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Reforming the Dysfunctional Capital Markets in Zambia

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ABSTRACT: *Over fifty (50) years after independency, Zambia's economy continues to see modest economic growth rates, high unemployment and noticeable levels of poverty, all attributable to the economy's inability to spur production and create jobs. In the abundancy of an entrepreneurial spirit and natural resources, the key missing factor of production has been adjudged to be access to cheap capital for the people who need it the most – Small and Medium Enterprises (SME).*

Researchers and Economists worldwide have done numerous studies, often in far-flung areas, as to the reasons why African economies lack cheap capital to support entrepreneurship and have advanced a simplistic assertion, without loss of generality, that among the enumerated findings, the poor savings culture inherent in the country is solely accountable for the failure of the depository financial institutions to mobilise sufficient deposits for on-lending to the SME (Maimbo and Mavrotas, 2003; Wennekers and Thurik, 1999;). And they claim that this is true for Zambia as it is for the rest of Africa.

On the contrary, there is observable evidence that Zambia's economy is overflowing with capital in private hands which the current financial system fails to mobilise. If the financial reforms were to be undertaken to usher in a different capital market arrangement, this capital would, no doubt, find itself in entrepreneurial hands.

Notwithstanding the foregoing, the existence of private capital in the midst of the paucity of financial intermediation for cheap credit for the SME signals a significant market failure for an economic structure driven by the SME. As such, like any other market failure, there is need for Government intervention.

KEY WORD: *Capital Market, Foreign Direct Investment, FDI, Informal Sector, Securities and Exchange, Stock Market, SME, Zambia*

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I. INTRODUCTION AND LITERATURE REVIEW

A number of studies such as the ones by Levine (2005), Rajan and Zingales (1996), Greenwood and Jovanovich (1990), among others, continue to highlight the existence of a causal relationship between developed Financial Systems, stock markets in particular, and long-run economic development. However, this is in as far as country specific conditionalities such as market liquid, low market volatility, domestic capital mobilisation and intermediation in the financial market is taking place but nonetheless, causality exists. With the causality relationship established, countries like Zambia with an endemic problem of modest growth rates should then be admonished to reform its financial institutional environment to ensure market liquidity and low volatility. The financial system should, at the very least, be able to mobilise domestic savings and ensure market intermediation.

Therefore, it is not inconceivable that a country can achieve economic growth that is endogenously influenced by the volume of financial intermediation in the economy as opposed to a never-ending pursuit of exogenous influencers, such as FDI, at the expense of everything else. This is provided that enough domestic savings can be mobilised and made available as cheap long-dated capital.

With the help of the International Finance Corporation (IFC) and the World Bank, Zambia setup what has come to be called the Lusaka Securities Exchange (LuSE) as part of the financial universe whose key objective was to be a source of cheap capital to drive the economy. However, the role that LuSE has played to date remains questionable, at best, and at worst, has been counterproductive This has been exemplified by more attuned literature on the role of capital markets which has focused, to a large extent, on whether the set capital market can, within the financial "stratosphere", become a cheap source of capital, as it were, for business start-ups to support expansion plans for small scale enterprises (SME) and LuSE's performance is evaluated against this background. As such, LuSE was consummated with the primary mission to become a platform for local enterprises to raise relatively cheap and long-term capital. This has not been the case.

On the other hand, depository financial institutions, who are supposed to compliment LuSE as sources of capital are themselves biased towards enterprises with security in the form of collateral and the majority of the capital seekers, SMEs, do not have collateral. In this kind of environment, extending credit to any enterprise requires that the borrower has pledged collateral equivalent to, or more than, what is being applied for. In other words, in order to get credit, one has to prove that they do not need it in the first place because they have sufficient capital any way, be it in different asset and liquid forms. As such, the Zambian capital market has by default excluded the Small and Medium-sized Enterprises (SME), all blamed on the financial systems' inability to mobilise domestic savings.

II. DEPOSITORY FINANCIAL SYSTEM

Zambia, like many African countries, has a well-developed depository financial intermediary industry, from an institutional point of view, regulated by a central bank (Bank of Zambia). Notwithstanding this, the up-take vis-à-vis savings remains low. In this environment, a number of Commercial Banks exist offering bank deposit services, mainly in the form of Notes and Coins, symptomatic of such institutions.

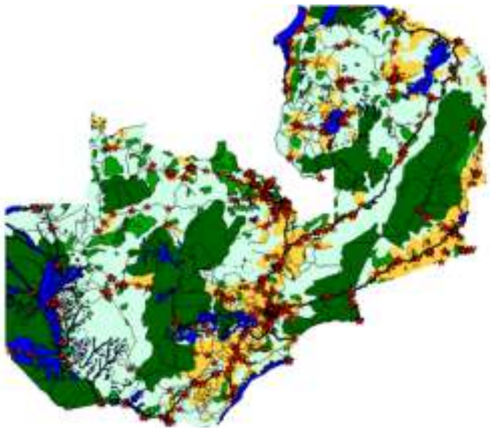
It follows therefore that the litany of commercial banks in Zambia have the ability to create money by making loans to clients, be it short term or long term loans. One should then expect that the banks would inherently be in a hurry to extend recoverable loans bringing about competition with one another. This should surely lead to the reduced price of money, and by implication lending interest rates, in order for banks to remain competitive. However, as noted by Maimbo and Mavrotas (2003) and supported by FSD Zambia (2017), the tendency of the commercial banks operating in the country has been to invest in high yielding and risk free assets such as Government Bonds and Treasury Bills instead of lending to businesses. In effect there is a forced or pseudo crowding-out effect that would have been created not because the market liquidity has been mopped up by government borrowing but because the banks only see that avenue as the only safe haven for their capital. This exacerbates the problem of lack of access to cheap capital for the SME in the country.

As such, the depository financial system has failed to play any meaningful role in the provision of investment capital for small-scale businesses along with the low savings culture alluded to earlier.

III. FINANCIAL ACCESS POINTS

Perhaps, the reason for the low savings culture in the country can be attributable to the non-availability of financial access points across the country. All the available statistics indicate that about 58% of the economically active population of 5,859,221 (MLSS, 2016) is in rural areas and yet banking services access points are mostly in urban areas and along the line of rail as per below adapted Zambia Formal Financial Services Access Points Survey of 2015 (fsdZambia, 2017).

Picture 1: Formal Financial Services Access Points



★ Formal access points

Source: fsdZambia

Of economically active population, 84% is engaged in some gainful economic activity in the informal sector (CSO, 2016) and the majority are in rural areas. This cohort in the informal sector would be needing access to banking services including maintaining an account with a bank just as much as their counterparts in the formal sector would. However, only a paltry 24.8% have access to a formal banking service with 3.8% having access to a microfinance in one form or the other (fsdZambia, 2017). Therefore, it defies logic why there is no concerted effort to enhance coverage of financial institutions in rural areas. The cohort of potential users of the financial services in rural areas is mainly in agriculture, retail and trading with different financial needs from the formally employed individuals. Top of their needs is a flexible system that will allow them access to their capital every day of the week and at all times with near zero administration costs. No existing financial institution in Zambia today will give its clients such a service with an exception of the trusted "Pillow Bank".

Many inferences can be made from the above poor distribution of financial services such as the negative externality of low savings mobilisation as alluded to by Maimbo and Mavrotas (2003) and fsdZambia (2007). However, their explanation of why the country has low savings mobilisation is less accurate and tendentious such as their wild assertion that Zambia has a record of low savings mobilisation due to a myriad of factors that include the poor state of the economy, increased levels of poverty and unemployment. They list other factors as the bank closures that took place in 1995 and in 1997/8, increased investment in property for private and commercial purposes, foreign exchange liberalization, the absence of rural financial savings institutions, the parastatal sector reforms and the HIV/AIDS epidemic.

With an exception of the absence of rural financial institutions and alternative investment vehicles available to individuals, such as property, the rest of the factors listed can hardly be proven. The assertion that HIV/AIDS has impacted the savings in the economy is premised on the assumption that the economy is operating at near full employment when it comes to skilled labour, as is the case in the Western world, such that there is a savings "shortfall" created by those affected by HIV/AIDS that may no longer be economically active. But it is not true. Neither is it true that the economically active individuals who can afford to save suddenly cannot do so because they are spending their potential savings on burying relatives. If that can be believed, then anything is believable. HIV/AIDS is not unique to Zambia, countries that are worse off such as Botswana, Swaziland and Lesotho have better savings statistics than Zambia and therefore there ought to be other credible factors other than the effect of HIV/AIDS as advanced. The same can be said about the poverty and unemployment levels, which are structural in nature. There has to be country specific criterion other than the textbook ones of poverty and unemployment. The liberalisation of the foreign exchange market in the context used by Maimbo and Mavrotas (2003) does not have any impact on the savings culture purely on the basis that over 70% of the economy is informal. Having an opportunity to maintain a Swiss bank account as assumed by the duo to be the negative externality of the exchange control liberalisation, will not appeal to this cohort.

Lastly, the closure of the banks happened before most of the potential young depositors were even born and for most, this is a distant memory that will have very little bearing on the decisions taken today. The real substantive matters identified are the absence of rural financial savings institutions and the availability of other investment vehicles ideal for the informal sector that have more competitive returns than the fledgling financial system would give. Both of these could very easily be addressed by prudent financial reforms.

IV. PAST FINANCIAL REFORMS

During the 1980s and 1990s Sub-Sahara Africa, Zambia included, underwent a series of financial sector reforms. The significant reforms undertaken during 1992/93 focused on restructuring government banks, prudential supervision reforms as well as foreign exchange and interest rates liberalization (Maimbo and Mavrotas, 2003). Reforms did not include a country specific introspection as to whether the Capital Market, which included the depository intermediaries, was well positioned to facilitate access to long-term cheaper capital for which the market is designed in the first place.

A reform so diverse was bound to spell disaster for the economy especially that some of the policy choices themselves were not complementary. One profound element of the reforms conducted in 1993 was the removal of all restrictions on the Lending and Deposit rates (deregulate interest rates) for commercial banks (Maimbo and Mavrotas, 2003), this later came to be the achilles that worked against the sector it was designed to promote. The effect of this has been that interest on deposits are very low, usually in single digits, while interests on loans are between 25% to 40%. The spread cannot be justified. Additionally, the commercial banks have all sorts of hidden charges on their accounts such that the resultant effect is erosion of one's deposit. This does not encourage savings.

Nonetheless, the reforms were centred on reforming financial sector arrangements to ensure sustainability of the Financial Institutions but however missed the aspect of the availability of the financial institution in rural Zambia and the access to capital by the SME. The reforms were more academic aimed at shaping the financial institutional structure as would be recommended by a classic case study out of Europe. However, as observed by Murinde (2006), one major weakness of existing studies has been that the capital markets in Africa are treated as if they are homogenous and therefore a one-size-fits-all solution is applied across. More so that these markets should be structured in the same manner as is the case in the developed countries. The reality is that informality in Zambia is endemic and thriving. It must be allowed to thrive while reforms around "support" structures such as Capital Markets are made, taking into account the engine of Zambia's economy, the SME. Other economic structural issues are worth considering.

Burnell and Randall (2008) weighed in on the failure of the financial reforms undertaken in most of Africa, Zambia included and surmised that the reforms focused so much on supply side factors of the economy and did not pay attention to the market preconditions that needed to obtain in the economy for the reforms to be effective. They made an observation that there ought to be some market preconditions before the market can be "shocked" to react to the demand stimuli. They proceeded to advance preconditions of adequate market structures that need to be in place for the market, on the supply side, to react to an effective demand that included adequate technology, infrastructure development, entrepreneurial skills and management skills. Whereas these can be challenged, the core of the issue is capital availability to kick-start industries. However, their further observation of Zambia having a shortage of entrepreneurial, organizational and managerial expertise as a reason for the reforms failure has no basis and is completely inaccurate. This perpetuates a long held perception on Africa in general that there is a servile lack of self-confidence among citizens and that tyranny, disorder and corruption still perpetually thrive in Zambia as well. Yes, Sub-Sahara Africa still has pockets of challenges but this is a region with the largest diversity of languages, cultures, and national economic performance, among others, in the whole world and generalising an observation may be disingenuous. As Chege (2000) observed, if one made such disparaging and sweeping generalizations now in vogue about all Asians in continental Asia, the Jews, or the Americans, would generate a global outcry of unprecedented proportions.

V. NEED FOR FURTHER REFORMS

For the Zambian economy to make any meaningful strides, focus should be on the financial reforms specific to the design and operations of the capital market so as to encourage the use of domestic capital to stimulate economic performance other than the dogma of Foreign Direct Investment and the current obsession of broadening of the tax base. While important in their own rights, they are not nearly as important. The "bootstrap" works by McKinnon (2010) is a breath of fresh air when he suggests that successful development would depend largely on policy choices made by national authorities in the developing countries themselves which should be based on countries picking themselves up by their own bootstraps other than waiting for some magical panacea, usually of FDI, to rejuvenate their enterprises. The design of LuSE mimics the financial system of the developed economies and renders itself useless for most of the country's economic activity vis-à-vis raising of cheap investment capital.

VI. CONCLUSION

As a result of a failed depository financial system and the lope-sided design of the Lusaka Securities Exchange, whose participation requirements are to the exclusion of the SME, there is an urgent need of a capital market structure that would service the section of the economy that is espoused by the country's Seventh National Development Plan (SNDP) as the engine of economic development (MNDP, 2017). All manner of policy documents recognise that the Zambian economy is anchored by the SME, therefore there can be no better business case giving justification for the financial reforms of the capital market as opined by this paper. This is recognising that LuSE has no bearing on the economy of the country and therefore serves no purpose in its current format and the current structure of the country's economy which is, to a large extent, informal. The same conclusion was arrived at by a comprehensive study conducted by Marone (2003). Given the objectives of LuSE, it neither is a cheap source of capital nor is it a platform for wealth creation for the citizens.

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