)	558.3	441.5	368.8	555.0

Source: Bank of Zambia, CSO Zambia.

Following the dismal performance of these policies, Zambia embarked on a new set of political and economic reforms in the 1990s. A new Government was elected in 1991 and immediately embarked on dismantling the economic policies which had been pursued for almost 30 years. Top on the economic reform agenda was the restructuring of the financial sector. Adopting a fairly ambitious reform pace, the Government embarked on a full liberalization of the money and foreign exchange markets in the early 1990s. Controlling of interest rates was abandoned in October of 1992 while exchange controls were done away with in January 1994. Another key development was the introduction of a market-based system of issuing Government securities in 1993 and a stock exchange in 1994. Participation on both the bond and stock markets was fully open to not only residents but non-residents as well.

3. Non-residents holding of assets

Trends

Despite the lack of restrictions on participation on Government securities market, demand from foreign investors remained docile. It was until 2005 that there was a consistent growth in non-resident investors' appetite for the country's financial assets, particularly Government securities and to some extent, equities. Accounting for less than 1% of the total Government securities outstanding at mid-2005, non-resident holdings grew rapidly to about 18% by mid-2006 before tapering off to about 13% in later periods (Figure 1).

Within the Treasury bills portfolio, preference has been held largely in the 364-day maturity which accounts for an average of 60% of the total bills held by non-resident investors (Figure 2). The shortest maturity of 91-days typically accounts for about 5% of the investors' portfolio. Although initial exposure was concentrated in short maturing Treasury bills, there has been a consistent growth of appetite towards long term Government bonds (Figure 3). The Government bonds portfolio is itself dominated by the 5-year maturity, which until August 2007 was the longest tenor. However, it is expected that investors will dominate their portfolio with the newly-introduced longest maturity terms of 7, 10, and 15 years (Figure 4).

That foreign investors have expressed an increasing appetite for long term maturity portfolios is not entirely surprising for two reasons. First, it seems a combination of double-digit yields on these securities and an expectation of a strengthening local currency provides enough respite to maturity risk concerns. Second, the international capital market's capability to synthesize and repackage such risk exposures through derivatives that meet different tastes of various investors has been cited as one of the most powerful drivers of the increasing demand for emerging markets' local currency long term bonds (BIS, 2007).

Figure 1

Foreign investors' holdings of government securities

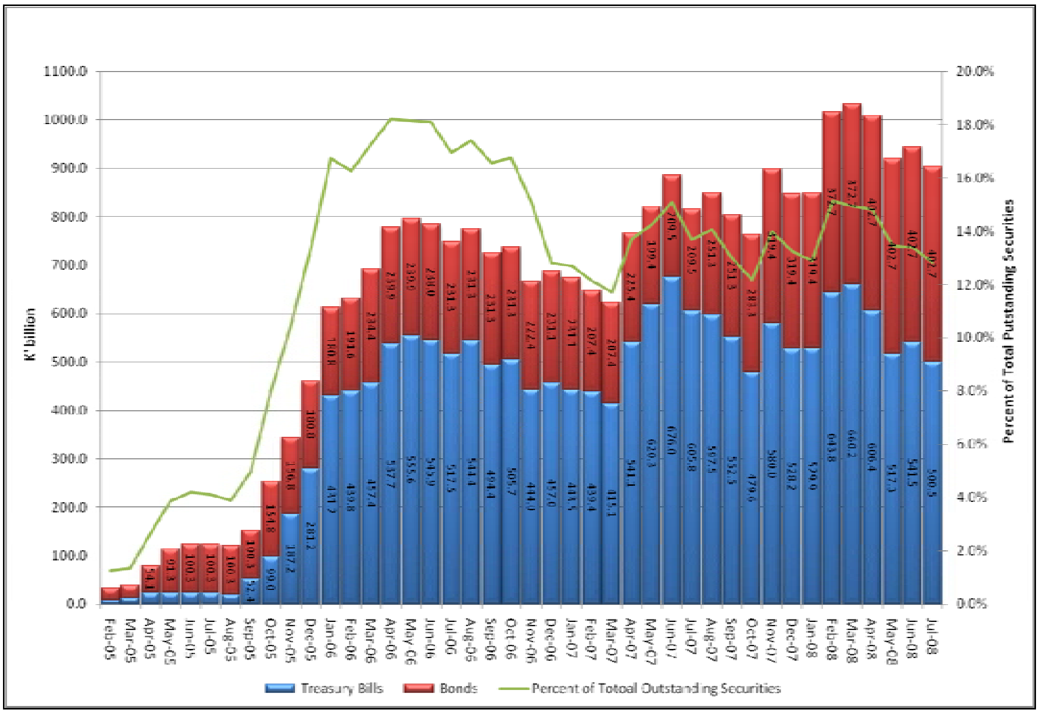


Figure 2

Foreign investors distribution of treasury bill portfolio

% of total held per week

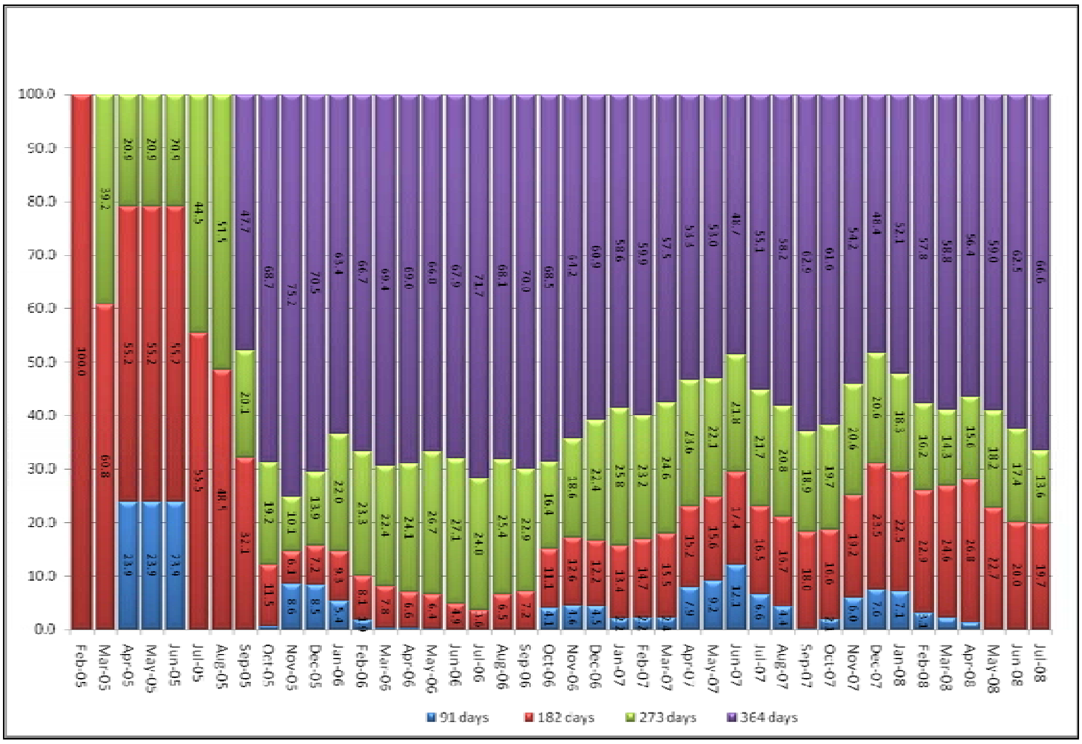


Figure 3

Distribution of govt securities portfolio

% of total holdings

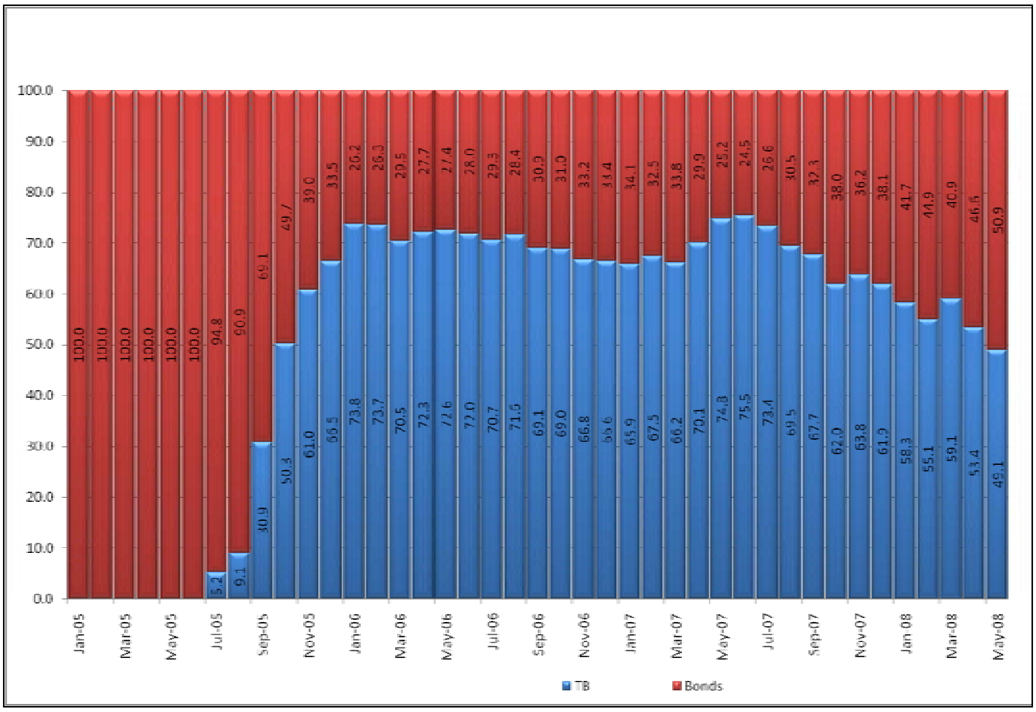
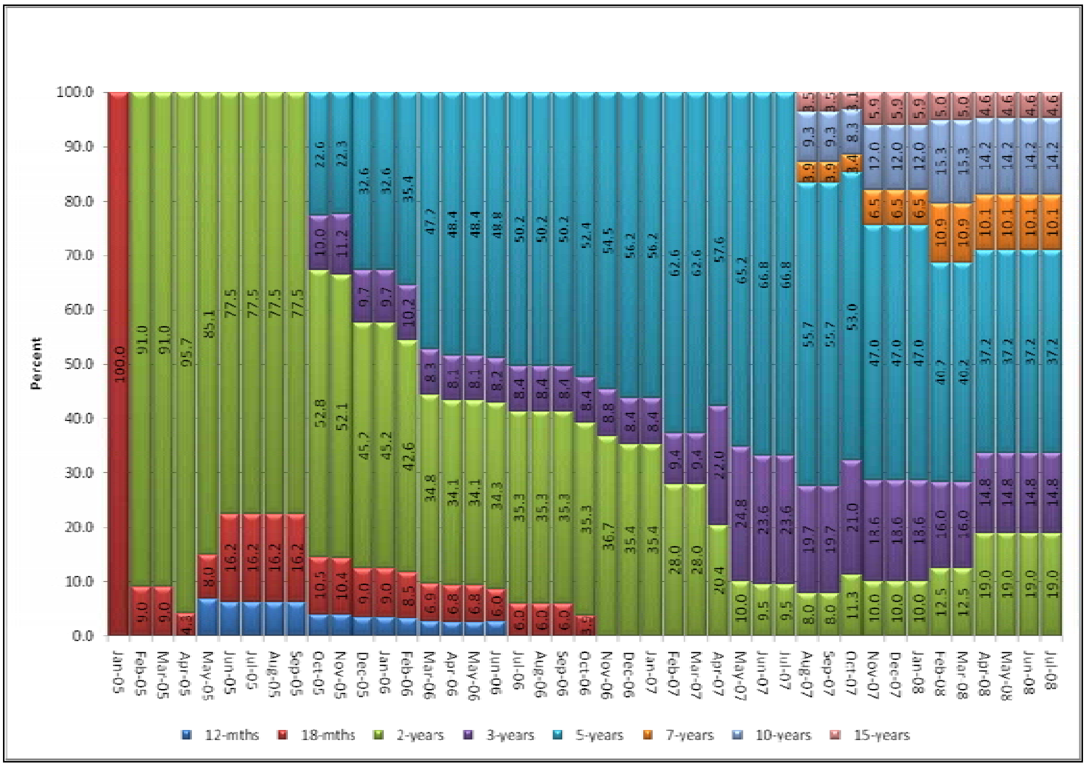


Figure 4

Foreign investors' holdings of government bonds

% of total held



Causes

In general, research on the major drivers of foreign portfolio investments into developing economies distinguishes two broad categories of factors. The first set of influences is classified as global or "push" factors which are somewhat independent of the domestic environment in the capital importing nation. The second group are local or "pull" factors which refer to the macroeconomic conditions specific to the capital recipient country (Calvo et al, 1993; Chuhan et al, 1993; Fernandez-Arias, 1994). Both push and pull factors appear to be behind the rapid influx of foreign portfolio inflows into the Zambian government securities market.

Following the low interest rates environment in mature markets, investors and fund managers have generally gone searching for better yield elsewhere. Such searches, though by far targeted towards Eastern Europe, Latin America and Asia, are finally finding their way to African markets. Concerns about political and economic policy risks seem to have been marked down over time. Better information, in-depth analysts' research, and indeed the consolidation of democratic governance structures have ensured that investors start to understand that Africa is not the same. Country-specific domestic policies are actively being looked at closely in appropriately choosing portfolio structures, in some instance, even creating dedicated African funds outside South Africa. Such global developments have contributed to the growth in foreign investor demand for Zambian assets.

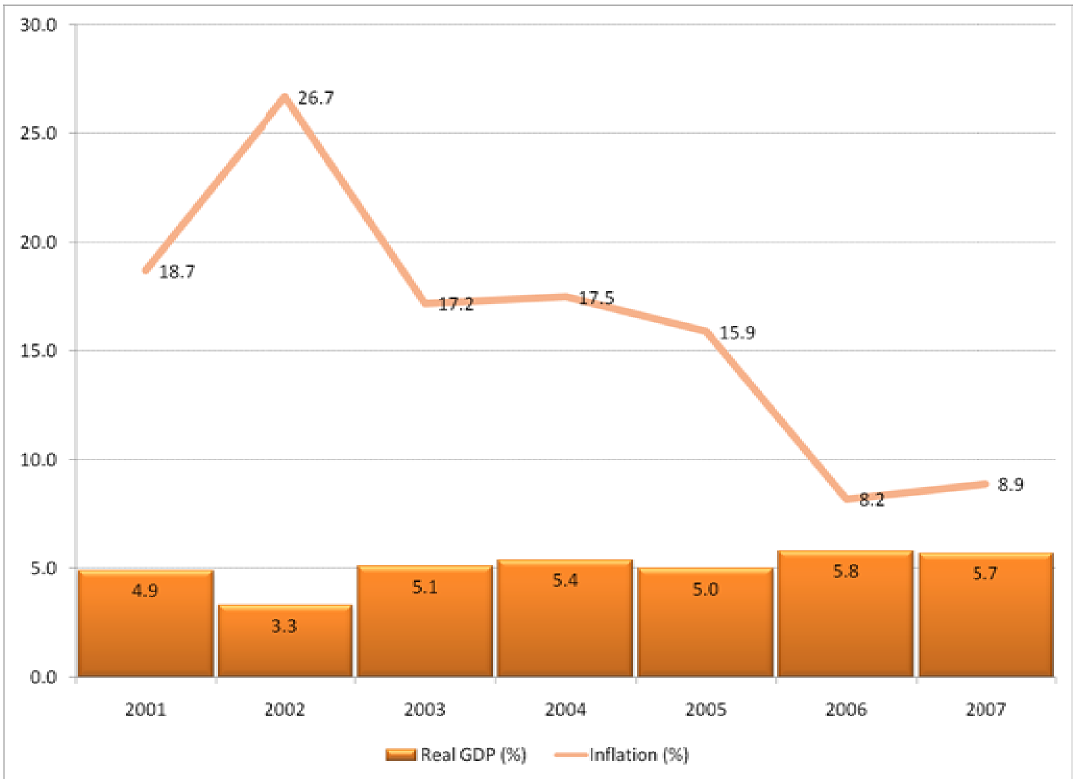
Besides the search-for-yield effects, macroeconomic developments in Zambia have also been arguably a major push for non-resident investors increased appetite for the country's assets. In recent times, Zambia – a typical commodity-based economy – has had its good fortunes that can only be possibly rivaled by its post-independence state in the 1960s and early '70s. Buoyed by a combination of a US$6.5 billion debt write-off in April 2005 and rising world copper prices in the last few years, the economy has experienced a sustained growth averaging 5% over the last 7 years.[2] These developments have been complimented by improved macroeconomic policy implementation, particularly increased fiscal prudence and a tight monetary policy stance, which has contributed by ensuring an attainment of single-digit inflation for the first time in more than 30 years (Figure 5).

[2] Until April 2005, Zambia's external debt stood at US$7.1 billion.

Figure 5

GDP growth and inflation

year-on-year percent change



Effects

In the wake of these macroeconomic developments, both official and private capital flows have increased, leading to a rapid build-up of international reserves and a rather strong appreciation of the exchange rate (Figure 6). On the monetary front, money supply growth has stayed at levels that are not entirely consistent with the policy objective of a single-digit growth rate range. Largely aided by capital inflows, money supply growth momentum seems sustained at above the 20% growth range, although down from the highs of the 2006 second-half and the 2007 first-half. In contrast with pre-July 2005, the banking system's buildup of net foreign assets (reflecting capital inflows) contributed strongly to monetary growth in periods beyond July 2005. In order to tame the inflationary impact of these events, a countercyclical monetary policy stance was adopted that ensured at least domestic credit growth's contribution to money supply remained benign (Figure 7)

Figure 6

Gross international reserves and exchange rate developments

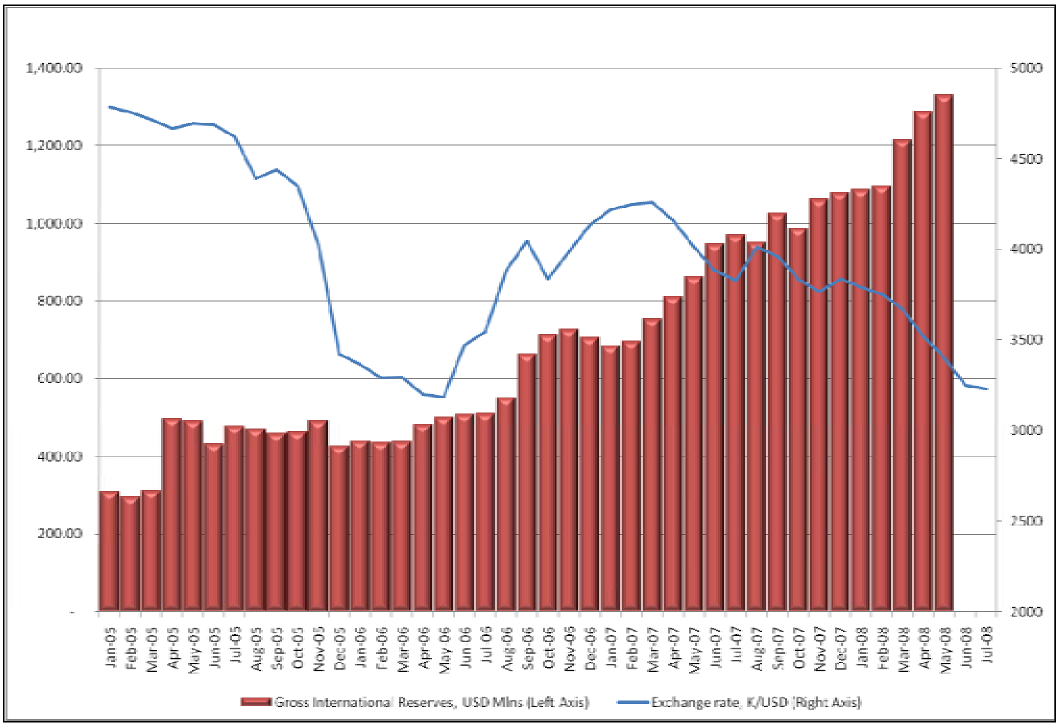
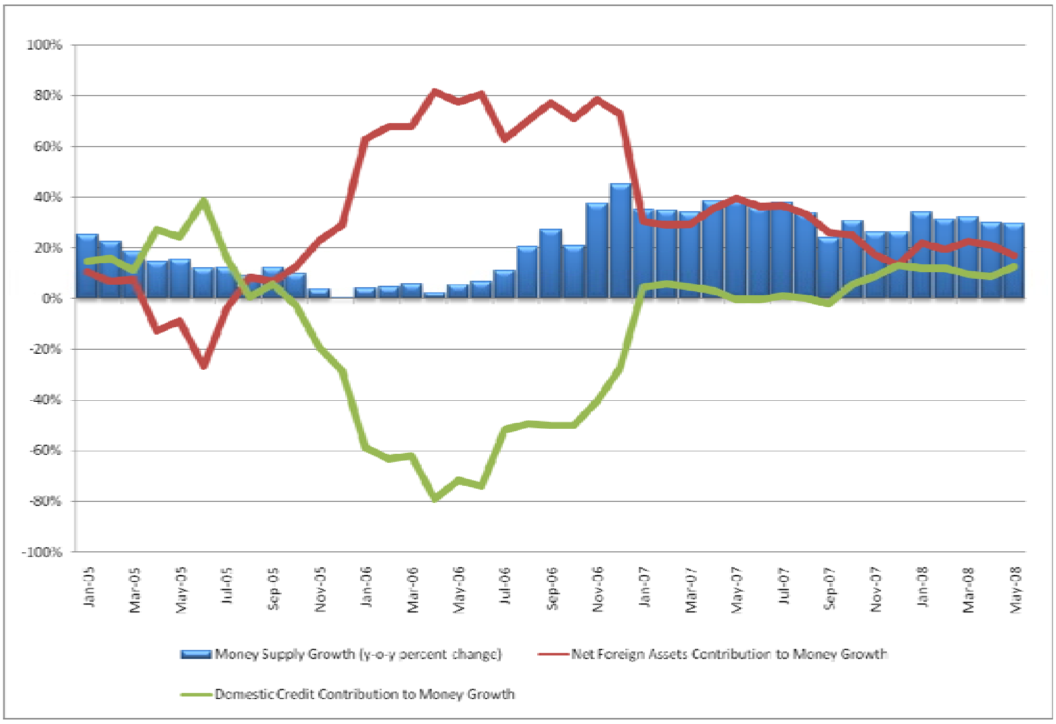


Figure 7

Monetary developments



Notwithstanding the growth in money supply, inflation has remained fairly contained, helped by a stronger currency and increased food production in the last few years. In addition, the central bank's sterilization efforts to a great extent kept base money from fueling further demand pressures in the economy.

4. Opportunities and challenges

One of the main benefits associated with international financial integration is that financial risks are no longer domesticated but dispersed and shared between residents and non-residents leading to lower interest rates and a smoothed consumption pattern (IMF, 2007). Indeed, the presence of foreign investors has contributed to diversifying the investor base of Government securities, which in the process has led to lower interest rates, particularly on Treasury bills.

Foreign participation in local markets can help in deepening Zambia's financial markets and in the process increase asset liquidity. In particular, international capital market activities that somehow generate demand for secondary transactions in the local market are critical in this aspect.

Capital inflows generally boost the supply of liquidity necessary for undertaking growth-enhancing investments in a country. This can happen for instance through loan syndications or indeed through outright stake-buying into privately held companies at costs of capital that are lower than without such inflows.

At a micro-level, the presence of foreign investors also increases the probability of the Treasury raising the required amounts of borrowing at lower interest rates which would otherwise not be the case where few resident investors dominate the Government securities auctions.

Though local markets can benefit in this manner, international portfolio flows are so far known to be volatile and can be a major source of market instability. Local bond markets therefore need to build capacity to withstand a sudden demise of non-residents' demand for assets. Local investors need to effortlessly step in where foreign investor demand has dried. But this capacity can be built and inculcated if foreign participation is encouraged to flourish in the local secondary market. Zambia should continue to vigorously develop structures that provide support and incentives for secondary market trading of financial assets.

Studies and surveys have consistently established that many foreign investors tend to gain exposure to developing-country financial markets through derivative transactions. The implication of this is that data on foreigners' outright holdings of financial assets may only provide a partial picture of the total exposure (BIS, 2007). Although indicators of capital flows can be obtained from the banking system's financial statements, it is not easy to fully monitor the final destination, and in some instances the quantity of foreign capital inflows. Statistical requirements for appropriate surveillance are therefore of immediate need and financial system supervisory authorities will need to build capacity to generate adequate surveillance for such developments.

With increased capital flows, domestic credit is bound to rapidly grow, and in the process breed an inflationary environment particularly in circumstances that promote consumer borrowing. Although credit to the private sector in Zambia has indeed been growing at about 35% year-on-year, with credit to households accounting for 30% of total bank loans, it is not entirely clear to what extent foreign capital inflows have played a role. To the extent that the banking system finances domestic credit by increasingly using foreign capital, a possibility of a financial crisis in the event such inflows abruptly stop should worry policy makers. Although this is not the case in Zambia, the challenge still remains that banking supervision should continue to be strengthened to monitor and measure these exposures to the greatest extent possible.

Unfettered capital inflows could precipitate a sustained local currency appreciation, which in turn could hurt Zambia's fledgling non-mineral export sector. Mindful of this, authorities are challenged to pursue policies aimed at avoiding a real exchange rate appreciation by ensuring that domestic inflation is contained.

5. Conclusion

After undergoing a long period of stagnation, precipitated by inappropriate economic policies, the Zambian economy has made a positive turnaround over the last few years. Of particular significance is the influx of foreign portfolio capital into the Government securities market which has grown at a rapid pace since mid-2005. This phenomenon appears to have been driven by both "pull" and "push" factors, consistent with the vast literature on the drivers of foreign inflows into emerging economies. The pull factors largely relate to the macroeconomic reforms that have improved the country's policy framework and investment climate while the push factors refer to the low yield rates in developed markets which has forced international investors to seek alternative investment destinations.

Among the effects associated with the increase in foreign portfolio inflows has been the rapid build up in international reserves, the strong appreciation of the Kwacha and above target money supply growth. The domestic economy's increasing integration in international financial markets brings several opportunities for the continued growth of the economy. External sources of financing could help deepen the local financial markets and provide additional and cheaper funds much needed for the country's investments.

Although, Zambia's share of portfolio inflows to emerging economies is minute, it still poses serious challenges to policy makers in managing these inflows given the high risk of sudden reversals or stoppages. This therefore requires authorities to adopt sound polices which will address these concerns. In particular, a stable macroeconomic environment needs to be maintained in order to sustain the favorable investment climate and investor confidence. Financial regulation and supervision also needs to be strengthened to avert any build ups in balance sheet vulnerabilities of the banking sector. For effective surveillance, it is also imperative that authorities improve the capacity to collect accurate and timely data regarding the composition and destination of these inflows.

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