# Issues On The Zambian Economy

*Special Edition in Commemoration of Bank of Zambia's 50$^{th}$ Anniversary*

THE BOZ READER, VOL.01, NO. 10, 2014

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2014

Bank *Of* Zambia

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**A Collection of Speeches and papers presented at the Bank of Zambia International and Business Symposia in Lusaka and Ndola**

**Compiled and Edited by the Economics Department of the Bank of Zambia**

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*Special Edition in Commemoration of Bank of Zambia's 50th Anniversary*

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# Foreword

The Bank of Zambia was established on 7th August, 1964 as the Bank of Northern Rhodesia with the issuance of the Ordinance No. 33 of 1964. The Bank celebrated its Jubilee Anniversary on 7th August, 2014 by lining up several activities to commemorate this momentous occasion and the theme of the Anniversary was **"50 years of Central Banking: Repositioning for the Future"**. As part of the Jubilee celebrations, the Bank hosted an International Symposium in Lusaka on 7th August 2014 and a Business Symposium for the Bank's Northern Region comprising the Copperbelt, Luapula, Muchinga, Northern and North Western Provinces on 8th August, 2014.

This Special Edition of the Bank of Zambia Reader is a collection of speeches and papers presented in the Lusaka and Ndola symposia by distinguished foreign and local speakers, who discussed different issues pertinent to the Bank's quest to reposition itself for the future and shared important insights into the topics affecting central banking. It is my belief that this Reader represents a valuable source of information on matters that affect the Bank of Zambia for the current and future generations. It also highlights the Bank's history over the past 50 years, including the challenges faced and successes scored over the years.

Central banking has undergone significant challenges and changes which have had an impact on the conduct of monetary policy in particular and central banking in general. As an institution at the centre of economic management, the mission and operations of the Bank of Zambia have been shaped by the prevailing economic and political paradigms at both the domestic and global levels. The prevailing economic and political paradigms have been reflected in the Bank's experiences, with the nationalisation programme in the early 1970s; the collapse in commodity prices and the debt crisis that followed in the 1980s to the liberalisation of the economy in the early 1990s, all requiring the Bank to change its operations and focus in line with prevailing economic and political realities.

Through this evolution and adaptation, the Bank has played a key role in the overall economic management of the economy and contributed positively and significantly to the overall development of the country. Prior to the liberalisation of the economy, the Bank of Zambia's monetary policy had multiple objectives which included the promotion of economic growth by such means as financing agriculture, small scale enterprises, and parastatals while at the same time pursuing its traditional roles of maintaining price stability as well as regulation and supervision of financial institutions.

After the liberalisation of the economy, which started in earnest in the early 1990s, the Bank's mission and role became more focused on the maintenance of price and financial system stability. In this regard, a number of notable achievements have been made including price stability reflected in single-digit inflation from December 2009 to date, increase in the primary capital for banks and non-bank financial institutions in 2012, rebasing of the Kwacha in 2013 and the maintenance of financial stability over the years, which has supported the growth of both banks and non-bank financial institutions. In addition, advances have made in the payment systems with the introduction of the Zambia Interbank Payment and Settlement Systems, Direct Debits and Credits Clearing; Cheque Imaging and Clearing Systems, Mobile Money and Point of Sale Machines. The increased use of mobile money has enabled an increasing number of our citizens to have access to financial services.

The success of our two symposia required the support and cooperation of various stakeholders and partners. In this regard, I would like to take this opportunity to recognise the support from our Guest of Honour the Honourable Alexander B. Chikwanda MP, Minister of Finance, who graciously opened the International Symposium and launched the book on Zambia's Economic Policies. I also wish to express my sincere thanks to Reverend Howard Sikwela, Copperbelt Province Permanent Secretary, for officially opening the Business Symposium in Ndola. Furthermore, I would like to thank Government Officials and Members of Parliament who accepted our invitation to the symposia. My sincere thanks also go to the SADC Central Bank Governors and Officials as well as other distinguished invited guests from various parts of the globe who took part in our $50^{th}$ Anniversary celebrations. I am particularly grateful to Professor Christopher Adams, Professor Benno Ndulu, Dr. Johan Van de Heever and Ms. Kristin Gulbrandsen for having traveled from the United Kingdom, Tanzania, South Africa and Norway, respectively, to participate in our Jubilee celebrations by presenting papers at the International Symposium. I wish to also pay tribute to the former Governors, Deputy Governors and Directors of the Bank of Zambia for their participation in the Symposia as well as all the presenters, the moderators and discussants, whose professionalism contributed immensely to the success of the symposia.

Last but not least, I wish to acknowledge that the success of the International and Business symposia is a credit to the efforts of the staff of the Bank of Zambia, particularly the Technical Committee which was responsible for organising these events. I, therefore, thank you individually and severally for having made both the international and business symposia a success.

**Micheal Gondwe**

Governor

Bank of Zambia

# Summaries of the Proceedings

# 1.0 Summaries of the Proceedings

## 1.1 Summary of Lusaka Proceedings

On 7th August 2014, the Bank of Zambia marked 50 years of existence since its establishment on 7th August 1964. The theme of the Golden Jubilee celebrations was **"50 Years of Central Banking: Repositioning for the Future".**

As part of the Golden Jubilee celebrations, the Bank hosted an International Symposium at the Taj Pamodzi Hotel in Lusaka on 7th August 2014 to discuss different issues pertinent to the Bank's quest to reposition itself for the future as well as to reflect on its past. Participants included: Central Bank Governors and officials from within the SADC region; prominent local and international institutions; policy makers, the business community, academicians and researchers; members of parliament; heads of financial institutions; local and foreign development partners; and Bank of Zambia Board members and staff.

Presenters at the Symposium included Dr. Justin B. Zulu, the first Zambian Governor of the Bank of Zambia; Professor Benno Ndulu, Governor of the Bank of Tanzania; Dr. Johan van den Heever, Head of Economic Reviews and Statistics at the Reserve Bank of South Africa; Ms. Kristin Gulbrandsen, Executive Director of the Norges Bank; and Professor Christopher Adam of the Centre for Study of African Economies (CSAE) at the University of Oxford.

The Symposium was officially opened by the Honourable Minister of Finance, Mr. Alexander B. Chikwanda and was closed by the Governor of the Bank of Zambia, Dr Michael Gondwe. The moderators were Former Bank of Zambia Governor Dr. Caleb Fundanga and Bank of Tanzania Director of Research, Dr. Joseph Masawe.

The following were papers presented at the Symposium:

1. A Historical Perspective of Bank of Zambia by Dr. Justin B. Zulu
2. The Conduct of Monetary Policy in Central Banks after the Global Financial Crisis by Professor Benno Ndulu
3. Prospects for Financial Reform – Enhancing Financial Inclusion with special reference to the experience in South Africa by Dr. Johan van den Heever
4. Economic Policy and the Management of Sovereign Wealth Funds by Ms. Kristin Gulbrandsen
5. The Role of Central Banks in Economic Development by Professor Christopher Adam

### 1.1.1 Opening Remarks by Dr. Michael Gondwe

The Governor welcomed the participant to the Symposium and thanked them all for taking time out of their busy schedules to attend the symposium.

The key message from the Governor's opening remarks was that the Bank of Zambia was established on 7th August 1964 as the Bank of Northern Rhodesia following the dissolution of the Bank of Rhodesia and Nyasaland after the breakup of the Federation of Rhodesia and Nyasaland. It was subsequently renamed the Bank of Zambia following the attainment of Independence on October 24, 1964. Over the past 50 years significant changes had taken place in the Bank's legal framework, functions and operations, reflecting developments in both the global and domestic economies. The Governor noted that these changes have been documented into a book, "***50 Years of Central Banking***," written in a very simple and easy to read style, targeting the general public.

The Symposium was also informed that Honourable Minister was going to launch a book on economic policy in Zambia entitled: "Zambia: Building Prosperity from Resource Wealth", which was the product of a joint project between the Bank of Zambia and the University of

Oxford's Centre for the Study of African Economies. The Book was a reflection on economic policy in Zambia, and the current challenges that policy makers faced. It covers a broad range of topics including fiscal and monetary policy, financial stability and governance issues. The authors of the book included the Bank of Zambia and the University of Oxford staff as well as other international authors.

### 1.1.2 Official Opening and Book Launch Remarks by Honourable Alexander Chikwanda, Minister of Finance

The Minister officially opened the Symposium and noted that the 50th Anniversary of the Bank of Zambia coincided with 50 years of Zambia's political independence. His central message was on the importance of the interplay between international and domestic events and pointed out that this link has gotten stronger over the past 50 years and is reflected in greater trade, financial and political integration.

On the domestic economy, the Minister observed that Zambia's financial markets remained shallow and did not effectively support small scale entrepreneurs in the economy who are the most dynamic creators of growth and jobs. He also intimated that to consolidate the economic progress made so far it was imperative that fiscal and monetary policies continued to complement each other to sustain the macroeconomic stability the country has achieved that was reflected in single digit inflation and lower budget deficits over time. The expansionary fiscal policy currently in place was aimed at addressing significant infrastructure deficit the nation has experienced over time.

The Minister emphasised the importance of governance and accountability. He stated that elected politicians had the duty of improving people's livelihoods and being responsive to their concerns, such as the high cost of credit and its availability, rising inflation and exchange rate instability. He reminded participants that these challenges fall under the ambit of the central bank while acknowledging that sound fiscal policy is an indispensable ingredient in addressing these challenges. This has been ably demonstrated in Zambia's own success in establishing and maintaining macroeconomic stability. Honourable Chikwanda also highlighted the possibility that there can be and often is a creative tension between fiscal and monetary policy, particularly in instances where fiscal policy is expansionary. He, however, pointed out that this can be managed through appropriate governance arrangements, which allow the central bank some operational independence while being accountable to the wider group of stakeholders. He intimated that the Bank of Zambia does have operational independence and on the whole cooperates well with the Ministry of Finance.

After his official opening remarks, the Minister, then went on to launch the book - Zambia: Building Prosperity from Resource Wealth.

# Summary of Papers Presented

### 1.1.3 A Historical Perspective of Bank of Zambia

*Presenter: Dr. Justin B. Zulu*

*Moderator: Dr. Caleb Fundanga*

The paper presented a history of the Bank and captured some capsules of institutional memory from the first Zambian Governor of the Bank. The paper pointed out that in the beginning as is the case today, the operations of the Bank were impacted by the country's governance system, economic structure, history as well as the central bank's own competence, capacity and entrepreneurship. In the early years after independence, the Bank's main preoccupation was monetary control and regulation of the financial system. The Bank was also banker to commercial banks and banker to Government, functions which have not changed since. He pointed out that over the years the volume and mix of these functions have changed. He added that in recent times, the Bank is more concerned with stability in the financial system and in prices than it was in the beginning. In addition, he noted that there has been a sweeping organic evolution of the Bank as it has taken the form of a more robust and comprehensive management of the regulation and supervision of the banks as well as non-bank financial institutions; the development of a modern payments and settlement system and implementation of an anti-money laundering regime.

In relation to the evolution of Bank staff, Dr Zulu indicated that in 1967, the Bank had a complement of 170 staff which peaked in 1992 to around 1,200. He stated that after various rounds of re-organisation the staff complement stood at around 523 in 2014. As regards staff mix, in the early years of the Bank, there were mainly economists in the Bank, but now the Bank has a mix of professional staff such as lawyers, accountants and finance professionals in addition to the traditional economists. The Bank of Zambia has had 13 Governors over its 50 years of existence and 3 generations of staff.

With regard to developments in the economy, he observed that the economy has diversified reasonably but mining still remains the predominant sector. Raw materials constitute 80% of the country's exports, but only accounts for 12% of GDP contribution. Among the notable indicators that have changed over time is inflation, which has reduced from the double and triple digits of the 1980s and 1990s to the single digits of the 2000s. These achievements could largely be attributable to prudent fiscal policies and appropriate monetary policies that successive governments have undertaken over the years.

Dr. Zulu urged the Bank of Zambia to remain mindful of the broader accountability to the markets and the general public.

### 1.1.4 The Conduct of Monetary Policy by Central Banks after the Global Financial Crisis

*Presenter: Professor Benno Ndulu*

*Moderator: Dr Caleb Fundanga*

Prof. Ndulu motivated his presentation by stating that there is a growing trend among African countries to enshrine in the law central bank independence as a way of preventing a fundamental undermining of the central bank's competence. He stated that across many African countries, macroeconomic stability has been attained and that it is clear that stability can deliver sustained economic growth. Inflation in Africa has declined from over 21% to an average of 8% among many African countries. The two decades of economic growth, averaging 5% has had a favourable impact on poverty reduction as highly populated countries such as Nigeria and Ethiopia have been growing on a sustained basis. He stated that according to the World Bank, 68% of Africans live in fast growing economies and that Africa has some of the fastest growing economies in the world. The growth rate of Africa's new middle income countries is faster than population growth rates, and as a result over 100 million people have been brought out of poverty in Africa in the last 14 years. These changes can be largely credited to macroeconomic stability that has delivered the sustained economic growth being experienced in Africa today.

Professor Ndulu stated that macroeconomic stability is an anchor for sustained economic growth although monetary policy has faced some challenges. One is the changing local context or environment for effective conduct of monetary policy given the supply-side shocks experienced by most African economies, with draught and oil price increases being more prevalent. Addressing these supply-side shocks is beyond the means of monetary policy. The second challenge deals with the effects and aftermath of the global financial crisis of 2008 coupled with the euro debt crisis of 2012. These episodes have led to exchange rate volatility with a bias towards depreciation that has had an adverse pass-through to inflation. The other challenge is related to a seemingly broken relationship between money supply and inflation partly due to the increase in monetization, financial innovation, and the advent of the mobile and e-money as a result of technological advancement. Further, foreign capital flows are yet another challenge faced by monetary authorities as they put pressure on exchange rates.

Monetary policy in Africa must change to face the challenge of not only focussing on price stability, but also financial stability after the global financial crisis. Maintaining low interest rates can cause excessive risk taking by economic agents leading to asset and property prices escalating to unsustainable levels. Central banks, therefore, need to strike a balance between maximizing output growth and minimizing excessive risk in order to contain the risk of surges in capital outflows that lead to currency crises. The shift in monetary policy framework implies less financing of fiscal deficits and that there should be more exchange rate flexibility with central bank independence emphasized and assured by law. Central bank independence can also be assured by central banks improving transparency and communication to the public on its independence in setting monetary policy targets and actions.

In order to improve liquidity on the market, central banks should be urged to adopt flexible instruments of monetary control such as term deposits, foreign exchange swaps and reverse repos. The biggest challenge in choosing an optimal level of inflation is the “time-inconsistency problem” so central banks should consider setting inflation targets as long-term goals of monetary policy.

Prudential policies that promote financial stability have an impact on monetary policy as they are intertwined. Monetary policy cannot solely restore financial stability; therefore, it is important for central banks to cooperate with other stakeholders in the financial system, including government to maintain a functioning financial sector. Coordination and cooperation amongst regional central banks and other financial institutions should also be strengthened to manage cross-border spill-over effects.

### 1.1.5 Prospects for Financial Reforms – Enhancing Financial Inclusion With special reference to the experience in South Africa

*Presenter: Dr Johan van den Heever*

*Moderator: Dr Caleb Fundanga*

The presentation first highlighted measures the South African Government took post-1994, to promote broader access to financial services for the vast majority of the population. The symposium was informed that South Africa's financial inclusion stood at 33% in 1994. To improve this statistic, a strategy was put in place with an emphasis to improve access to financial services through lower costs, promoting a competitive sector by building on existing range of banks of different sizes and opening the sector to foreign competition. However, these measures did not really work except for high net worth individuals and corporations.

Dr Heever also indicated that South Africa suffered a mini banking crisis between 1998 and 2003. The crisis prompted improvements in the regulatory environment and created an opportunity to re-engineer the process to achieve broad-based financial inclusion. Financial inclusion after the crisis shifted to larger banks which introduced various products including the Mzanzi account – a low cost low transaction account. In addition, the government and the private sector started paying out benefits through the banking system. The major problem that was left was the unsecured lending which was open to unscrupulous lenders.

The option of micro-lending was adopted in turn following the realization that the earlier initiatives did not benefit the intended groups. Micro-lending institutions were encouraged to improve access to finance, especially for the poor households. However, this brought about a challenge of high indebtedness as the poor households were borrowing for consumption at high interest rates. The paper also pointed out the need to balance macroeconomic stability and Financial Inclusion. Central banks world-wide find themselves in similar circumstances where they try to achieve competing objectives of achieving a more inclusive financial sector without losing focus on financial stability and at the same time ensuring that price stability was maintained.

### 1.1.6 Economic Policy and the Management of Sovereign Wealth

*Presenter: Kristin Gulbrandsen*

*Moderator: Dr Joseph Masawe*

This paper focussed on the economic policy framework governing the management of natural resource wealth in Norway. Although there were differences in the structure of the natural resource sectors in Zambia and Norway, the Norwegian model could provide useful insights on the implementation of a more robust policy framework for natural resource management.

Ms Gulbrandsen emphasised the importance of maintaining price stability as the core function for monetary policy because high and unstable inflation erodes the monetary system and confidence in a currency. She informed the audience that following Norway's independence, a constitution which established institutions with clearly distinguished roles and functions was enacted. The body of elected representatives was responsible for managing the monetary system and this task was subsequently delegated to the central bank. The central bank was an important institution that was used to restore confidence in the monetary system and currency, following periods of hyperinflation experienced under the rule of the Danish monarch. However, stability in the monetary system was not achieved immediately and it took 25 years for the central bank to fully consolidate its reputation.

A period of macroeconomic instability ensued with the onset of World War I in 1918, although, Norway did not participate in the conflict. The surge in export revenues during this period resulted in high public spending and credit growth. Faced with high inflation, the country tightened monetary policy which however led to the undesirable effects of bankruptcies and high unemployment. This macro instability meant that Norway had to revive confidence in its monetary system. The key lesson from this experience is that reducing inflation is costly for a central bank once the anchor has slipped.

Norway suffered a third episode of inflation in the 1970s and 80s, which occurred due to a misconception by policy makers that low levels of employment could be attained at the cost of high inflation. With the discovery of petroleum and higher export revenues during this period, policy makers embarked on a loose fiscal policy which resulted in higher rates of inflation and macroeconomic instability. These conditions weakened growth, necessitating a shift in economic policy management and the implementation of structural reforms in 1986. The central bank was given more independence and was to use a policy rate to achieve monetary stability.

On the fiscal front, a Sovereign Wealth Fund (SWF) was created in which excess revenues from petroleum exports were to be saved. With the setting up of the Fund, government spending was to be smoothened, at the same time income was to be saved for the future generations.

In addition, a fiscal rule was established in which government spending of petroleum revenues was limited to the real rate of return earned on the Fund. This rule ensured that only income generated from the Fund was spent and that capital was preserved for future generations. Restricting spending of current oil revenues has also helped contain the real appreciation of the local currency during periods of high commodity prices, which preserved the competitiveness of local exporters. In this regard, the Government ran a budget deficit of the same magnitude as the oil revenues earmarked for spending.

The value of the Fund had grown significantly and is expected to exceed the value of the remaining petroleum reserves over the next couple of years. This was made possible by a well-defined governance framework. The Fund is owned by the Norwegian people and the political responsibility of the Fund lies with the Ministry of Finance. The investment strategy principles of the Fund are enacted in Parliament and the responsibility for the management of the funds has been delegated to the central bank.

Sound and consistent monetary and fiscal policies were key to achieving and maintain a stable regulatory framework. Price stability is an onerous task to achieve, if fiscal spending is loose. She recognised that although Norway's economic policy had been a success in managing the cyclical commodity price movements, its resilience would be tested once the petroleum reserves and production had declined.

During the discussions, the audience was informed that Norway has developed robust industries around its petroleum industry which provide massive support, such as equipment and financial services. By developing a strong support network for the oil industry, Norway had strengthened economic linkages between the oil and non-oil industries which help ensure that oil revenues accrued to the local economy.

### 1.1.7 The Role of a Central Bank in Economic Development

*Presenter: Professor Christopher Adam*

*Moderator: by Dr. Joseph Masawe*

Professor Adams discussed the role of monetary policy in influencing economic development process. He provided a historical background of central banks' monetary policies and how this has evolved from the 1970s. In the 1970s, most African countries believed that monetary policy should be deployed as a purposive instrument in the broader development process. Thus, monetary frameworks in Africa had multiple objectives, geared towards the financing of government activities, the extension of subsidized credit to favoured sectors and managed exchange rates, rather than to the control of inflation. The combination of fiscal dominance and the over-burdening of monetary policy resulted in many African central banks generally doing too much but delivering too little.

By the early 1990s to 2000s, most countries moved towards floating exchange rates and there was erosion of fiscal dominance. These created conditions for conventional monetary policy regimes characterized by a single objective of reducing inflation. However, in the post global financial crisis era, there has been a shift in monetary policy regimes towards Inflation Targeting, which itself brought new pressures for central banks to broaden mandates to include output stabilization and financial system stability in addition to price stability. There is a growing trend for central banks to be more transparent in communicating monetary policy with much more engagement with market participants on central bank operations. Professor Adam stated that while this conventional approach of monetary policy is appealing, it has however, created a number of challenges.

These include the management of supply-side shocks, which cannot be addressed solely through monetary policy. Professor Adams also discussed the management of capital flows, and argues that while long-term capital flows are beneficial, they can also be costly. The volatility of cross-border capital flows can pose challenges precipitated through the financial sector. In view of the current financially integrated world, it is impossible to have monetary policy independence, a fixed exchange rate and open capital accounts, otherwise termed the 'trilemma'; hence countries have had to abandon fixed exchange rates. The global financial cycle had transformed this 'trilemma' into a 'dilemma', i.e., independent monetary policies are possible only if the capital account is managed directly or indirectly.

Professor Adams proposed that the right policies to deal with the 'dilemma' should aim at curbing excessive credit growth and leverage. A combination of macro-prudential policies is also needed, guided by stress testing and tougher leverage ratios. The paper notes the need for coherence in mitigating distortions brought about by short-term capital flows.

A number of issues were brought up during the discussion. Firstly, Angola indicated that the issue of lack of transparency in communicating monetary policy operations was true up to 2010 in the case of Angola. However, with the change of administration in the Central Bank, the Monetary Policy Committee (MPC) meets once a month and its reports are published. In addition, other committees, such as financial sector committee, committee for investment also published reports, including statistics on reserves. These reports were made available to the public. The Bank of Angola had a clear communication strategy, with campaigns to public and presentation of policies at national level.

On the question of distinguishing between good and bad controls in the private sector, and whether certain measures could be perceived as controls and therefore worsen the situation being mitigated, the Symposium was informed about good controls versus bad controls based on IMF November 2012 Report. In that Report, the IMF stance is that capital controls should not be tools you use as the first approach but should be part of macro-prudential regulatory kit. The private sector may not be able to distinguish between good and bad controls, hence the need for these measures to be clearly explained so that they are better understood. Good measures are when you communicate transparently and coherently. Tax measures are examples of good measures i.e. coherent, well understood and transparent. Evidence from other countries has not been so clear, an area where public policy, central banks and international agencies could focus.

With regard to question of pressure on exchange rates in Africa, and whether they are stage-managed by politics, participants were informed that capital flows cannot always be closed, as markets always find a way of filtering through the system. Hence, pressure on exchange rate will always arise. The real issue to be concerned with is the real exchange rate, which measures the real competitiveness of the country.

## 1.2 Summary of Ndola Proceedings

As part of the Golden Jubilee celebrations at the Bank of Zambia Regional Office, the Bank hosted a regional economic symposium at the Levy Mwanawasa Pavilion in Ndola on 8th August 2014 to discuss different issues pertinent to the Bank's quest to reposition itself for the future as well as to reflect on its past. Participants included the business community from the Copperbelt province, heads of local commercial banks, academicians and Bank of Zambia senior management, current staff and former employees.

Presenters at the Symposium included Mr Peter Banda, Senior Director Monetary policy at Bank of Zambia; Dr. E.W Chabala, Chief Executive Officer of the Securities and Exchange Commission; Dr. Sumbye Kapena, Dean of the School of Business at the Copperbelt University and Mr Lishala Situmbeko, Director - Treasury and Investment Management, Zambia National Commercial Bank Plc.

The Regional Symposium was officially opened by the Copperbelt Province Permanent Secretary, Reverend Howard Sikwela on behalf of the Copperbelt Province Minister, Honourable Mwenya Musenge. The moderators were all former Bank of Zambia Regional Office Directors.

The following were papers presented at the Symposium:

1. A Perspective on Economic Reforms in Zambia: Rationale and Impact on Economic Growth by Mr Peter Banda with Professor John Lungu from the Copperbelt University as a discussant;
2. Capital Markets: Lost Opportunities to the Zambian Economy by Dr E.W Chabala and Mr Steven Mpembele from Copperbelt University as a Discussant;
3. Financial Inclusion and Financial Literacy by Dr. Sumbye Kapena and Mr. Musapenda Phiri from the Bank of Zambia as a discussant; and,
4. The Foreign Exchange Market in Zambia: How it works and Prospects for the Future by Mr Lishala C. Situmbeko and Dr Lubinda Habazooka from the Copperbelt University as a discussant.

#### 1.2.1 Official Opening Remarks by Reverend Howard Sikwela – Copperbelt Province Permanent Secretary

The symposium was officially opened by Copperbelt Province Permanent Secretary, Reverend Howard Sikwela on behalf of the Copperbelt Province Minister, Honourable Mwenya Musenge.

In his speech, the Provincial Minister highlighted the roles of the Bank of Zambia Regional Office, which include provision of an inter-face between commercial banks and the Bank of Zambia in the Northern Region; providing banking services to ministries, provinces and other government spending agencies (MPSAS) through the five provincial accounting units in the Northern Region; facilitating cash deposits and withdrawals by commercial banks, inter-bank electronic clearing and real time gross settlement system (RTGS) transactions.

The Minister also acknowledged the changes that the Bank has undergone over the past 50 years to meet the demand for its services. He noted that due to the expansion of economic activities in the Northern Region, the Bank had introduced departments that were not earlier represented at the Regional Office to facilitate better monitoring of the activities. Further, the Bank had undertaken measure that was aimed at enhancing the soundness and stability of the financial system by revising the Capital Adequacy provisions and putting in place a robust regulatory framework.

The Minister also noted that main economic activities of the Northern Region revolve around mining. He pointed out that in the recent past mining activity had been scaled up due to increased international demand. As a result of the increased mining activity, there has been an increase in the number of commercial banks to meet the demand for banking services in the region. The Minister observed that the increased investor confidence in the economy as evidenced by establishment of value addition entities such as Zambezi Portland Cement, Dangote Cement Industries and Gourock Industries has increased the importance of the Northern Region in the economy. In this regard, the Bank of Zambia is expected to continue playing an important role in the economic activities of the Northern Region.

He concluded by noting that the anniversary marks 50 years of dynamic transformation and achievements accomplished by the Bank, with some important milestones such as achievement and maintenance of single digit inflation, introduction of Credit Reference Bureau, successful currency rebasing, improved cheque clearing process period and a stable financial sector.

### 1.2.2 Keynote Address by Dr. Tukiya Kankasa-Mabula, Bank of Zambia Deputy Governor –Administration

The keynote address at the Symposium was made by the Bank of Zambia Deputy Governor - Administration, Dr. Tukiya Kankasa-Mabula. Her address focused on the history of the Bank of Zambia during the period 1964 to 2014. She noted that over the last 50 years the BoZ organisational structure and operations had undergone multiple changes to meet the ever changing Zambian economic terrain and development. During the last 50 years, the Central Bank faced a number of challenges which included shortage of qualified staff, conflicting mandates, shortage of foreign exchange, economic decline, bank closures and under-developed financial markets. Therefore, the commemoration of the 50th Anniversary for Zambia provided an opportune time to reflect on the history of the Bank and the way forward.

The Symposium was informed that the Bank started its operations as the Bank of Northern Rhodesia on 7th August 1964 following the break-up of the Federation of Rhodesia and Nyasaland, and on attainment of the country's independence was renamed the Bank of Zambia. Over the years, the Bank has made significant strides including significant investment in human resources to suit the ever changing global and domestic economic terrains. She noted that this investment has resulted in the Bank now being staffed by a highly qualified compliment of economists, lawyers, accountants, supervisors, regulators, financial analysts among others ready to meet the economic challenges the country faces. Going forward, this mix of qualified staff would enable the Bank to be much more pro-active in keeping with the ever changing monetary and financial sector landscape.

The Deputy Governor also observed that the Bank has over the years continued to modernise both monetary and supervisory policies in line with its mission of maintaining price and financial system stability. She noted that during the last 50 years, the banking sector has grown from 3 foreign banks in 1967 to 19 local and foreign-owned commercial banks and 112 non-bank financial institutions at end-June 2014. The Bank had also embarked on empowerment of citizens through improved financial access by implementing the Financial Sector Development Plan (FSDP) spearheaded by the Government in collaboration with the Securities and Exchange Commission, and the Pensions and Insurance Authority since 2004. She indicated that the main objective of the FSDP is to broaden and deepen the financial sector in Zambia

In concluding the keynote address, the Deputy Governor emphasized that the Bank of Zambia's objective is to promote price and financial system stability for balanced macroeconomic development and believed that this objective remained appropriate for the future.

# Summary of Papers Presented

### 1.2.3 A Perspective on Economic Reforms in Zambia: Rationale and Impact on Economic Growth

*Presenter: Mr. Peter Banda*

*Discussant: Professor John Lungu*

Mr Peter Banda, Senior Director for Monetary Policy, discussed the reforms that Zambia had undertaken since the early 1990s, outlining their rationale and impact on the county's economic performance. He highlighted the macroeconomic problems that had characterised the economy, including prolonged periods of high inflation, sluggish growth and external shocks in the 1970s and 1980s and in the early 1990s. The paper also offered some suggestions on further policy reforms that are required to sustain macroeconomic stability and growth going forward.

In the early 1990s, the prolonged stagnation of the economy necessitated the impementation of significant and sustained reforms. The authorities first objective in the reform process was the attainment of macroeconomic stability in order to revive economic growth. In this regard, rigorous monetary and fiscal policy reforms were put in place aimed at reducing the growth in money supply and cutting fiscal deficits in order to reign in inflation.

Alongside wide ranging economic reforms which included external sector and trade reforms were also changes in the conduct of monetary policy which were instituted to underpin macroeconomic stability. In this regard, the objective of monetary policy was narrowed to focus on creating a stable macroeconomic environment to support sustainable economic growth while implementation of monetary policy shifted from relying on direct tools to indirect market-based monetary policy instruments.

To create a private sector driven economy, authorities embarked on the privatisation of state owned enterprises ranging from mining, transport, manufacturing, financial services and bakeries which were characterised by low productivity and undercapitalization. This privatisation process also helped to free the limited government resources.

The paper notes that overall the economic reforms have had a positive impact on the performance of the Zambian economy. As a result of the reforms, real GDP growth recovered strongly, rising from an average of 0.8% per annum in the 1990s to 5.6% per annum in the 2000s. The country's external sector indicators also improved over the last two decades. The level of external debt declined from mid-2000s while the level of debt service also fell. Total reserves as a percentage of external debt rose from 2.3% during the period 1985-1989 to 56.5% in 2012. In addition, the country also recorded a favorable balance of payment positions as a result of increased exports as well as inflows foreign direct and portfolio investments.

As regards poverty reduction, the paper indicated that there has been a positive impacted on the incidence of poverty in the country overtime as a result of the economic reforms undertaken. Given the pro-poor approach of the current authorities in economic management, policies that focus on areas that were previously marginalised such as rural areas are expected to go a long-way in turning around the economic fortunes of rural areas, thereby helping in reducing the high incidences of poverty that characterise many rural areas.

The paper concluded that the challenge going forward is to sustain the improved macroeconomic environment and enhance the participation of the vast majority of the population in the nation's growing prosperity through the expansion of job opportunities. Sustaining robust and inclusive growth going forward requires continuing with reforms that allow the private sector to flourish. The perspective of the central bank in this case was that focus should continue to be on the pursuit of appropriate monetary policy and financial sector stability that will ensure the maintenance of a stable macroeconomic environment necessary for sustainable economic growth and development.

In the discussions led by the discussant, Professor Lungu, indicated that the 1991 reforms were good though there is room for improvement. He emphasised that part of the problem the country faced after independence had to do with the employment of unqualified Zambians though nationalisation in critical positions who subsequently failed to drive the development agenda. Further, he was of the view that the policy of import substitution and the failure to adequately respond to higher oil prices on the international market and declining copper prices contributed to the stagnation of the economy prior to embarking on comprehensive reforms in the 1990s. Professor Lungu however pointed to country wide infrastructure developments and economic growth as positive aspects since liberalisation but reiterated that going forward, there was need to address income inequalities.

During the general discussion, questions were raised about the meaning of poverty reduction and whether Zambia had any poverty targets. Another participant also agreed with the presenter that there was income inequality and inquired whether government had embarked on any programmes to try and mitigate the inequality. The meeting was informed that poverty could be defined in a number of ways and that the challenge was to equitably share the benefits of this positive growth to the majority of the population. Programmes such as the fertilizer support programmes and others were meant to help the vulnerable in society.

Another participant observed that there were low levels of literacy at independence that could not sustain the required economic growth and suggested that it would be an interesting exercise in future to compare the different political dispensations and measure the effectiveness of their policies to enable the country understand what infrastructure was need and when it was need to inform future policy. Questions were also raised on the impact of borrowing on the Zambian economy. The meeting was informed that borrowing was still sustainable and within acceptable limits.

The meeting also wanted to know what the Bank of Zambia was doing about inflation and exchange rate volatility. The meeting was informed that relative macroeconomic stability has been achieved in the economy as reflected in inflation, which has been maintained at single digits since 2006 and that the central bank always intervened to smoothen volatility of the exchange rate in either direction and did not target any specific rate.

### 1.2.4 Capital Markets: Lost Opportunities to the Zambian Economy

*Presenter:Dr. Wala Chabala*

*Discussant: Mr. Steven Mpembele*

Dr. Wala Chabala, in his presentation, reflected on lost opportunities to the Zambian economy arising from under-developed capital markets in the country despite the capital markets having been in existence for the last 20 years. The capital market in Zambia is characterised by low numbers of listed private companies; it is perceived as a club and is characterised by poor information and data dissemination. The capital market is very small and hence it is constrained in playing an effective role in the economy. In this regard, the capital market has been unable to contribute meaningfully to a stable fiscal environment, act as a platform for commodity trading or exchange, or indeed a platform for small and medium enterprises (SMEs) to contribute to economic growth.

The paper indicated that poor performance of the capital markets in relation to the money market has created an unhealthy imbalance in the financial markets system which needed to be corrected. The paper proposed measures to address the imbalance to ensure that the capital markets play a significant role in the economy. These measures included the Securities and Exchange Commission continuing to spearhead the development the capital market in conjunction with other stake holders, particularly the Lusaka Stoke Exchange, and ensuring that as far as possible multinational companies and suitable state owned enterprises partially list on the stock exchange. In addition, the paper suggested that infrastructure development projects should use the capital markets to raise the requisite funds. Further, the paper proposed that trading of all significant commodities should be migrated onto exchanges in Zambia for commodities such as emeralds, other metals and agricultural commodities. These measures, if successful, would go a long way in developing the capital market in Zambia.

In conclusion, the paper suggested that it might be appropriate for a Capital Markets Development programme to be established to drive the transformation required in development of the capital markets to enable it play a significant role in Zambia's economic development.

The discussant, Mr Steven Mpembele was of the view that Zambia as an emerging market needs capital markets to develop. He indicated that factors that have greatly contributed to the failure of capital markets in Zambia included few players on the capital market; lack of transparency of the market, a difficult registration process that made the market unattractive; lack of information on economic activities making planning difficult and a lack of proper marketing of our country to the external world. This in his view was in addition to a stagnant bond market; poor regulation by the SEC; cultural and traditional beliefs about wealth creation in the country and high withholding taxes adversely affecting would be investors.

During the general discussions, participants expressed a view that the process and costs involved in listing at the stock exchange were high and advised the SEC to address these concerns. In addition, the discussions revealed that the levels of savings in the country were too low and this made it difficult for most of the population to participate in the stock market. The meeting also suggested that it was important for the regulators to make it easy for SMEs to participate in the capital markets as it was a cheaper source of funds.

### 1.2.5 The Foreign Exchange Market in Zambia: How it Works and Prospects for the Future

*Presenter: Mr. Lishala Situmbeko*

*Discusssant: Dr. Lubinda Habazooka*

This paper discussed the operations of the foreign exchange market in Zambia and highlighted exchange rate determination by making a distinction between the pre and post-liberalisation episodes. The paper also presented an overview of the theory on the determinants of the exchange rate as well as the microstructure model of the foreign exchange market. The paper noted that understanding the microstructure perspective was fundamental to gaining an appreciation of the current foreign exchange market in Zambia. The key features of the model are that there is dealing amongst dealers in the interbank market; dealers have an informational advantage by observing customer order flow and that dealers are risk averse.

With regard to the exchange rate regimes, the paper noted that in the pre-liberalisation period, the exchange rate was a controlled price and after the liberalisation period a floating system was introduced as part of the broad macroeconomic reforms implemented after 1991. The paper noted that there were 12 exchange rate episodes in Zambia from 1964, starting with the exchange rate being fixed to the Pound Sterling between 1964 and 1971 to the introduction of the broad-based interbank foreign exchange market system introduced in 2003.

Most of the trading currencies on the Zambian foreign exchange market are dominated by the trades between the Kwacha and US dollar. Other currencies traded on the foreign exchange market include the Rand, Euro and Pound. The most popular foreign exchange (FX) instrument is the spot FX instrument. FX hedging using forward contracts is still low and the development of derivatives market remains a challenge until the money market and yield curve are developed to the same level as the foreign exchange and money market.

The market is a two-tier market, involving the interbank markets for the commercial banks on one hand and the market between banks and their customers. The paper argues that a discussion of the foreign exchange market should also consider the actual workings of the market as advocated by microstructure theory which includes 'order flow'; a variable derived from the actual transactions within the market mechanism itself. Further, the paper also highlighted how an actual dealer operates within the Zambian foreign exchange market and outlined what happens in the dealing room by defining the roles of the foreign exchange dealers, money market dealers and sales dealers.

In terms of regulation, the paper notes that the foreign exchange market is regulated by the Bank of Zambia which licences authorized foreign exchange dealers, mainly commercial banks and bureaux de change. The key market for price discovery is the interbank market. The rules for the interbank market are set by the Interbank Foreign Exchange Market and all commercial banks are signatories to a foreign exchange code of conduct.

The conclusion of the paper was that the market mechanism was still the most viable option for price discovery in the foreign exchange market now and into the future. In addition, diversity in foreign exchange supply was cited as desirable going forward.

In the discussions, Dr. Lubinda Habazooka mostly agreed with the presentation and generally indicated that the foreign exchange market in the world is very developed in that most contracts involve swaps and forward contracts. The discussant indicated that in the banking sector foreign exchange business was very lucrative and noted the possibility of cartels being formed by the banks in this respect to increase their revenues. The observation was made in the context of the developments in the foreign exchange market in the earlier part of 2014 and the increase in imports of road building materials by the Government.

### 1.2.6 Financial Inclusion and Financial Literacy

*Presenter: Dr Sumbye Kapena*

*Discussant: Mr. Musapenda Phiri*

The paper reviews the key theoretical, empirical and policy developments of financial inclusion and literacy with the purpose of drawing useful lessons for Zambia and other developing countries in general. This paper discusses the current scholarly and policy debate on financial inclusion in the context of the field of economic development. The debate is on with what can be done to alleviate poverty in developing countries through financial inclusion.

In this paper, Dr Kapena reflects on the fact that financial inclusion, which broadly aims at ensuring that no one was excluded from access to the financial services, is recognized as one of the important ways of bringing about desired economic outcomes. The paper presents both theoretical and empirical literature which traces the debate on financial inclusion, and it's positive influence on key economic outcomes for the poor households such income, consumption, access to health facilities as well as protection against potential shocks. Financial inclusion also enables the marginalised sections of society to build assets and improve their wellbeing.

The paper covers developments from the mid 1940's when the economic prescription moved from focusing on one determinant of financial inclusion-saving- to multiple determinants and the return to focus on one determinant after the global financial crisis i.e. financial literacy. The G20 and other international organisations have taken the lead in spearheading financial literacy as the key determinant of financial inclusion after the global financial crisis. The paper also covers the general principles and frameworks of financial inclusion including the global partnership for financial inclusion (GPFI), Maya Declaration and OECD/INFE high-level Principles on National Strategies for Financial. Education

With respect to Zambia, Dr. Kapena notes that Zambia has now prioritized financial literacy and is committed to improving financial literacy, and improving measurement in line with the new thinking after the global financial crisis. He cautions against this approach because there is a possibility of achieving very little in the area of financial inclusion if financial literacy finally turns out not to be an important factor for financial inclusion. He also pointed out that Zambia has taken an institution-centered approach to financial learning and has planned to commit a huge amount of resources. The broad focus is to cover all school going children, youths and adults; at their learning places and outside their learning places, in the case of the first two categories; and at their work places and outside their work places, in the case of adults.

The paper highlighted some of Zambia's main achievements as follows:

- The country is already close to achieving the 50% target and might have to update commitment based on the results of upcoming FinScope Survey;
- By March 2013, the number of districts provided with banking and financial services increased to 86;
- The number of bank branches and agencies increased from 277 in September 2011 to 322 as of March 2013;
- The country developed an index to measure the depth and breadth of financial inclusion;
- Finalized the draft framework on branchless banking;
- Draft bill for the Unified Collateral Registry was prepared in March 2013 for consideration and review by key stakeholders;
- The revised Banking and Financial Services Bill has been reviewed by stakeholders and has been harmonized with other key financial sector laws;
- In July 2012, launched the financial education strategy with four priority target groups: children, youth, adults and cross-cutting programs; and,
- Held Financial Literacy Week in March 2013, resulting in a total outreach of 4,600 young people across 22 locations in Zambia,

The increased focus on financial inclusion and financial literacy since the 2007-2009 global financial crisis increased the knowledge of researchers and policy makers. However, the paper cautions against transferring resources to the implementation of the new financial inclusion policy focusing only on financial literacy that could result in relative neglect of the existing policies that have already been proved to be useful so far. The paper contends that this applies even in cases where financial resources are externally provided specifically for implementation of the new policy.

The discussant, Mr Musapenda Phiri indicated that the financial inclusion strategy has been designed in accordance with international standards. He indicated that there were adequate human and technical staff to drive the process and that it was important to note that Bank of Zambia, Securities and Exchange Commission and the Pension and Insurance Authority were facilitators and not enforcers. The National target is to increase financial inclusion to 50%. He intimated that the scope of Financial Education Coordinating Unit (FECU) was broad enough to take such a challenge and would work with institutions already involved in financial education such as CAMFED. With regard to the paper, Mr Phiri indicated that conventional model guidelines were highlighted in the paper although he was of the view that there was need for Cabinet Office to involve provincial Permanent Secretaries as regional champions for financial inclusion. Mr Phiri also informed the meeting that FECU was currently working with Ministry of Education to introduce financial literacy in the curriculum.

# DETAILED SPEECHES

# 2.1 The Role of China in Africa's Development

**Keynote Address at the Bank of Zambia 50th Anniverssary Gala Dinner**

Jean Louis Ekra*

*The Guest of Honour, Honourable Alexander B. Chikwanda, Minister of Finance of the Republic of Zambia,*

*The Governor of the Bank of Zambia,*

*Governors of Central Banks,*

*Former Governors of the Bank of Zambia,*

*Government Officials here present,*

*Officials from Regional and International Organisations,*

*Your Excellencies, Members of the Diplomatic Corps,*

*Deputy Governors,*

*All Protocols Observed,*

*Distinguished Ladies and Gentlemen*

I would like to begin my remarks by thanking the Governor, my old time friend Dr Michael Gondwe, for inviting me at the occasion of the celebration of the 50th Anniversary of the Bank of Zambia. I am particularly honored to be given the opportunity to deliver a Keynote Address on "**The Role of China in Africa's Development".** This is a very interesting and timely topic. But it is also challenging at a time when a "Grand Debate" on the nature of China's relations with our continent is taking place in different quarters across the world.

Before I begin my remarks on this topic, please allow me to congratulate the Government and the Bank of Zambia for the implementation of financial reforms and the conduct of prudent monetary policies which have enabled the country to keep a right balance between inflation control and economic growth, thereby achieving a good macroeconomic performance over the years. I know how difficult it is to conduct macroeconomic policies in an environment that lacks a developed capital market. Once again, congratulations.

Turning to the topic of my intervention, I would like to propose centering my remarks on four main issues of interest to all of us. Firstly, I will like to talk about the above-mentioned "Grand Debate" on the real nature of the economic relations that have significantly increased between Africa and China during the last two decades or more. Secondly, I will try to review briefly Sino-Africa relations from a historical perspective. Thirdly, I will endeavor to show that China has achieved a level of development that enables it to continue to improve the living standards of its own population while helping other countries or regions of the world, including Africa to achieve real economic progress in win-win partnership arrangements. Fourthly, I will propose sectors where China could invest as a strategic partner in order to enable Africa to achieve its industrialization and other economic development objectives in the decades to come before concluding my remarks.

*President and Chairman of the Board of Directors Afriexlmbank. Speech delivered at the Bank of Zambia Golden Jubilee Dinner at the Intercontinental Hotel Lusaka, 6th August 2014

*Mr. Chairman,*

*Your Excellencies,*

*Distinguished Ladies and Gentlemen,*

During the last two decades, economic and political relations between Africa and China have become a subject of a heated debate among African and non-African intellectuals and policy makers. On one side of this debate, there are some who see these relations as a welcome form of partnership that is likely to enable Africa to lessen its heavy dependence on traditional trade and economic development partners and finally become a significant player in the global economy.

Others argue that China's policy towards Africa aims primarily at countering efforts by western powers to improve human rights and governance in Africa. The same circles insist that China protects “rogue African states” and competes “unfairly” with western firms in bids for contracts in Africa. Some people warn that the heavy volume of concessional loans provided by China to African countries are debt-creating and may result in another African debt crisis in the future. They also blame Chinese workers for taking away job opportunities that could be filled by Africans in the framework of projects financed by China. Still others strongly believe that China's behavior in Africa is a “new form of colonialism”. The list of accusations does not stop there.

In response to these accusations, Chinese officials have been somewhat defensive, arguing that the main objective of China's Africa policy is to create a “new type of strategic partnership with Africa” that is based on the need to achieve “political equality and mutual trust, economic win-win cooperation and cultural exchanges”. In so doing, China claims that it is in fact supporting Africa's quest for a real economic development and more influential role in the emerging world order, including Africa's quest to secure permanent representation in the Security Council of the United Nations.

I am of the view that it would be a mistake for Africa to choose a side in this debate. This position is very important for Africa because, as the saying goes; “**when two elephants are fighting, small animals must find a hiding place in order to avoid being squashed in the process**”. At the time when Africa is facing formidable challenges, which include widespread poverty, inability to increase its shares of global industrial output and trade flows, lack of infrastructure, etc., Africa must look for partnerships with all developed and emerging economies that are honestly willing to help it successfully address its current and future economic and social developments challenges.

The controversy about the role of China in Africa is surprising because some of the countries that blame Africa for “allowing China to exploit its resources and behave like a new colonial power” have themselves developed very strong economic and trade relations with China. Presently, Africa is not even one of the main trading partners of China, which are the United States of America, the European Union, Japan, the ASEAN countries, and South Korea.

Therefore, one cannot avoid the temptation to conclude that Africa has become an important battleground for big powers' politics for the control of its natural resources.

Africa must be pragmatic in its relations with the rest of the world, keeping in mind that all countries must have the welfare of their people as their first priority. It is therefore necessary to examine how China as an emerging economic powerhouse can usefully participate in the economic and social development of the continent while at the same time facing its own challenges in the global economy. In other words, what does Africa offer in terms of investment opportunities that can make a partnership with China a win-win arrangement for both sides?

The experience of China in lifting a significant portion of its population out of poverty during the last three decades can help African countries rethink their development strategies that have been hitherto influenced by policy prescriptions of neoclassical economic dogma.

*Mr. Chairman,*

*Your Excellencies,*

*Distinguished Ladies and Gentlemen,*

Sino-Africa relations from a historical perspective.

What we know is that relations between China and Africa have a long history and have not always been led by economic interests alone. In this regard, it is important to remember that they have been strengthening since the Bandung Conference of 1955, which brought together Asian, independent African countries and some representatives of African independence movements, only 6 years after the founding of the People's Republic of China in 1949. The stated objectives of the conference were to promote Afro-Asian economic and cultural cooperation and oppose “colonialism” and “neocolonialism”.

Seen from that perspective, relations between Africa and China have been the consequence of the realization that both sides were facing similar historical challenges that could be best addressed in the framework of a new partnership.

Looking back, Sino-Africa relations can be best described as having gone historically from China supporting politically African liberation movements with the objective of freeing African countries from colonial control by European powers to present-day foreign direct investments to Africa. Between these two forms of engagement, were two phases. After many African countries became independent, China, which was still struggling with its own economic development difficulties, gave grants to some African countries to finance a number of projects such as sport arenas, conference halls, hospitals, roads, etc.

One example which is noteworthy is the construction of Tanzam or Tazara railway which enabled Zambia to have access to the port of Dar-es-Salaam during the period of Apartheid in South Africa. Apart from financing infrastructure projects, conference centers, and hospitals, China has also trained African engineers, medical doctors and other technicians in many areas.

The next phase of Sino-Africa economic and financial cooperation was characterized by the provision of concessionary loans by China to African countries. However, with the growing involvement of the private sector in the Chinese economy, sharp increases in trade and investment flows between China and Africa have been recorded in the last two decades.

China's trade with Africa has risen significantly from $ 2 billion in 1999 to more than US$ 126 billion in 2012, surpassing the EU and the United States of America to become the continent's largest trade partner. Currently, China's share of total African trade stands at about 17%. Apart from trade flows, China has been increasing its capital flows to Africa, including investments in the financial sector, the exploitation of mineral resources, and the development of agriculture in many countries across the continent. One example of that is the shareholding of Eximbank of China at the African Export-Import Bank (Afreximbank) which I have the honor to represent here today.

While this development has enabled our continent to diversify the destination markets of its exports away from our “traditional trade partners”, it has not significantly contributed to the much-needed diversification of our export products which are still dominated by agricultural commodities and minerals. Even more important is to note that our cooperation with China has not yet helped Africa to transform its raw materials locally before being exported. In most cases, our exports to China are not technology-intensive.

China's direct investment in Africa, as reported by the National Bureau of Statistics of China, amounted to US$11.67 billion in 2009, up from US$6.6 billion in 2006 though data from other sources show higher figures. Among the 800 Chinese enterprises investing in Africa, only about 100 are state-owned. The rest are private businesses with interests ranging from trade, manufacturing and processing, services and communications, to agriculture and natural resource development.

Nobody can deny that China has shown on various occasions its commitment to "teach Africa how to fish". At the Ministerial Conference in Addis Ababa in 2004 it pledged to train 10,000 African professionals in scientific subjects. This is a convincing sign that China is indeed determined to transfer technical skills to Africa.

Although China's assistance to the development efforts of African countries has been remarkably strong, it is not granted without conditions. First, the implementation of projects financed does not allow African enterprises where they exist to bid for construction works. Second, contrary to what is widely believed, China's financial and technical assistance is preconditioned by "One China" policy which requires all partner countries of China to acknowledge that "Taiwan is a Province of China" and to sever their "official ties" with the government of the "Republic of China".

China had signed investment contracts with more than two-thirds of African countries and continues to look for new investment opportunities in the continent. Some large contracts signed by China in Africa include building a hydroelectric power plant in Mozambique and implementing several investment projects in Nigeria, Sudan and a number of other African countries.

*Mr. Chairman*

*Your Excellencies,*

*Distinguished Ladies and Gentlemen,*

Now we let us examine whether China can continue to improve the living conditions of its large population while helping Africa to successfully address its current and future development challenges. The answer to this question is not as simple as it would seem.

The main question that needs a clear answer, in analyzing economic and political relations between Africa and China, is whether China is willing to "**teach Africa how to fish" instead of offering it fish?** In other words, can and is China willing to help Africa increase its global shares of industrial output and manufactured export products, thereby taking advantage of the globalization process which helped the Asian Tigers to move forward, as the former Prime Minister of Singapore, Lee Kwan Yew, puts it in his book titled "From Third World to First".

In trying to answer this question one should look at China's position in the global economy today. In terms of surface area, China is the fourth largest country in the world after Russia, Canada and the United States of America. According to most recent estimates, China remains the world's most populous country in the world with over 1.4 billion inhabitants at the end of 2012. This figure does not include the populations of Taiwan, Province of China, and the special administrative regions of Hong Kong and Macao. With its urban population estimated at 712 million at the end of 2012, about 52.6% of the Chinese people live in urban areas, more than doubling from 26% in 1990. This urbanization poses new challenges to the Chinese authorities regarding the provisions of various services.

However, it is important to note that the economic progress that China has achieved after the implementation of key reforms that began in 1978 has put the country in a position to deal with new challenges in the medium to long-term. According to the International Monetary Fund, China became the world's second largest economy in 2012. In 2010, it became the world's top manufacturing country by output, returning to the position it occupied in the early 19th century and replacing the USA which was the world's largest during the last 110 years.

Because of that, China became the world's largest trading country with a total international trade of US$ 3.87 trillion in 2012, more than 3 times Africa's total trade that year. Its international reserves, estimated at US$2.85 trillion by the end of 2010 were the largest in the world. China's middle class, defined as people with incomes ranging from $10,000 and $60,000 a year, which is equivalent to $ 27 and $ 164 a day, respectively, has grown to reach more than 300 million people, almost equal to the size of the population of the USA in 2012.

China's currency, the Renminbi (RMB), is gradually becoming a medium of exchange in international transactions since the global financial crisis that began in 2008. As a consequence of that crisis, China established the “Dim Sum Bond” market and expanded “Cross-border Trade Renminbi Project”, which helped establish pools of offshore RMB liquidity. In November 2010, Russia began using RMB in its bilateral trade with China. Countries which have followed the example of Russia in the meantime are Japan, Australia, Singapore and the United Kingdom. As a result of this internationalization of the Chinese currency, RMB became the eighth most-traded currency in the world in 2013.

The recent creation of two lending financial institutions by the BRICS provides China with an additional instrument for the support of African development efforts during the years to come.

In recognition of the important role that China plays today in the global economy in general and in Africa in particular, the first Annual General Meeting of the shareholders of Afreximbank held outside Africa took place in Beijing, China, in July 2012.

*Mr. Chairman*

*Your Excellencies,*

*Distinguished Ladies and Gentlemen,*

My last remarks will focus on areas where China could invest in Africa. There are so many investment opportunities in Africa today that it would be very difficult to list all of them. Nevertheless, I would like to list some them without any implied order of priorities.

Africa has a huge potential for industrial development. Learning from the successful experiences of Japan and South Korea, Africa must adopt an industrial development path which is based on strong infant industry protection policies combined with an aggressive export-oriented strategy. In addition, since Africa is well-endowed with various natural resources, it must develop an industrial sector that uses mainly raw materials produced domestically.

Therefore Africa needs the capacity to transform its raw materials locally as a full-fledged participant in global value chains. If China is prepared to transfer the requisite technologies that will enable Africa to achieve its industrial development potential and increase its manufactured exports in the medium-term and beyond, it must benefit from appropriate incentives so that it can become Africa's main strategic partner in that area.

The use of new technologies, including internet facilities and cellular phones, has increased very considerably in Africa during the last decade. However, Africa is still far behind all other developing regions of the world in that area. Therefore, Africa must promote investment in the development of new technologies. This would be a very lucrative business along with technologies which would modernize its system of telecommunications. I am pleased to announce that, in order to promote investment in new technologies, Afreximbank is already working closely with two major Chinese cellular companies. Nevertheless, there is still room for additional investment flows from China to Africa in this sector.

In the agricultural sector, the Comprehensive Africa Agriculture Development Programme (CAADP) constitutes the basis for future investment by African governments and foreign partners. CAADP was the result of an assessment by the NEPAD, with technical assistance from the Food and Agriculture Organization, on the investments required to bring per capita food production to a satisfactory level in the medium- term and beyond. Here, Africa can benefit from China's assistance to make the African agricultural sector more competitive in the world.

Water supply is another area where many investment opportunities exist in Africa. In many African countries, water is slowly becoming a scarce resource. In the process the supply of water has become a lucrative business, particularly for foreign direct investment. This is due to the fact that, today, most people in Africa have difficult access to drinking water. It is therefore imperative that arrangements be made rapidly to facilitate foreign capital participation, jointly with African governments and private sectors in water supply projects. These projects would also increase Africa's agricultural production and livestock development.

As regards energy, it is estimated that the vast majority of Africans do not have access to electricity. This is mainly due to insufficient supply of energy and the fact that most of the African populations live in rural areas which are not connected to national grids. As a result, people use dry wood and animal dung mainly for cooking and heating purposes. These sources of energy are not efficient and non-renewable. In addition, they have adverse effects on the environment.

It is therefore necessary to invest in the development of new sources of energy in Africa. This investment activity could take place in projects supported by African governments in partnership with domestic and foreign private investors. This investment could promote rural electrification through the construction of hydropower plants or the use of solar systems, as well as, wind and geothermal sources of energy. The experience of China in this area could be very useful for the continent.

Although all African governments understand the importance of infrastructure for the economic development of their countries, the lack of financial resources has so far limited the implementation of infrastructure projects in Africa. One way to change that situation is for Africa to develop its transport infrastructure with private sector participation in a public-private sector partnership. This could take the form of “build, operate and transfer (BOT)”. Here, high priority should be given to projects intended to promote physical integration of African countries, thereby contributing significantly to an increase in intra-African trade.

These projects could include highways, railways, waterways, and airports. The participation of foreign investors, with China playing a key role should also to be encouraged.

Africa has a huge potential for the development of tourism. As it seems, a very high percentage of growth in the tourism industry has benefited mainly the developed and many

Asian countries during the last three decades. Apart from Egypt, Kenya, Morocco, Tunisia and South Africa, the majority of African countries do not yet represent an attractive destination for tourists with high incomes. To attract such visitors, African countries must offer modern facilities for (i) transport from outside and within Africa; (ii) accommodation comprising first class hotels, motels and resorts; (iii) attractions, including game parks and museums; and (iv) travel agents who can organize tours, ground transportation and travel incentives, etc. African countries must also offer travel related services such as financial services and publications to guide tourists. Since all these facilities are not yet fully available, there is room for investment. Private foreign capital in the form of joint ventures with domestic private capital could make profitable investments in this sector. China could share its experience in this area with African countries.

To assist African countries in the development of the tourism sector, Afreximbank has developed a Facility called "Construction/Tourism-Linked Relay Facility (Con Tour)". The main objective of Con tour is to promote the development of tourism projects and facilities in Africa to international standards and on a commercial basis through a risk sharing arrangement that leverages Afreximbank's strong credit standing and its preferred creditor status in its member countries. This facility is one mechanism through which Chinese investors could support the development of the tourism sector in Africa.

Africa is sitting on a potential wealth that could materialize through investment in land development. This is due to the fact that foreign and domestic investors could derive huge profits from investing activity in the construction of shopping centers, as well as commercial and industrial properties in large African cities. Unfortunately, The World Bank's Doing Business report gives reasons for the failure of property markets to develop in Africa. The main factor is the high costs incurred in the process of formalizing, registering and transferring properties.

In the average African country, a simple formal property transfer in a large city costs 14 per cent of the value of property and takes more than 100 days. The costs of registering property in Africa are only one of the institutional weaknesses that limit the emergence of a profitable property market. Other factors include the time and cost involved in enforcing a contract. Contract enforcement problems constitute another hurdle to the provision of mortgage finance. Restrictions on foreign ownership in many African countries also limit the development of property markets.

With appropriate reforms, all these hurdles could be eliminated, thereby creating a very favorable environment for the development of commercial and residential properties, as well as for agricultural development in Africa during the years ahead. Such reforms would also help African countries peacefully address issues related to land grabbing by foreign investors across the continent. At the same time, it would provide numerous investment opportunities to foreign investors, including those from China.

*Mr. Chairman,*

*Your Excellencies,*

*Distinguished Ladies and Gentlemen,*

Before I conclude my remarks, let me say that Africa must be thankful for what China has been doing to help our continent come out of absolute poverty. However, it is very regrettable to note that, apart from infrastructure projects, China's investment activities in Africa are highly concentrated on the exploitation of natural resources.

This raises questions as to whether China is really prepared to transfer the necessary technologies for the independent industrial development of Africa. Unless China includes the industrialization of Africa in its investment strategy, some people will continue to accuse it of applying a new version of the dependency theory by taking advantage of the helplessness of African countries and exploit their resources without really creating a "strategic partnership".

A strategic partnership requires that China assists African export enterprises in their efforts to become participants in global value chains and increase significantly at least their exports of semi- processed products.

*Mr. Chairman,*

*Your Excellencies,*

*Distinguished Ladies and Gentlemen,*

I cannot say the last words without suggesting what the way forward should be. Therefore, let me share my thoughts with you regarding what I believe should be ideally the ultimate form of Africa's cooperation with China and what Africa and China should do to their relations to the Next Level.

In this regard, I would like to remark that it is presently very difficult talk about "Africa" on the one hand and China on the other. If we want to be realistic, we must recognize that China is one country dealing individually with 51 African countries with which it has diplomatic ties. Therefore, the "Africa" we are talking about comprises countries with population sizes ranging from about 100, 000 (Seychelles) to 170 million (Nigeria).

Given that situation, it is my view that Africa must achieve its full economic and financial integration if it wants to deal with China on near equal footing. This represents a precondition for Sino-Africa cooperation to take its ultimate form. In this regard, I have a Dream of a Day when Africa will no longer be a mere receiver of any form of "AID" whether it takes the form of grants or loans, but will be able to extend loans to Chinese enterprises. This will be the day when TRADE will have replaced AID and African foreign direct investments to China will have become a normalcy. Both sides will then be able to celebrate a true relation of partnership and mutual respect. The Day I just talked about is not near. It will not be tomorrow and may not even be in this decade. But it will happen in the future.

Until we reach that point, what could be the Next Level of Sino-Africa cooperation? As you may recall, I indicated that the Chinese currency is increasingly being used for international transactions, including the existence of an offshore bond market for the Renminbi trading. I would like to urge African central banks, including the Bank of Zambia to examine how that new development can benefit Africa. I would also like to suggest that African countries try to mobilize more resources from the Chinese capital market. I would also like to encourage African enterprises to explore the possibility of creating joint ventures with Chinese enterprises.

In this regard, I would like to indicate that Afreximbank can support African enterprises which are interested in the establishment of joint ventures with Chinese firms through its Export Development Programme (EDP). This Programme includes Twinning and Market Access Services whereby Afreximbank uses its extensive contacts to foster alliances between parties with proven technical and managerial competencies as well as market access capabilities. These joint ventures would enable African enterprises to acquire new skills and benefit from the transfer of technologies from Chinese firms.

*Thank you for your kind attention.*

## 2.2 Speech by Dr. Michael Gondwe, Governor – Bank of Zambia

Our Guest of Honour, Honourable Alexander B. Chikwanda M.P., the Minister of Finance;

Government Officials here present

Distinguished Governors and Deputy Governors and Executive

Officials from regional and international Organisations;

Honourable Members of Parliament;

Former Bank of Zambia Governors present;

Distinguished Invited Speakers;

Your Excellency's, the Members of the Diplomatic Corps;

Distinguished Guests Ladies and Gentlemen.

It is indeed a great honour and privilege for me to stand here before you as we celebrate 50 years of the existence of the Bank of Zambia. I would like to welcome you all to this joyous occasion as we commemorate fifty years of existence of the Bank of Zambia. May I extend a special welcome to colleagues and friends, from the region and from further afar, that have joined here us today. We are grateful and honoured to have your presence at this symposium. My task this morning is to introduce our Guest of Honour. Before I do so, I wish to say a few words about our 50th anniversary and the book that the honourable Minister will also be launching on economic policy in Zambia.

The Bank of Zambia was established on 7th August 1964 as the Bank of Northern Rhodesia. It was subsequently renamed the Bank of Zambia following the attainment of Independence on October 24, 1964. We have come a long way since then, with many changes having taken place in our legal framework, functions and operations. These changes have reflected developments in the global economy as well as our domestic economic and political transformations. In this regard, the Bank of Zambia has produced a book, charting our history over the past 50 years. It is written in a very simple and easy to read style targeting the general public. We gather here this morning to take stock of these events and changes, to assess the new challenges that lie ahead and to share views and experiences on how we can ensure that the Bank of Zambia plays its part in promoting growth and supporting the Government's efforts to ensure that all of our citizens have a stake in the prosperity of our nation. It will come as no surprise to many of you that we believe that we can do this best by promoting price and financial system stability.

Distinguished Guests, this morning the Honourable Minister is launching a book on economic policy in Zambia: “Zambia: Building Prosperity from Resource Wealth”. It is a reflection on economic policy in Zambia, and the challenges that policy makers face and covers a broad range of topics including fiscal and monetary policy, financial stability and governance issues. This book has been a collaborative effort between Bank of Zambia staff, international authors and the University of Oxford's Centre for the Study of African Economies. Here I must mention our sincere gratitude to Professor Chris Adams, who is able to join us today, and Professor Paul Collier for their stewardship in bringing this project to fruition. We hope that this will be an informative book and that it will act as an important reference point for policy makers both within Zambia and in other countries. Copies will be available for the general public later in time for our 50th Independence celebrations in October.

With these few remarks, it is indeed my honour and privilege to call upon the Honourable

Minister of Finance, Mr. Alexander Chikwanda, MP to address us and officially open this symposium.

I thank you.

# 2.3 Speech by Honourable Alexander B. Chikwanda-Minister of Finance

***"Plus ca change, plus c'est la meme chose" [Jean-Baptiste Alphonse Karr]***
***(The more things change the more they stay the same)***

The Governor of the Bank of Zambia;

Distinguished Governors and Senior Officials from Regional and International Central Banks;

Honourable Members of Parliament;

Your Excellencies the Members of the Diplomatic Corps;

Distinguished Speakers;

Distinguished Guests, Ladies and Gentlemen.

It gives me great pleasure to open this important symposium as we celebrate not only 50 years of the establishment of the Bank of Zambia, but 50 years of our political independence as well. I am particularly pleased that the Bank of Zambia has been able to assemble an impressive list of speakers, who I have no doubt will give us important insights into the conduct of monetary policy and the management of natural resource wealth in the challenging international economic environment that we face today. I am especially pleased to see former Governors present, including our first Zambian Governor Dr. J. B. Zulu, and I am sure they will give us a fascinating perspective on central banking in Zambia.

The French journalist and critic Jean-Baptiste Alphonse Karr coined the phrase ***"plus ca change, plus c'est la meme chose"*** – commonly translated as the more things change, the more they stay the same. This saying has great resonance as we reflect on the momentous changes that have taken place in economic and political governance both on the international stage and in our own economies. Indeed, there has been an important interplay between international events and domestic events and this link has gotten stronger over the past 50 years and is reflected in greater trade, financial and political integration. Here, one can think of the important role that the World Trade Organisation or WTO has played and its predecessor the General Agreement on Tariffs and Trade or GATT; the increasing integration of our capital markets and the tremendous growth in capital flows across the world which was made painfully clear during the global financial crisis; as well as increased economic and political integration as exemplified by the European Union and the adoption of a single European currency - the Euro.

In my brief remarks this morning, I really wish to reflect on some of these issues and their relevance to Zambia and in doing so I wish to make four points: The first point I wish to make is that fiat money has indeed been a great invention. This is reflected in the range of financial instruments that serve as a means of exchange, a unit of account, or a store of value and in the growth of futures and derivatives markets that trade these instruments. However, when the pace of this innovation has significantly deviated from productivity growth in the real economy then typically economic disaster has occurred – as reflected in the recent global financial crisis – or countries have failed to fully exploit their growth potential. In Zambia today, I tend to think that the latter has occurred because our financial markets remain shallow and still do not effectively support small scale entrepreneurs in our economy who are the most dynamic creators of growth and jobs. Yet it is through growth and job creation – driven by the small scale enterprises that offer the best hope of addressing poverty and inequality, particularly in our rural areas. Central banks must do more to promote this process.

This brings me to the second point I wish to make which is that if we are to consolidate the economic progress that we have made, then fiscal and monetary policy must work together. In the past Zambia has had experience of large budget deficits, focusing on consumption expenditures with a heavy reliance on central bank borrowing. The results were high inflation, low growth and general economic stagnation. Thankfully, we have been able to achieve macroeconomic stability over time with single digit inflation and lower budget deficits over time. Between 2011 and 2013, economic growth rate has averaged 6.6 percent on an average annual basis, using our rebased Gross Domestic Product figures. Over this same period, the fiscal deficit has averaged 3.5 percent per annum, although the fiscal deficit has grown from 1 percent in 2011 to 6.6 percent in 2013, reflecting an expansionary fiscal policy aimed at addressing our significant infrastructure deficit. If we do not address these infrastructure challenges, we will constrain future growth and fail to create jobs, raise incomes and reduce poverty, particularly in our rural areas where poverty remains around 70 percent, compared to 30 percent in the urban areas. In this regard, efforts by the central bank to support the provision of long-term credit by promoting financial sector deepening as well as efforts to expand financial services, particularly to the rural areas are important interventions.

It will come as no surprise to many of you that fiscal and monetary policy do not always work together. My third point is therefore that governance arrangements and accountability matter. As politicians, we are elected by the people to improve their livelihoods and we must therefore be responsive to their concerns, whether this is the high cost of credit, the availability of credit or high inflation and exchange rate instability. Addressing these challenges falls under the purview of the central bank. However, we are all aware that sound fiscal policy is an indispensible ingredient in addressing these challenges and this has been ably demonstrated in Zambia's own success in establishing and maintaining macroeconomic stability. There can be and often is a creative tension between fiscal and monetary policy, particularly in instances where fiscal policy is expansionary. However, this tension is best managed through appropriate governance arrangements, that allow the central bank to have at the minimum operational independence and also makes them accountable to the wider group of stakeholders and not simply the Government. In Zambia, the Bank of Zambia does have operational independence and on the whole cooperates well with the Ministry of Finance.

My final point is a reflection on current trends in central banking. In Zambia, the Bank of Zambia's objective is to promote price and financial system stability for balanced macroeconomic development. I believe this objective remains appropriate for the future. A common trend is that central banks have become more forward looking and increasingly provide more explicit views to the market and to the general public on the perspectives that guide their policy decisions and how they will achieve their mandate. This is irrespective of whether central banks have a single target of maintaining price stability or whether they have a dual mandate of promoting growth as well. The rationale as I understand it is simple: the clearer central banks are about future policy actions, the better they are able to anchor inflation expectations and therefore influence the economic behaviour of stakeholders, whether they are financial market players, firms or individuals. This is also consistent with ensuring that central banks are accountable to the people just as Governments are.

I wish to end my address with a cautionary tale: The success of these new frameworks ultimately depends on the credibility of the central bank. But this credibility can only be built over time and is based on the central bank's ability to meet its objectives and to address the economic challenges it faces in a credible way. There is in fact no substitute for central banks remaining eternally vigilant: the financial sector must continuously be encouraged to support real economic activity and to promote productivity growth; it must be continuously strengthened by building international reserves and ensuring that financial institutions are appropriately capitalized and are well managed; monetary policy frameworks must be enhanced by investing in people and building institutional knowledge; and consultation with the public in an open and transparent way must be strengthened. It is my sincere belief that this conference is an important part of this effort and process.

These imperatives have remained relevant over time and from this perspective, one can indeed agree that Jean-Baptiste Alphonse Karr's dictum remains relevant: ***"the more things change, the more they stay the same"***.

I thank you for your kind attention.

# 2.4 Keynote Address by Dr. Tukiya Kankasa-Mabula, Deputy Governor - Administration

The Guest of Honour – The Copperbelt Provincial Permanent Secretary MP

The Acting Director – Bank of Zambia Regional Office, Mr. Patrick Mulenga

Chief Executive Officers

Senior Government Officials

Management of Bank of Zambia

Distinguished Invited Guests

Members of the Press

Ladies and Gentlemen

Let me just say "ALL PROTOCOLS OBSERVED"

On behalf of the Bank of Zambia and indeed on my own behalf It gives me great pleasure to be present at the regional business symposium in Ndola as we celebrate 50 years of the establishment of the Bank of Zambia, under the theme "50 years of Central banking: Repositioning for the Future".

It is my honour to extend a warm welcome to all of you. I also wish to express my gratitude to the Honourable Minister for Copperbelt – Mr. Mwenya Musenge MP, for accepting our invitation to officiate at this special occasion.

I am particularly pleased that the Bank of Zambia has successfully organised a number of activities to celebrate our 50th Anniversary, including two business symposiums in Lusaka and Ndola, respectively, comprising of distinguished speakers, whom I have absolutely no doubt will give us important insights into the topics that are going to be presented here today.

Over the last 50 years, the operations of the central bank in Zambia has been shaped by the changing landscape of both the economy and the financial sector and I am proud to say that we as central bankers have played a key role in the overall economic management of the economy and contributed positively and significantly to the overall development of the country.

The factors that have shaped the operations of the Bank have been varied and many and include political ideology, economic systems, global and regional issues as well as ability and competence of central bank staff.

*Distinguished Guests*

Without going into great detail, it is important to take note that the Bank has faced a number of challenges over the course of the last 50 years. I am sure the presenters here today will touch on a lot of these issues. These challenges include:

a) Shortage of qualified local staff in the aftermath of independence
b) Dual mandate of price stability and promotion of economic growth which was sometimes conflicting
c) Shortage of foreign exchange leading to creation of a parallel market
d) High inflation rates in the period after liberalization of the economy
e) Bank Closures in the late 1990's after liberalization
f) Underdeveloped secondary markets

g) Money laundering and counterfeit notes and
h) Limited access to financial services by the majority of the population particularly those in rural areas.

This 50th Anniversary celebration therefore gives us an opportunity to reflect on where we have come from and what aspirations we have for the future. At this particular time, it is apt to quote the words of the first Zambian Governor Dr. J.B Zulu who said that "it is prudent to see and know where we are coming from so that we can frame the future with a reasonable amount of hindsight in tow."

In my brief remarks this morning, I wish to reflect on some of these issues and give a brief history of the Bank of Zambia and our aspirations for the future.

As you may well know, the Bank started its operations as the Bank of Northern Rhodesia on 7th August 1964 following the breakup of the Federation of Rhodesia and Nyasaland, and on attainment of the country's independence was renamed as the Bank of Zambia.

You may be interested to know that the Bank of Northern Rhodesia and subsequently the Bank of Zambia was originally located in the old Bank of Zambia Building currently housing the passport office, while the Regional Office was officially opened on 27 April 1979.

*Ladies and Gentlemen*

Against this background, I wish to highlight several significant achievements of the Bank:

Firstly, over last 50 years, the Bank has invested significantly in its most important asset- its human resource. This has set the base for all the achievements the Bank has attained in the past and has proved to be an invaluable asset in the times of crisis. In the last 50 years the staff compliment of the Bank has grown from over 100 in the early 1960's to a peak of around 1200 in 1992, and was 528 as at June 2014.

From having a majority of qualified economists in the early years, the Bank is now staffed by a highly qualified compliment of lawyers, accountants, supervisors, regulators, financial analysts among others. Going forward this mix of qualified staff will enable the Bank to be much more proactive in keeping with the ever changing monetary and financial sector landscape. In addition, this will also ensure that the Bank continues to play a significant role in economic development.

Secondly, the Bank has over the years continued to modernise both monetary and supervisory policy in line with its mission of maintaining price and financial system stability.

After the attainment of independence, monetary policy was basic and sufficient to deal with the shallow financial sector at the time. However following the Mulungushi Reforms in 1968 – which was the basis for the economic policies pursued from the 1970s through to the 1980s - the conduct of monetary policy changed and focused on multiple objectives of price stability and economic growth which sometimes had conflicting demands. The performance of the economy deteriorated, while the central bank had to use direct tools of monetary policy, including the use of a fixed exchange rate.

In 1991, the then, Government liberalized the economy and consequently monetary policy was re-oriented towards providing a suitable environment for the development of the private sector and the use of market based instruments.

This change in policy has contributed to the reduction of annual inflation to single digits, such as the current inflation rate of 8.0 % as at end-July 2014 from a peak of 197.0% at the end of December 1992. In addition, annual inflation rate has averaged 7.0% since 2010. The exchange rate was also liberalized in 1994 with the central bank only intervening to smoothen exchange rate volatility.

Supervisory policy has also taken on significant importance over the years, particularly after the banking crisis in Zambia during the late 1990's following the liberalization of the economy.

Currently the Bank of Zambia has two departments supervising and regulating the financial sector, which comprises banks and non-bank financial institutions. This is particularly important because the Bank wants to ensure that the financial sector continues to play its intermediation role efficiently with minimum disruption and to ensure that the confidence and interests of the investors and customer funds in the financial sector are safeguarded.

The banking sector has grown from three (3) foreign banks in 1967 to 19 local and foreign owned commercial banks and 131 non-bank financial institutions at end June 2014.

The Bank remains committed to empowering the Zambian people through the provision of affordable, accessible and convenient banking services, whilst also promoting financial inclusion. This is being principally done through the Financial Sector Development Plan (FSDP), which has been implemented by the Government in collaboration with the Bank of Zambia, Securities and Exchange Commission and the Pensions and Insurance Authority since 2004. The main objective of the FSDP is to broaden and deepen the financial sector in Zambia.

Another notable achievement has been the advances made in the payment systems which were virtually absent in the 1960's. Reliable payment systems are important in facilitating settlement of transactions in the economy.

In partnership with the Bankers Association of Zambia, the Bank undertook work to significantly reform the country's payment system. This collaboration resulted in the enactment of the National Payment Systems Act in 2007 which empowered the Bank to oversee the country's payment system and the introduction of various payments systems including; Zambia Interbank Payment and Settlement Systems, Direct Debits and Credits Clearing; Cheque Imaging and Clearing Systems, mobile money and Point of sale machines. The increased use of mobile money has enabled a vast majority of the citizens of the country to have access to financial services.

With these developments in technology and innovation the Bank in collaboration with the financial service providers is committed to ensuring the integrity and safety of the payments and settlements systems.

My final point is to emphasise that the Bank of Zambia's objective is to promote price and financial system stability for balanced macroeconomic development. I believe this objective remains appropriate for the future.

In this regard, the Bank is repositioning itself by becoming more forward looking and more transparent and accountable in its monetary and supervisory policy decisions. This is partly the rationale for moving towards an inflation targeting framework. In addition, the Bank, taking into account the causes and effects of the global financial crisis, has been implementing risk based supervision and most importantly has created a Financial Stability Unit.

Further, the Bank will continue to promote financial inclusion and financial literacy to ensure that in the medium to long-term an increased number of Zambian citizens will get access to finance in order to create jobs and become economically active and contribute to sustained economic growth in the next 50 years.

I wish to end my address by emphasizing that the operations of the central bank and indeed the financial sector as a whole must be enhanced by investing in people and building and sharing knowledge. This symposium is an important part of this effort and process and I wish you all a fruitful discussion.  I thank you for your kind attention.

## 2.5 Speech by Honourable Mwenya Musenge, MP Copperbelt Provincial Minister

Dr. Tukiya Kankasa-Mabula – Deputy Governor, Bank of Zambia
Honourable Members of Parliament Present
Chief Executive Officers
Senior Government and Bank of Zambia Officials
Distinguished Invited Guests
Members of the press
Ladies and Gentlemen
Let me just say “all protocol observed"

*Distinguished invited Guests, Ladies and Gentlemen,*

It is my singular privilege to address this special celebration, the 50th anniversary since the inception of the Bank of Zambia. It is also special because this occasion provides us with an opportunity to reflect on the many developments that have taken place in the country since 1964.

*Distinguished Invited Guests,*

I am aware that the Bank of Zambia Regional Office provides an inter-face between the banking customers and the Bank in the northern region. Accordingly, the Regional Office provides banking services to ministries, provinces and other government spending agencies (MPSAS) through the five provincial accounting units in the Northern Region of Zambia - that is - Northern, Muchinga, Luapula, Copperbelt and North-Western provinces for execution of their respective budgets.

*Ladies and Gentlemen,*

I am also aware that as a banker to commercial banks, the Regional Office hosts commercial bank accounts, and hence is responsible for the management of the electronic payment systems and clearing of cheques in the northern region. The Regional Office also maintains Government's provincial administration and revenue collection accounts, including those of the Zambia Revenue Authority (ZRA). As a currency circulation point, the Regional Office receives consignments of new notes for issuance to the northern region, facilitates cash deposits and withdrawals by commercial banks, and facilitates inter-bank electronic clearing and Real Time Gross Settlement System (RTGS) Transactions.

*Distinguished Guests, Ladies and Gentlemen,*

Central banking has undergone significant changes over the past 50 years. Since its establishment in 1964, the Bank of Zambia has also undergone significant changes and has played an important role in the economy of the northern region.

In this regard, Ladies and Gentlemen, I am also aware that following the expansion in economic activities in the Northern Region as well as the restructuring exercise of the bank in 2003, the Bank of Zambia introduced departments which were not represented at Regional Office such as:-

- Economics
- Financial markets
- Bank Supervision and
- Non-Bank Financial Institutions Supervision.

This resulted in the expansion of the operations at Regional office, enhanced information flow and data collection, and timely surveillance and provision of specialized security services.

*Ladies and Gentlemen,*

I am aware that, the stability and soundness of the financial system heavily depends on the adequacy of capital. We do recall that, the financial crisis saw the depletion of capital for most banks in the world and those which failed to stand the pressure collapsed. This prompted a relook at the capital requirements so as to ensure banks provided for the risks that were not covered such as market and operational risks. I am informed that, in order to make the commercial banks more resilient to external and internal shocks, in 2012 Bank of Zambia(BoZ) increased the minimum capital requirement from k12 billion across the board to K104 billion for local banks and K520 billion for foreign banks.

The move was also aimed at ensuring that commercial banks mobilise additional resources to enable them to participate effectively in national economic growth and provide more credit. The measure would also strengthen the financial base of the banks and thereby safeguard the interest of depositors.

*Ladies and Gentlemen,*

I am also happy to learn that the Bank of Zambia has also identified financial inclusion as one of its key strategic objectives, influenced financial service providers to relax requirements for persons who are excluded from financial services especially women, both in urban and rural areas, in acquiring banking and financial products and services by making access easier and has established a financial education coordinating unit to contribute to financial education of various strata of the society. This development, Ladies and Gentlemen, will enhance economic activities in the Northern Region because financial literacy coupled with easier access to finance will result in prudent and effective utilization of financial services. It will also enable our people in the northern to take advantage of the opportunities available in the region due to the existence of the mines.

*Distinguished invited Guests, Ladies and Gentlemen,*

I am aware that the main economic activities of the Northern Region mainly revolve around the mining sector which is also the major source of revenue for the nation. As you may be aware, Zambia has a mining history which spans over ninety years including the late 1960's, when Zambia was the world's third largest copper producer, after the US and the former

Soviet Union. Mining was and remains central to the Zambian economy. It has played a key role in the social and economic development of the country.

Zambia has predominantly been a copper mining country being the largest copper producer in Africa and the world's seventh copper producer. In the 1970's, copper production in Zambia reached its peak (700,000 tons). Subsequently, falling copper metal prices caused annual production to drop to 200,000 tons in the late 1990's. Since the early 2000 following completion of the· privatization of the mining sector, Zambia's mining sector has recovered sharply.

With the rising prices of metals on the international commodity markets spurred by increased demand for metals from Asia, especially China, Zambia's copper production has surpassed its peak recorded in 1972 of 700,000 tons. Zambia has continued to attract foreign direct investment in the mining and this has supported this increase in copper other metal production. Copper production has increased from 572,793 tons in 2008 to over 800,000 tons in 2013 with a projection that copper production will reach 1,500,000 tons by the year 2016 on account of new mining projects that are currently under development.

The mining sector has attracted investments in excess of US$ 8 billion since 2000, creating over 74,000 jobs by 2013 up from 27, 000 jobs in 2000.

*Ladies and Gentlemen,*

Because of the increased mining activities, we have seen an increased presence of commercial banks in the Northern Region which is very commendable. As government we shall continue to support such positive initiatives which are aimed at increasing economic development in the region and the nation at large.

*Ladies and Gentlemen,*

As you are all aware, Copperbelt Province in particular, was one of the regions that were hit by the economic recession following the closure of various manufacturing industries resulting from liberalization of the economy in the early 1990s. I am happy to see that investor confidence can now be seen through various establishments that are adding value to the economic growth of the region such as:-

- Zambezi Portland Cement
- ELSEWEDY Electric of Egypt
- Cement Manufacturing Plant by Nigeria's Dangote Industries
- Gourock Industries
- The Jacaranda and Kafubu shopping malls.

Government has further come up with initiatives to resuscitate other economic ventures providing support to the mining industry by investing in infrastructure developments especially in the construction of roads.

*Ladies and Gentlemen,*

As the Governor, has already alluded to, this anniversary marks 50 years of dynamic transformations and achievements accomplished by the Bank. I am aware of some of the milestones that the Bank has achieved in the last 50 years such as single digit inflation, introduction of the Credit Reference Bureau, successful currency rebasing, reduction in the days of cheque clearing and indeed a stable financial sector. For all these, I would like to commend you Governor and your team.

*Ladies and Gentlemen,*

As we celebrate the Golden Jubilee of the Bank's existence, I am confident as economic activities continue to improve in the Northern Region, the Bank of Zambia will continue repositioning itself and face these challenges head-on, in order to provide the required services to our people and contribute more effectively to the economic regeneration of the Northern Region.

*Distinguished invited Guests, Ladies and Gentlemen,*

It is now my singular and rare privilege to declare the Bank of Zambia Northern Region 50th anniversary symposium officially open.

May God bless you all!!!

I thank you.

# DETAILED PAPERS PRESENTED

# 3.1 A Historical Perspective of the Bank of Zambia

**Dr. Justin B. Zulu***

### 1. Introduction

The topic of the symposium is rather ambitious. It appears to promise all kinds of goodies, exploits and future visions of the Bank of Zambia in a predictable domestic or global economic terrain. I cannot characterize the future economic horizon or terrain as predictable. I can predict that Bank of Zambia will be there no matter what. This is not how I see my role in the context of celebrating the fifty year anniversary of the existence of the Bank. I see my primary role as sharing with you capsules of a shared institutional memory as it evolved over that period of time. We are generally not used to such a narrative in this country. We tend to be preoccupied with moving forward and managing as best we can. I intend to back against that mindset. My conjecture is that it is prudent to see and know where we are coming from so that we can frame the future with a reasonable amount of hindsight in tow. Consequently, this brief account will comprise of broad strokes, more in black and white than grey and in a simple narrative of reflections over the past half century. Celebrating 50 years is a once in a lifetime event, it calls for sobriety and reflection over the past and hope and confidence in the future.

### 2. General Observations

The Central Bank is an established institution in the overall governance structure in Zambia, indeed in any country. It is thus an intrinsically living organism. Its role and effectiveness or otherwise, are characteristically contextual. They are impacted by a country's governance system, a country's economy and structure, a country's history and not least, by the Central Bank's own competence, capacity and entrepreneurship. Needless to say, that all these are dynamic factors, as well as drivers. There is the temptation to think of the Bank of Zambia in the past 50 years, in the context of the domestic economy and its evolution. But one has to be mindful that the Bank is an integral part of the evolution of the international generic concept of the central bank in an increasingly integrated world economy. Besides, we have to look at both the evolution of the organic institution per se, as well as the evolution in policy formulation, and implementation in order to profit the most from looking backward as well as forward. The two are effectively two sides of the same coin. The exercise is by any measure an inexhaustible topic about which nobody can do full justice. But I intend to be brief by focusing on a few structural and systemic shifts and trends.

### 3. The organic Institution

In the early years of the Bank of Zambia the original functions provided the basic business and preoccupation of the institution. They were: government banker, banker of commercial banks; regulator of monetary activities; lender of last resort and manager of exchange controls in the field of trade and commerce. This list has both, expanded and become complex beyond imagination. And I can bear witness to that because I was there very early.

*Dr. Justin B Zulu was the first Zambia Governor of the Bank of Zambia (1967-1970)

The Bank was the government banker like today; it was banker to the commercial bank community like today; it was regulator of monetary activities through the use of the bank rate and treasury bill and other debt management operations like today; except that the volumes, mix and frequency of such activities pale in comparison to present exigencies by close to fifty times. Many will be surprised to learn that Exchange Control Operations accounted for close to fifty percent of the overall staff contingent. This reflected an era when government policy included the monitoring of external trade flows, the policy to indigenise economic activity, and the effort to ensure a more balanced bank credit distribution between indigenous and non-indigenous borrowing enterprises as well as individuals. Today this sounds like a fairytale. But at the time the total population was around 3.5 million, the annual growth rate above 13%, and the economy, while basically market driven, functioned with a strong dose of state participation. It can be observed that the most sweeping organic evolution has taken the form of a more robust and comprehensive management, the regulation and supervision of the banks as well as non-bank financial institutions; the development of a modern payments and settlement system and installation of a money laundering regime. These developments and structures were unthinkable in the 60s and 70s or early days of the Bank of Zambia. It is important to briefly touch on these transformative adjustments framing the growth, maturation, consolidation and coming of age of the institution.

After the initial 10 to 20 years of existence the institution rose to a multiplicity of challenges in the domestic economy and similar ones in the world economy. First, and without going into detail, the economy is reasonably diversified. Even as the copper sector remains formidable as ever, there are major developments in nontraditional exports and imports, for instance. Agriculture activities in volume and range are coming up strong and pushing the envelope. The Zambian agricultural sector, including agro-processing, contributes about 40 percent of the Gross Domestic Product (GDP), 67 percent of total employment, supplies the bulk of raw materials which account for over 80 percent of the manufacturing sector's value added, and contributes more than 12 percent of foreign exchange earnings.

Social infrastructure, economic infrastructure, energy infrastructure, transport infrastructure have all been fiercely competing for a strong and increasing share and showing in the Gross Domestic Product. The sustained strong economic growth, at around 6.4 per cent on average between 2004 and 2013 is founded on a stable macroeconomic environment. The economic growth has been broad based mainly driven by the agriculture, mining, manufacturing, retail and trade; construction and tourism sectors.

The role of the Central Bank in deploying the monetary and non - monetary instruments and regulatory tools at its disposal, has risen to the occasion. It has ensured a smooth flow of economic activity while keeping a vigilant and watchful eye on inflationary pressures. In the latter case, the chronic double digit inflation of the 80s and 90s was firmly brought down to single digit over the years. Annual overall inflation declined to 7.1% in 2013 from 17.5% in 2004. In July 2014 inflation was recorded at 8.0%. Underlying the favourable inflation developments in reducing inflation to single digits, have been among others, prudent fiscal policies and appropriate monetary policies instituted by the Government and the Bank of Zambia, respectively.

Take the issue of the regulation and supervision of the banking and non-banking financial operations. This sector, together with the Central Bank, is what is commonly referred to as the financial system. It oils the real economy, the government business and social activity. In my view, the financial system is the plumbing or, if you like, the infrastructure, not only of monetary policy management, but the real economy as well. With vastly increased economic and financial activity, the Central Bank has been increasingly obligated to step up to the plate i.e. to sharpen and strengthen its operational tools, institutions and structures.

This is for the purpose of promoting stable economic activity and bolstering conditions of prosperity and growth. Indirectly, the Central Bank, through its role, has been contributing its fair share to the creation and growth of sustainable employment and livelihoods. Since the liberalisation of the economy the number of banks and non-banks has grown from 3 commercial banks and virtually zero non-banks to 19 commercial banks and 121 non-bank financial institutions at end-March 2014.

The supervision and regulation regime is not simply for ensuring a strong infrastructure to frame sustained economic and financial activity. This is an indispensable tool for promoting a healthy financial system. The financial system cannot automatically properly perform its appointed multitasks as described, if it is not in the best of health. Just like a human being, the undisputed anchor of the economic system must be robust and healthy. Among other things, the Central Bank has to be on top to ensure that the players and partners in the financial system, particularly the banks, have adequate provision in the way of capitalization. It is the nature of the financial players, in the perpetual quest for defending the bottom line, to continuously put out financial products. And it is the responsibility of the Bank to monitor the integrity of such products as well as track the likely impact or implication on the transmission of monetary policy signals and other monetary tools. It is also the capacity and readiness on the part of the Central Bank, through regulation and supervision, to ensure that, the fierce rat race for the bottom line amongst financial sector players does not undermine nor inhibit the growth of a healthy competitive environment. The Central Bank is mindful that healthy competition in the financial system is indispensable and in the best interest of the primary consumer of the financial services and products. Additionally, it has been imperative to promote a steady growth in the number of players to further strengthen and consolidate the competitive environment.

In the past 50 years the movement of rogue moneys or funds, financing and financed by illegal or unsavory activities, from around the world, has increased exponentially. These supersize money movements can and do destabilize the local financial system. In this respect, the Central Bank has equipped itself to the teeth, with a robust anti-money laundering regime. This is the capability to protect the integrity of the local financial system, and as a consequence, the integrity of the international payments system in the global economy. This capacity in the Bank would have been unimaginable twenty or more years back. Another systemic feature of vastly enhanced Central Bank capacity, unimaginable twenty or thirty years back, is the installation of a modern high-tech payments and settlement system. The Central Bank positions itself at the apex or management centre both as a major player as well as facilitator. This is to ensure the integrity of payments and settlements system. The regime has to be healthy, efficient and rapid enough to meet the payments and settlement needs of the entire economy. In this unique partnership the Central Bank, the banks and other financial institutions, have a shared, if not common interest.

Looking back to the past 50 years, it is more than evident, that the direct and indirect impact of the installation of a robust regulatory framework for supervision, money laundering, regulation and payments system has created an enabling environment for the development and growth of capital markets. At this point, and even if all change is by nature work in progress, it is imperative to pose and check out some landmarks in the organic and structural transformation of the Bank as follows:-

- Staff compliment grew from 170 in 1967 to a peak of around 1200 in 1992. Currently the staff complement of the Bank is 523 in 2014 after going through restructuring.
- Professional capacity and competence have vastly transformed from a few economists and statisticians in the sixties to a well installed complement of lawyers, accountants, supervisors, regulators, financial analysts etc. giving the institution both the needed

muscle and eyes and ears to secure an authoritative surveillance on various sectors of the economy.

- There have been 13 generations of the endangered and expendable species called Governors, and nearly three generations of the general staff.
- Zero banking supervision and regulation in the sixties is today a fully-fledged robust surveillance regime.
- Zero money laundering capability in the sixties to the current James Bond like commando style apparatus to enforce zero tolerance in 2014.
- A rudimentary payment and settlement system in the sixties, to the current high-tech and speedy structure, and indispensable tool for facilitating economic transactions.

**4. Monetary policy operations and Central Bank independence**

It was observed earlier that the organic and operational policy aspects of the Bank of Zambia, indeed any Central Bank, are two sides of the same coin. Positive changes in the structural or systemic environment of the Bank must inevitably bolster policy formulation and implementation. Other obvious drivers include the growth in the capacity, competence and effectiveness in the management of the generic job description, but also in the management of the Bank's position in the context of the country's overall governance system.

In policy formulation and implementation, change and adjustment over the 50 years, have been typically incremental but dramatic. In the first 10 to 20 years monetary policy instruments and the environment were basic. The fixed Bank rate concept and the fixed exchange rate regime were simple mechanisms. But they fitted the limited institutional environment, rules and operational capacity as well as practice, in the domestic and international context. Monetary operations included interest rate setting, Treasury bill operations, credit policy, liquidity requirements and other government debt management operations. These were similarly basic, and reflecting the economic and business conditions prevailing. Over the years, however, monetary and debt management operations have become increasingly complex. They have been responding to a rapidly evolving institutional, economic and financial environment, as well as sovereign needs at home and abroad. The Bank of Zambia has been continually evaluating its policy options and operations to adapt and benefit from experience. In addition, the Bank has also continued to seek more effective and innovative platforms for strengthening and promoting economic activity and growth.

This brings up the old question of monetary policy being the major, primary or only concern of the Central Bank, apart from the issue of price stability or inflation. Of course in a developing economy the Central Bank must look out for challenges such as structural rigidities and deficits, and weak or nonexistent institutions in the economic environment. Consequently, the Bank has not spent much capital on the ideological, theological, academic or indeed theoretical debates, interesting as they may be. It is such debates that can make conducting monetary policy activity, look like climbing a tree from the top. Armed with greatly revamped institutional and operational capacity in the likes of supervision, regulation and promotion of financial development and inclusion, the Bank has come to view monetary policy formulation and implementation in a holistic fashion. Hence, the health and stability of the financial system is an equal partner in the business of framing the Bank's role in the economy. In short, today there can be no such thing as effective monetary policy without financial stability. Unlike in my time, today Central Bank policy making requires climbing a tree from the bottom. Monetary policy and financial stability are genetically two sides of the same coin.

The capacity and competence in the management of the Bank have grown exponentially and to levels unimaginable in the sixties and seventies. In earlier times, the exchange control department was the largest followed at a far distance, by administration and then research, statistics and operations. A more dynamic job description has unveiled the requirement of a variety of strategic professional skills. For the Bank to effectively deliver on its mission, it needs Economists, Lawyers, Financial Analysts, Accountants, Regulators and Supervisors, to mention just a few. But this is also true in the international organizations which exercise oversight on developments in the international monetary system. This is a far cry from fifty years back, when economists were the dominant professional staff contingent. If not properly monitored or if left to its own devices, in the name of self-regulation, the financial system can bring the real economy crushing down with dire consequences for all. The new environment reflects a highly integrated, vigilant and complex, operational capacity in the institution. This is as it should be. This is to ensure that it remains competent and effective in executing its greatly expanded and expanding missions.

I need last, but not least, to touch on the perennial issue referred to as the independence of the Central Bank. At one point 46 years ago, I approached the Minister of Finance on a major policy directive about which the Central Bank had had no knowledge prior to the public unveiling. I drew attention to the fact that according to the Bank of Zambia Act, the Central Bank was government advisor. He had no idea about the legislation nor its relevance to the particular action by Government. He had never read the Act in the first place. I reckoned that few governments, leaders indeed in any government, read the Central Bank Act. An important and instructive conclusion to draw for those charged with running Central banks, is that it is more profitable to focus on the role rather than on the independence in the overall governance structure.

I would not wish to sound combative. But it is my strong suspicion that authorities, the world over, and in their wisdom, embraced the concept of a Central Bank from a mix of motivations. The preeminent one was probably to give the appearance of being in keeping with political correctness. It is, therefore, up to the Central Bank to craft an effective role within the parameters of the Act. Many indispensable operations on the economic front are operationalised only by the Central Bank given the institutional capacity and competence under its command. Over the past 50 years the Bank of Zambia has survived 13 Governors including myself. It continues to deliver, and the authorities continue to turn to the Bank for indispensable technical assistance and counsel, but also for economically impossible operations. A Central Bank is intrinsically indispensable, by design or by omission irrespective. The management of the Central Bank is well positioned to exploit the special privilege of protecting the integrity of the financial system. It is actually King in the jurisdiction of the banking and financial sector. There it wields significant power and influence over the activities, conduct and transactions amongst the players. This is to say that there is no shortage of opportunities for the Central Bank to play an effective role in a given economy.

Going forward on its undisputed role and independence, the Central Bank must remain mindful of a broader accountability and the medium to long term perspective in relation to major markets. The market segments include government, the economy, the financial sector and not least the general public. This would be the way forward in a democratic society of many competing voices and interest. To address this, the institution must, as in the past, retain the readiness to activate, at short notice, the capability to proffer, cogent and analytical positions on critical debates pertaining to the economic and financial system. This must be so whether or not solicited, and whether or not taken on board. The Bank must continue to create space for the special privilege of participation behind closed doors. In this frame of reference, when the Central Bank wins or loses a fight, it is the wider society which wins or loses.

# 3.2 The Conduct of Monetary Policy in Central Banks after the Global Financial Crisis

**Benno Ndulu***

**Abstract**

The financial crisis of 2007-2008 revealed pitfalls and risks to the conduct of monetary policy. In the context of lessons and challenges which emerged after the crisis, this paper examines three main areas for sub-Saharan African countries that require rethinking. The paper suggests that: reforming the monetary policy framework, institutionalizing coordination between micro- and macro-prudential regulatory institutions within and between countries and, designing appropriate mechanism to deal with spillover contagion effects can reduce risks to monetary policy and greatly make monetary policy successful. Africa has made significant gains in economic scale and discipline in the past two decades. Drawing from this fact, the paper advocates the use of collective action to help mitigate the contagion effects of global crises and to anchor effectiveness of monetary policy.

## 1. Introduction

The last two decades has seen strong growth in the African acceptability of the significant role macroeconomic stability and more specifically prudent monetary policy plays in anchoring sustained growth. It is remarkable that since mid-1990s more than 3 out of every four countries in Africa has proceeded to provide some form of legal framework of central bank independence in the conduct of monetary policy. In at least 14 countries (CFA Franc Zone and Central African Franc Zone) such independence is further anchored by an external agency of restraint in the form of a currency board anchored by a foreign reserve currency. At least another five, such independence is enshrined in the constitutions of these countries (South Africa, Kenya, Uganda, Ghana).

During these two decades the gains in macro stability are evident in the sharp decline in inflation rates, across most countries contraction of fiscal deficits and building of both fiscal and external buffers that countries withstand the first wave of pressures from the global financial crisis. Average inflation in Sub Saharan African economies declined sharply from the average of 21.1 between 1995 and 2001, to 10.1 percent between 2001 and 2005; to an average 8.8 percent between 2006 and 2012. More significantly the phenomenal turnaround of African economic growth during the two decades has helped to cement the acceptance of macro stability as an anchor for growth. Measured in purchasing power parity terms, Sub-Saharan Africa's economy in 2013 was 2.6 trillion; larger than UK and French economics; two and a half times the Australian economy and more than 6 times the size of the Belgian economy – our “traditional” comparator. The economy of Africa as a whole was 3.5 trillion in 2013, making it the 5$^{th}$ largest economy in the world. With average per capita income of $1,500 (lower middle income country level) 40 percent of African population live in 23 middle income countries. The region has a middle class population of 350 million, larger

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than the USA. This improved record of faster growth has also been accompanied by significant poverty reduction in the region. It is estimated that about 100 million Africans have been lifted out of poverty since 2000, partly enabled by the much faster and steady growth in many countries. However, poverty still abounds and is particularly severe in Africa's populous countries including Democratic Republic of Congo and Ethiopia.

In order to sustain this impressive pace of progress, monetary policy needs to be kept supportive of maintaining a high rate of growth. To achieve this, several challenges have to be faced. These challenges can be grouped into two sets. One relates to the changing local context for effective conduct of monetary policy. It includes a significant influence of supply side shocks to inflation (food and imported inflation); and a weaker link between money and inflation with increasing monetization of the economy, financial deepening and technological change in the financial sector. The second set of changing conditions relate to dealing with the effects of the global financial crisis and its aftermath.

## 2. The Changing Context for the conduct of Monetary Policy in Africa

### *2.1 International Context*

A consensus that guided the conduct of monetary policy around the world for more than three decades before the financial crisis of 2007-2009 was that central banks can greatly contribute to the economy by delivering price stability. Output stability was not assigned large weight in the conduct of monetary policy while financial stability was mostly left to microprudential regulatory institutions, with monetary policy largely dealing with its effects. Therefore, it was conceived that price stability would guarantee output and financial stability.

To achieve price stability, central banks either opted for monetary or inflation targeting. An exception, perhaps, was the European Central Bank which employed a "two pillar" strategy. In Sub-Saharan African (SSA) countries, many central banks conducted monetary policy based on monetary targeting (IMF, 2014,a). These monetary policy strategies were successful in many countries in delivering low and stable inflation. Output was generally less volatile in many countries, especially in advanced economies. Generally, the period before the onset of the crisis was referred to as "Great Moderation" era (Mishkin, 2010).

The onset of the crisis greatly challenged the monetary policy paradigm that shaped the thinking about the practice of monetary policy. Financial imbalances grew considerably in advanced economies (especially in the U.S) at the time price stability had been achieved and output was less volatile. The imbalances also occurred amidst prevalent view that preserving financial stability and supervision was a task of microprudential regulatory institutions. As the financial imbalances grew and confidence and trust among financial institutions declined, the interbank liquidity dried up leading to credit crunch and crisis. The crisis caused panic and distortions in the financial markets that spread across countries and sectors.

Given the scope and scale of the crisis, central banks had to resort to unconventional measures as conventional monetary policy instruments proved inadequate (IMF, 2014,b). The measures employed varied across countries depending on the scope and scale of the impact of the crisis. Most commonly, central banks employed the following measures: (i) quantitative easing and large credit easing, (ii) broadening and lowering of the quality of financial instruments eligible as collateral for accessing central bank loans, (iii) executing various forms of lender-of-last resort measures to bail out troubled banks, and (iv) purchase of securities to improve liquidity.[1] These were complimented by government intervention through provision of credit to troubled industries and exporting sector. These measures

[1]Stark (2009), Mishkin (2010), Pattipeilohy et al. (2013) and Bayoumi et al. (2014) provide detailed discussion.

were intended to provide economic stimulus, reduce distress in the financial markets and improve transmission mechanism of monetary policy. This was a sharp contrast from previous financial crisis episodes during which central banks had to increase interest rates to protect the value of currencies and contain capital outflow.

Clearly, the crisis and the manner in which monetary policy was conducted during the crisis contain lessons for the design and conduct of monetary policy going forward and, to cope with or prevent future crises should they arise. These are discussed in this paper around three themes: (i) conduct of monetary policy, (ii) linking microprudential policies with macroprudential policies, and (iii) coordination to deal with cross-border spillover effects. These issues are discussed mostly in the context of Sub-Saharan Africa.

### *2.2 The Local Context*

An important challenge that monetary policy faces in SSA is the large influence of supply side shocks to inflation.

The significant role of supply side shocks to inflation were amply demonstrated during the global financial crisis 2007/09. After a decade of comparatively low inflation, averaging 9 percent for Sub-Saharan Africa, it sharply increased to 15 percent during 2007-09 driven primarily by food inflation, which doubled from 10 percent to 20 percent during the same period (IMF 2014a). In a second episode of 2010-2011 partly driven by trade shocks and sharp depreciation of local currency, the East African region experienced another very sharp rise in inflation approaching or exceeding 20 percent in Burundi, Kenya, Ethiopia, Tanzania and Uganda (IMF, 2014a, p.47). During both episodes, countries had to resort to countercyclical monetary and fiscal policy which partly impacted negatively on growth. The level of distress in the execution of policy was high and authorities had to combine conventional monetary targeting with a range of other interventions to manage inflation expectations.

The second major challenge from changing context is the weakening of the relationship between money and inflation in the region. The correlation between inflation and broad money ($M_2$) has declined from 0.88 in 1989 – 2002 to 0.20 in the period 2001 - 2012 (IMF 2014a p 48) and the correlation is also found to be lower for low inflation countries. Velocity of circulation is declining with both increased monetization of the economies and financial intermediation as well changes in the technology applied to payment systems and introduction of mobiles money (Davodi, Dixit, and Pintor 2013; Adam and O'Connell, 2013).

These challenges call for the review of monetary policy framework away from monetary targeting to other more flexible forms which we discuss later. This shift partly should exploit the reduced fiscal dominance in the region, which enhances the scope for central banks independent action. Central bank financing to the government has sharply declined from an average of 12 percent of GDP between 1990 and 2000, to nearly 2 percent of GDP in 2012 (IMF, 2014, a,p.50). Independent action by central banks has also been enhanced by the higher exchange rate flexibility regimes now operative across many countries in the region.

## 3.0 Implications for the Conduct of Monetary policy

### *3.1 Primacy of price stability objective in expanded mandate for financial stability*

Maintaining price stability remains the central focus of monetary policy after the crisis. However, this "single policy goal" view which dominated the thinking and practice of monetary policy for many years before the crisis was greatly challenged during the crisis. As a result, after the crisis, many central banks have been given more explicit role of maintaining financial stability. Some central banks in SSA have established financial stability units or departments to monitor and evaluate risks to the financial system. Of course, having one roof removes bureaucratic impediments and greatly improves exchange of information and analysis.

A challenge facing central banks is how to integrate financial stability issues into the conduct of monetary policy to ensure that the price stability objective will not be compromised. In addition, there is a view that that additional explicit mandate of financial stability to monetary policy could compromise central bank independence and credibility. These challenges can be avoided by appropriately delineating between monetary policy and prudential policies, including a disciplined policy setting process to reduce risks to the objective of price stability. Central banks may also consider lengthening the horizon for achieving the inflation target to accommodate financial stability issues, which will allow larger variations in the short-term.

Financial stability units should be strengthened to be able to assess key risks facing the financial system by identifying those which present systemic vulnerability and implement risk mitigation measures. Financial stability reports should be produced on regular basis and discussed by monetary policy committee, so that policy decisions can be made and actions implemented decisively, flexibly and in a timely manner. The experience of Tanzania is a case in point. From the time of crisis, the Bank of Tanzania has sustained daily surveillance meeting at which developments in the financial sector are examined and timely policy decisions executed. Meanwhile, a financial stability unit was formed and transformed into a directorate within the central bank. Financial sector stability issues are discussed by the Board of Directors and decisions are coordinated and executed by the central bank along with monetary policy actions. Financial surveillance within the Bank of Tanzania has helped to identify major weaknesses in the financial sector and their likely impact on the potency of monetary policy. It has also improved the analysis of how the conditions in the global markets can impinge on domestic monetary policy.

### *3.2 Withstanding the capital flows pressure as advanced countries exit from the unconventional policy measures*

The crisis highlighted the existence of potential for large capital flows in search of higher yield (flight for quality). As the advanced economies gradually emerged from the crisis, central banks in those economies begun to implement “tapering” policy to exit from the unconventional policy measures. This led to large capital outflows from emerging and developing countries to advanced economies. To cope with this situation, central banks in emerging and developing countries employed a variety of measures to limit the impact on exchange rates and domestic financial system. These measures included large-scale foreign exchange market interventions, which to a large extent, reduced foreign exchange reserves. Going forward, we need to be mindful of the fact that such policies by advanced economies are far from over. To ease the strain on foreign exchange reserves, central banks in SSA need to enhance their capacity to monitor and manage surges in capital flows. Additionally, central banks may need to establish a collective self-insurance by pooling reserves to ease the impact of large sudden capital flows.

### *3.3 Difficulties of maintaining a low level of interest rates*

A lesson from the run up to crisis is that before the many central banks in advanced economies, especially in the U.S., conducted ease monetary policy by keeping policy rates at low levels. During the crisis, central banks also used unconventional measures to ease monetary policy. In most countries, policy rates were reduced to unprecedented low levels, in some instances reaching the zero lower bound (Mishkin, 2010; Craig, 2011; Bayoumi et al., 2014). In both periods, inflation rates remained low and stable despite the easing of monetary policy.

While low interest rates can be a welcome phenomenon, maintaining a low level of interest rates for a considerable period of time can lead to destabilizing effects. One potential effect is that such a policy can increase the propensity of economic agents to engage in excessive risk taking. Asset prices, including property prices, can escalate to unsustainable levels and lead to systemic consequences when prices correct (Craig (2011). Keeping interest rates at low levels can also be a disincentive to saving and lenders. As observed by Taylor (2013), a "forward guidance" of maintaining short-term interest rates low may cause long-term rates also to go down and eventually encourage more borrowing. But if actual long-term interest rates happen to be below the equilibrium between borrowers and lenders, there would be little incentive for lenders to lend at those rates while borrowers would. This will lead to decline in credit and reduction in output and aggregate demand as a result of unintended consequence. Furthermore, maintaining low interest rate policy can make money markets and banks awash with a large amount of excess reserves for a prolonged period of time. This could impair intermediation and efficient operations.

Therefore, central banks in SSA may need to pay great attention to the longer-term potential effects of maintaining interest rates at low levels. A balance between maximizing output growth and minimizing excessive risk taking needs to be kept so as to mitigate the risk of surges in capital outflows that could lead to currency crisis.

### *3.4 Difficulties of exiting fiscal policies implemented during the crisis*

The crisis caused rapid deterioration in economic activity and prospects. Many governments responded by adopting stimulus policy. As a result, fiscal deficits and debt substantially increased. In some countries, debt-to-GDP ratio has increased to more than 100 percent. The momentum of government spending has also been kept high after the crisis. The large government debts in these countries can be perceived as being sustainable at current relatively low interest rates. Going forward, the high debts may become unsustainable, especially if interest rates rise from current levels. For monetary policy, there is potential for emergence of fiscal dominance that could pose risk to central banks' operational independence. Central banks may also face pressure to adopt quasi-fiscal roles, such as providing credit to government, hence, undermining monetary policy objectives. In SSA, this is complicated by the fact that the concept of central bank independence does not seem to have been fully understood by the public.

For central banks to ease the challenges of central bank independence and insulate central banks from temptation of governments to manipulate monetary policy goals and actions, monetary policy framework should include a program of improving communication to the public on central bank independence and improve transparency in setting monetary policy targets and actions.

### *3.5 Monetary policy tools for liquidity management*

At the time of the crisis, central banks resorted to unconventional measures of improving liquidity in the markets as existing liquidity facilities proved inadequate. This highlights the need to review liquidity management framework to maintain stable monetary conditions, increase resilience against possible stress in the markets and, incentivize financial institution to improve risk and liquidity management. Central banks may expand eligible collateral and incentivize counterparts to hold and use these financial instruments and design flexible liquidity management tools, such as special term deposits, foreign exchange swap facilities and reverse repos where these instruments have not been used. Similarly, the banks should be encouraged to adopt flexible instruments to facilitate liquidity in the money market.

### *3.6 Challenge of choosing a credible nominal anchor to deliver price stability*

Choosing a credible nominal anchor and adhering to it, is a crucial element for monetary policy to deliver price stability. In SSA, there has been intense discussion about moving away from monetary targeting to inflation targeting regime due to instability of money demand function[2]. Many central banks are at various stages of adopting inflation targeting. In the East African Community, the Bank of Uganda adopted "inflation targeting lite" in 2011 while South Africa and Ghana adopted inflation targeting long time ago.

The lack of traction of interest rate cuts and the breakdown of monetary policy transmission at the time of the crisis highlighted the need for rethinking about this policy framework. As most central banks in SSA countries contemplate or implement programs for adopting inflation targeting, they should be mindful of these challenge, especially at the times of turmoil. Central banks should not completely ignore the information content of money to future inflation.

In addition, despite the significant growth and transformation of financial markets in recent years, the level of development of financial markets in most SSA fall far below compared to other countries outside the region. Secondary trading of securities is small due to low liquidity in the market and financial instruments traded are few, mainly government or central bank debt securities and spot foreign exchange. These challenges provide little prospect for financial markets to transmit monetary policy signals. There is need to continue developing the financial markets to increase the interest rate sensitivity so as to improve the conduct of monetary policy and increase resilience of the markets to shocks. The measures should include reforms to remove impediments, such as legal and regulatory framework, modernizing market infrastructure strengthening regional coordination and integration of initiatives in the existing economic blocs for sharing information and experiences.

### *3.7 Challenge of choosing optimal level of inflation*

A general consensus in economic literature is that low and stable rate of inflation is desirable for promoting economic growth. The reverse is true for high and volatile inflation rate. The question is what level of inflation is desirable and whether it is symmetrical across countries. This question is critical in maintain a balance between inflation and output, as reduction of inflation rate to low levels is associated by output loss. Also, frequent changes of inflation targets can also lead to "time-inconsistency problem".

The empirical research does not provide a uniform conclusion on the desirable rate of inflation. For example, Ndulu and Masawe (2013) estimated the optimal level of inflation of 8 percent for Africa and observed that Adam *et al*. (1996) estimated the optimal inflation rate for Ghana, Kenya and Tanzania to be between 11 percent and 15 percent and Khan and Senhadji (2001) gave a range of 11 percent to 12 percent for developing countries. Ironically, the target for inflation rate in many sub-Saharan African countries has traditionally been set consistent with the rates prevailing in their trading partners, commonly at 5 percent or

[2]The theoretical base of this policy strategy is the New Keynesian model of monetary analysis. The model hypothesizes that monetary policy can be conducted without explicit reference to money entering the transmission mechanism, with interest rate serving as the operating target.

below. This is mostly rationalized in the context of maintaining export competitiveness. Central banks may need to consider setting inflation targets as a long-term goal of monetary policy and determined their short-term targets based of prevailing economic conditions.

### 4.0 Linking micro prudential policies with macro prudential policies

One lesson from the crisis which came out explicitly was that monetary policy and financial stability are intrinsically intertwined. It showed how financial instability can affect monetary policy and how monetary policy actions can help restore financial stability. By implication, it revealed how prudential policies designed to promote financial stability can have impact on monetary policy. For example, Mishkin (2010) observed that macroprudential policies designed to restrain leverage or a credit bubble will reduce credit growth and eventually reduce output or aggregate demand. To protect output and aggregate demand from falling, monetary policy can be eased. Similarly, if monetary policy is eased, for example, by setting the central bank policy rate low, it can cause excessive risk taking behaviour and eventually can lead to a credit bubble. In such as case, tight macroprudential policies may be required to counter the effect. This relationship underscores the need for coordination between monetary policy macroprudential policies to ensure stability of inflation, output and financial sector.

A critical question of the relationship discussed above is how it can be executed to deliver desirable outcomes. One possible arrangement is to have separate regulatory institutions; central bank and macroprudential regulator, as was the case before the crisis in most countries in SSA. The problem however, is that under this kind of arrangement, there is great likelihood for each institution to primarily care about its mandate (Bayoumi et al., 2014). It entails complex institutional arrangements, which may require establishment of a separate regulatory institution to resolve conflicts. Given the relatively weak coordination amongst regulatory institutions in SSA, central banks become a natural choice for assuming the mandate of financial stability.

### 5.0 Cooperation and coordination to overcome spillover effects

The crisis highlighted that risks and problems to one country's economy can be caused by events outside its borders and from sectors within the economy that are not directly in the realm of the central bank. It also revealed that monetary policy alone can hardly be used to restore financial stability and economic recovery. The crisis further showed that financial stability cannot be managed by a single country and highlighted the importance of cooperation among central banks to maintain proper functioning of the financial sector.

Another lesson from the crisis is that capital can flow in and out of a country in response to investors' portfolio re-balancing caused by changes in monetary policy of reserve currency countries (Bayoumi et al., 2014). A case in point is the recent capital volatility in emerging and developing countries which occurred due to the " tapering policy executed by the U. S. after the crisis. This can also happen amongst small open economies in SSA and the crisis showed limitations of individual country actions in dealing with adverse spillovers.

For SSA countries, these challenges can be redressed in a variety of ways. One approach involves formalizing and strengthening cooperation and coordination among central banks and other financial institutions to manage cross-border spillover effects. Regional initiatives, such as SADC and EAC, have the advantage of bringing together cross country knowledge and experiences and implementing collaborative actions. Second, designing an integrated surveillance and mechanisms of enforcement of monetary policy cooperation and coordination amongst partner states can be a solution. Finally, cooperation and coordination can be done through agreements on a set of economic and monetary (financial) indicators set, and an effective mechanism for ensuring compliance.

18 countries in Sub-Saharan Africa belong to active currency board zones. These include 14 countries belonging to the CFA franc zone in West Africa, Central Africa and Comoros which anchor their monetary policy collectively on a foreign reserve currency, the Euro. Another 4 are in the Rand area in Southern Africa, anchored on a local currency, the South African rand. Efforts are at an advanced stage towards a Monetary Union in East Africa involving 5 countries. Nearly half of the countries in Sub-Saharan Africa therefore either already or about to belong to some form of Monetary Union arrangements, involving collective agency of restraint and bestowing greater degree of central bank independence. The growing feature of collective action can be harnessed to help withstand shocks from spillover.

The international financial institutions, such as the IMF, can be encouraged to support regional initiatives by providing effective surveillance, shaping the regulatory framework and evenhandedness. This should be accompanied by policy dialogue in order to bridge possible divergent opinions. Governments also need to enhance efficiency in budgetary operations and maintain macroeconomic stability to support the conduct of monetary policy.

## 6. Conclusion

In discussing about the conduct of monetary policy after the crisis, this paper identifies three main areas that are relevant to countries in SSA: the role of monetary policy in the post crisis economic conditions, (which has been dubbed “new normal” by Bayoumi, T. et al, 2014); ways of improving the link between microprudential polices and macroprudential policies and their implication to monetary policy and, designing appropriate framework of managing cross-border spillover effects. More broadly, the first issue concerns the need for central banks to reform the monetary policy framework to redress contemporary challenges. The last two issues can be viewed as a reflection on the need to institutionalize the capacity to effectively respond to problems that can emerge from the financial sector. They also relate to the need for central banks to integrate prudential policies into monetary policy frameworks.

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# 3.3 Prospects for Financial Reforms – Enhancing Financial Inclusion With special reference to the experience in South Africa

**Johan van den Heever***

## Introduction

It is an honour and a privilege to be invited to attend the 50th anniversary celebrations of the Bank of Zambia. I wish to thank Governor Michael Gondwe for inviting the South African Reserve Bank (SARB) to present a paper at this celebratory conference. Upon your kind invitation, the Committee of Central Bank Governors of the Southern African Development Community (SADC) has also scheduled its half-yearly meeting here in Lusaka this week, thereby enabling more governors to join your celebrations. Thank you for hosting us and for being wonderful hosts indeed.

This year, South Africa celebrates 20 years of democracy; this celebration also marks 20 years of strong ties between the South African Reserve Bank and the Bank of Zambia, ties that go back to the struggle against apartheid and the struggle for independence in Zambia. I wish you well on this auspicious occasion and, on behalf of all South Africans, I wish you the best of fortunes for the next 50 years.

My talk today covers a synopsis of our experience in South Africa over the past 20 years in reforming the financial sector and promoting financial inclusion. It has not been a smooth journey. We have experienced several turbulent periods, including a significant crisis in our second-tier banking sector, the impact of the global financial crisis, and more recently the unsustainable expansion of unsecured credit and its aftermath.

## Competing objectives

Our journey has required us to balance several competing objectives – objectives which, I am sure, are similar to the ones you seek to achieve here in Zambia. We seek a more inclusive financial sector in terms of ownership and control. We seek broader access to a range of financial services for the millions of South Africans currently excluded from the financial sector. We seek to protect citizens from unscrupulous business practices which try to exploit the vulnerable. We seek a stable and profitable financial sector able to make a positive contribution to growth and development. We seek security for the millions of people who have placed their deposits, investments and retirement savings in financial institutions.

All these objectives are important, and making progress on all these fronts requires continuous improvement to our regulatory and policy framework as well as to the institutional architecture responsible for regulation. Within these multiple objectives, there

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The views expressed in this paper are those of the author and do not necessarily reflect the views of the SARB.

are also some difficult trade-offs that we have had to confront – trade-offs which, I am sure, you face as well.

**Post-1994 challenges**

In 1994, the newly elected democratic government in South Africa inherited a weak economy, crippled by mismanagement, fiscal recklessness, sanctions and a lack of competitiveness. Notwithstanding these weaknesses in the broader economy, the financial sector was among the most sophisticated in the world. South Africa had a well-developed banking sector, a large pool of institutional savings invested through pension and insurance funds, a deep and liquid stock exchange, and a sizeable domestic bond market. There were, however, two glaring weaknesses in this financial architecture. The first was that the majority of the population was excluded from the services offered by the financial sector. Except for costly and rudimentary retirement savings for a small proportion of black workers, the vast majority of black workers did not have bank accounts and even fewer had mortgage bonds. The sector was also highly concentrated, with a few large players dominating the market. In general, competition was low, prices were high, and consumers, irrespective of race, did not get good value for money.

It was no accident that a highly developed and sophisticated financial sector excluded the vast majority of South Africans. South Africa's financial sector had developed over a century and a half alongside the burgeoning mining sector. The country's long-established stock exchange brought together investors with capital and mining entrepreneurs who were undertaking risky and long-term investment in the mining sector.

The banking sector developed to a significant extent by providing capital to smaller businesses and white workers who benefited from the mining boom. The sector, alongside state-owned development financial institutions such as the Land Bank, played a critical role in growing commercial agriculture to ensure food security for South Africa. In the post-World War II era, the financial sector played an important role in supporting industrialisation and economic diversification. In short, the development of the financial services sector was integrally linked to the growth and development strategies of the apartheid state.

The big challenge for the newly elected democratic government in 1994 was to see how the sophistication and depth of the financial services sector could be used to support a new, post-apartheid development strategy while at the same time ensuring a stable and profitable financial sector which could attract investment. A balance had to be struck between broadening access and lowering costs while maintaining a sound and stable financial services sector. South Africa confronted this set of challenges within a particular global environment where capital was flowing more freely than ever before and globalisation in general was accelerating. This changing environment introduced both risks and opportunities for South Africa.

Under apartheid-induced sanctions, South Africa had to manage the financial account on its balance of payments very tightly. As a result of capital flight, both legal and illicit, the country was forced to run a current account surplus for much of the 1980s and early 1990s. The central bank managed an array of complex exchange controls designed to prevent capital from leaving the country. So in addition to the complex financial sector reforms that we had to embark on, we were also confronted with the difficult balance between maintaining and reforming an antiquated set of financial controls while at the same time opening up our financial account to attract foreign capital inflows and enable South African corporates to diversify their investments globally.

Promoting financial inclusion became the first priority for financial sector reforms after

1994. The first broad strategy was to promote a competitive environment, with the hope that it would drive down costs which would in turn promote broader access. South Africa was fortunate in that it had a range of banks of various sizes. It had a number of small banks and several regional banks. Policymakers also opened up parts of the banking system to foreign entrants. This strategy worked for only a small part of the banking sector. Greater competition brought down costs in niche banking areas targeting high net worth individuals as well as corporate and investment banking.

These reforms had little effect on bank fees in general. In fact, as a result of rising bank charges, the number of bank accounts actually fell throughout much of the 1990s. South Africa went further and relaxed foreign ownership restrictions for the large commercial banks in the hope that bank fees in South Africa would converge to international levels. Unfortunately this did not have the desired effect.

**The mini banking crisis of 1998-2003**

The 'diversity and competition strategy' was then dealt a major blow in the aftermath of a severe macroeconomic shock in 1998, during the Asian crisis. In 1998, South Africa suffered from a sharp depreciation of the exchange rate. The SARB responded by increasing its key accommodation rate[1] rapidly, from about 15 per cent to about 22 per cent in a matter of months. The depreciation of the exchange rate and the sharp increase in interest rates slowed the economy and resulted in millions of households struggling to repay their debt. Many of our second-tier and mutual banks were highly leveraged and, as we discovered, several of them were not very well managed. Higher interest rates and falling repayment rates alongside a more difficult international financial environment resulted in difficulties for a number of these second-tier banks. As investors saw trouble in one or two banks, confidence in other smaller banks fell, resulting in a mini banking crisis. In a period of six years from 1998, South Africa lost about 23 banks – almost the entire second-tier banking sector.

The SARB acted quickly to prevent further contagion and, together with National Treasury, intervened to protect depositors. The authorities managed to persuade some of the bigger banks to take over some of the smaller banks by agreeing to underwrite the risks in some of the smaller banks. The resolution of some of these banks entailed significant fiscal costs. At the end of this mini banking crisis, South Africa was left with fewer, but more stable, banks. It did, however, leave the sector more concentrated than before.

This mini banking crisis drove home several lessons. Firstly, South Africa was confronted for the first time with the trade-off between a vibrant, diverse and competitive banking sector, and a robust and stable one. Inadvertently, we chose to end up with a safe and stable banking sector, but we did sacrifice diversity and competition. The second lesson learnt was how to resolve a failing bank and that this required strong cooperation between the central bank and the fiscal authorities. In particular, the crisis taught us that the best place to locate the regulator of banks was the central bank because the central bank has first line of sight on any impending crisis. The third lesson was about the type of regulation and regulatory framework that would work in our context. We shifted from a generally hands-off approach, which was the global trend generally, to a much more intrusive regulatory approach.

The mini banking crisis prompted South Africa to improve its regulatory institutions and capacity. South Africa subscribes to the Basel Core Principles, which require SARB to approve any major investment or share ownership change. South Africa is also one of the

[1]The main policy interest rate set by SARB is the repurchase rate: the rate at which accommodation is routinely extended to banks. Before March 1998, it was known as the 'Bank rate'.

few jurisdictions where banks are required to seek approval for the appointment of non-executive directors. The Registrar of Banks is in almost daily contact with banks on various issues. We see it as our job to understand, in detail, the risk management models and approaches of the commercial banks.

Notwithstanding these improvements, financial sector regulation is an evolving practice. There are on-going risks, stemming from both domestic and international sources. As regulation becomes more complex, the ability to effectively regulate the sector becomes commensurately difficult. Furthermore, a tighter regulatory environment can increase the incentives for regulatory arbitrage, thereby bypassing the purview of the authorities. In such a complex and changing environment, we remain vigilant about the risks in the sector and we are in no way complacent.

**Financial inclusion after the mini banking crisis**

After the mini banking crisis of 1998-2003, efforts to promote financial inclusion shifted to the larger commercial banks. Policymakers focused on three broad fronts. The first was to attempt to force banks to lower costs to make it more feasible for lower-income workers to use banking services. This was a tough objective to meet, for several reasons – not least of which was resistance from some of the banks. Fees in the banking sector were often opaque and difficult to understand, even for the most financially sophisticated customer. It had become clear that even though there were four large banks that 'competed' with each other, pricing outcomes were not very competitive. However, through increased use of technology, competition from new banking platforms (such as mobile phones) and significant moral suasion, banking fees have come down.

The second initiative resulted in a campaign by the banks themselves to introduce a special type of low-cost, low-transaction bank account called the Mzansi account. This initiative proved highly successful as millions of previously unbanked people started to have access to the banking system.

The third strategy was to shift an increasing proportion of government's social grant beneficiaries into the banking system. Today, about two thirds of social grant beneficiaries have their grants paid directly into their bank accounts. This has been a very positive development, banking the unbanked and creating improved economies of scale in a financial environment where overheads are high and marginal cost are low.

Independent of any direct attempt by government, more and more firms began to pay their employees through bank transfers rather than through cash. This move was driven largely by the rising costs of moving physical cash, at a time when crime levels were high and 'cash in transit' robberies became almost a daily occurrence in South Africa.

The net effect of these initiatives was that the number of adults with bank accounts went up from about one third in 1994 to about 75 per cent today. About 30,7 million people aged 16 and over either have or use financial products and services to manage their financial affairs. However, despite this progress, millions of adults still do not have a basic bank account.

**Micro lending**

In the late 1990s, a fairly minor amendment was made to the Usury Act which regulated the maximum interest rate that could be charged on small loans. This change resulted in a massive increase in both microlending and the number of legal microlenders. Following several attempts to regulate this burgeoning sector, government eventually passed the National Credit Act in 2005 (which came into effect in 2007). This Act also saw the introduction of the National Credit Regulator. The objective of this Act and its accompanying regulations was to formalise the microlending sector, to improve market conduct in the sector, to regulate fees and changes, and to prevent abusive practices. The Act also introduced a centralised database which could be used to track credit history in order to manage the risk profile of lenders. While the National Credit Act reduced the level of abuse in the system, it did not eradicate abusive practices entirely. Some 12 000 microlenders are currently registered under the National Credit Act. The capacity to effectively regulate such a large number of entities would test even the most competent regulator.

The growth of the microlending industry had several advantages but also introduced numerous risks and challenges for the regulators. Access to credit, particularly for family emergencies, is essential to promote welfare and reduce vulnerability amongst the poor. The advantage of these reforms was that, for the first time, poor households had access to credit from formal, legal entities; previously they had to borrow from illegal, unregulated loan sharks. However, along with greater access to credit came a sharp rise in household indebtedness and clear evidence that poor households were using very expensive credit to supplement their consumption.

After the 2008 global financial crisis, as demand for mortgage credit and from businesses slowed down, the formal, regulated parts of the banking sector entered the unsecured lending market to boost their margins. Between 2010 and 2012, this unsecured lending market grew from about R5 billion a year to about R50 billion a year. While this cycle of rising indebtedness did not pose a systemic risk to the financial sector, the SARB became increasingly concerned with the long-term social effects of such a sharp rise in high-cost credit. There was mounting evidence of social stress as workers got themselves into a spiral of debt at very high interest rates. This phenomenon began impacting on the industrial relations environment, contributing towards an increase in labour stress on the factory floor.

In late 2012, the SARB and National Treasury started to raise the alarm bell with the banking industry. While the Chief Executive Officers (CEOs) of banks recognised the social stresses that unsecured lending was causing, they were also mindful that unsecured lending was highly profitable in an environment where bank lending in general was very weak. Over the course of 2013 and 2014, through persuasion and saturation, the banks began to retreat from the unsecured lending market. At present, growth in unsecured lending to households stands at about 2 per cent a year, much lower than two years ago. We fear, however, that as the formal and regulated banks retreat from this sector, less formal and more unscrupulous lenders will enter the fray.

This experience with unsecured lending taught us several lessons. Firstly, while broadening access to credit can have positive developmental effects, there are also huge risks and significant unintended consequences for families and society as a whole.

Secondly, even with sound legislation and regulation, it is sometimes difficult to properly regulate a sector as large and diffuse as the unsecured lending sector, as many operators fall outside of the banking regulatory framework.

Thirdly, valid and legitimate attempts to regulate a sector can push people into the waiting arms of less scrupulous operators, increasing their vulnerability.

Fourthly, financial sector regulation requires cooperation and coordination between all the entities involved in their regulation. In particular, there needs to be an established hierarchy to resolve jurisdictional disputes between regulators and to define clearly what falls under macroprudential regulation and what constitutes market conduct regulation.

**Institutional saving**

There is a significant irony in the structure of South Africa's savings industry. On the one hand, the country has a very large pool of institutional savings built up over more than a century. In fact, South Africa's institutional savings as a share of gross domestic product (GDP) rank among the highest in the world. This is in part reflected in the fact that the market capitalisation of the Johannesburg Stock Exchange (JSE) is about twice the size of GDP. On the other hand, however, South Africa has a very low overall savings rate, about 14 per cent of GDP, lower than most developing countries.

While the reasons for this low savings rate are complex, at least one explanatory factor is high cost structures in the pension and retirement savings industry. Unless a person is saving a large amount of money each month, about R1 000 (or US$100), the returns to the saver, after deducting fees and other charges, are often negative. In an economy where the median earner takes home about R3 800 a month, there is little incentive to save. Reform efforts in the institutional savings arena have focused on reducing complexity for customers and increasing transparency of products. In addition, government has partnered with trade unions to attempt to raise the quality of pension fund trustees in order to improve decision-making in pension fund investments. South Africa has also made significant reforms to its tax system to encourage institutional savings.

South Africa has a range of laws and regulations that govern where pension funds can invest, what type of assets they can accumulate, and what type of risks they can take on. In general, pension funds have limitations on the amount of money they can invest offshore and, locally, they are restricted to investing in listed equities and certain grades of bonds. This has generally protected long-term savers by limiting the risks that pension funds can assume.

These reforms have resulted in an increase in the proportion of workers who are able to save for retirement, albeit off a low base. Workplace provident funds, which are largely defined as 'contribution pension funds', form the bulk of South Africa's retirement savings. Improved stewardship over these investments and the generally positive performance of both the economy and the equity market has resulted in rising wealth effects for many workers.

An area in which we have not made much progress is discouraging workers from cashing in their retirement savings before retirement. Policy has to strike a difficult balance. On the one hand, policymakers recognise that a large proportion of low-income workers have little savings and, in an environment where unemployment insurance is limited and credit markets are weak, it is reasonable to expect workers to dip into their retirement savings when confronted with retrenchment or a family emergency. But dipping into their retirement savings not only means they lose the tax benefits, but often means that workers retire with little savings. In general, retirement earnings provide an average replacement rate of about 30 per cent where 60 per cent is the international benchmark. Furthermore, this average is skewed by the fact that for low-income workers, the replacement rate is often far lower than 30 per cent. Most low-income workers end up relying on the state old-age pension grant, which presently stands at about R1 300 a month (less than $130 a month).

Proposed reforms to the retirement fund industry aim to limit early withdrawal from retirement funds in order to enable workers to retire with a higher replacement rate. However, this reform is only likely to work if complemented by reforms to unemployment insurance, health insurance and credit markets. Put differently, through a combination of public provision and market provision, workers should be able to manage life's unforeseen events without dipping into their retirement savings.

Financial inclusion is not just about giving access to banking services to a wider range of people. It is also about using the financial sector to drive a development agenda that is inclusive. In South Africa, we have used a charter process, a voluntary process of dialogue and target-setting, to get banks to agree to invest in areas such as housing and small business development. The long-term insurance industry also invests in public-sector bonds, particularly the bonds of state-owned enterprises that are funding large infrastructure programmes. The charter process also includes targets for broadening the ownership of the banking sector to people from historically disadvantaged backgrounds, especially women. Furthermore, there are targets for investing in townships and for staff and management development, and incentives to encourage procurement from small businesses.

But the charter process has not been perfect. There have been differences of opinion on which social responsibilities banks should be obliged to undertake. There have also been differences of opinion on the pace of increasing black ownership. Again, policy has to balance the need for diversity in ownership with the need for a strong, financially sound financial sector.

**Twin Peaks regulation**

Taking into account the lessons learnt from our experiences over the past 20 years and drawing on best practice from international responses to the financial crisis, South Africa is in the process of adopting a Twin Peaks model of regulation for the financial sector. In this framework, the SARB will have responsibility for prudential regulation and supervision. Government has also broadened SARB's mandate, giving it a more explicit mandate for financial stability. SARB will become the resolution authority, with specific responsibility for the resolution of systemically significant financial institutions. Once the legislative process is complete, the prudential regulation of the insurance industry will shift to the SARB from the Financial Services Board where it presently resides. Market conduct regulation will be split between the Financial Services Board and the National Credit Regulator.

The coordination of macroprudential oversight with microprudential and market conduct regulation will occur through the establishment of the Financial Stability Oversight Committee, which will be chaired by the Governor of the SARB and will include all market conduct regulators and National Treasury.

Macroprudential regulations and tools are relatively new instruments. They are yet to be tested. The SARB is watching closely what other countries do. We are keen to learn about how they approach the financial stability mandate. And while we have made considerable progress in designing an architecture that we think could work and are in the process of legislating this architecture, we are in no doubt that the actual practice of enhancing financial stability is a process that requires on-going learning, testing and evolution. We are keen to learn from you, just as much as we are keen to share our experiences with you.

Through trial and error, we have developed an understanding of the balance between financial inclusion, and a sound and stable financial sector. This is an on-going process. We have also learnt that aspects of financial inclusion can lead to unintended consequences such as an unsustainable rise in unsecured debt, often at very high interest rates. Experience has also taught us the need for cooperation among policymakers and regulators.

SARB continues to promote financial inclusion within the framework of a sound and well-regulated financial sector. But overregulation, sometimes proposed by well-intentioned and well-resourced regulatory authorities with a centre of interest in economies where circumstances differ significantly from our region, can raise cost and make it more difficult for ordinary people and small businesses to access financial services. Whatever regulations we design and enforce – prudential, anti-money laundering, anti-terrorism financing etc. –we must always be very sensitive to the impact they will have on ordinary people. Here, regulators need to strike a fine balance, avoiding the extremes of overregulation on the one hand and inaction on the other. In this way, financial inclusion can be sustainable and the financial sector can play a role in meeting the socio-economic objectives of the country.

**Financial inclusion and the central bank's core mandate**

Macroeconomic instability is a great enemy of financial inclusion. Sharp swings in interest rates and credit conditions have harsh consequences for many of the new entrants to the financial markets who have neither the knowledge and experience nor the financial reserves to deal with such volatility. Conversely, financial inclusion benefits from monetary policies that consistently pursue financial stability and low inflation. In South Africa, the adoption of formal inflation targeting in 2000 has resulted in more stable conditions in the money and capital markets, somewhat lower nominal interest rate levels, less interest rate volatility, and a reduction in the financial stress levels of users of financial services. By just sticking to our central bank's core mandate, we give strong support to sustainable financial inclusion.

**Final thoughts**

Again, I wish to congratulate the Bank of Zambia on the occasion of its 50th anniversary. I look forward to even stronger ties between our institutions over the next 50 years.

# 3.4 Economic Policy and the Management of Sovereign Wealth

**Kristin Gulbrandsen***

## Introduction

I am delighted and honoured to be here in Lusaka, celebrating the Bank of Zambia's 50th Anniversary. Allow me also to congratulate the Government and people of Zambia on Zambia's 50th birthday, to be celebrated later this year.

Norges Bank has participated in a cooperation programme with the Bank of Zambia since 2011. The programme has been of benefit to both parties and many of my colleagues have found it to be a valuable experience. I greatly appreciate this opportunity to talk to you today.

My main topic today is the economic policy framework in Norway and the management of Norway's oil fund, the Government Pension Fund Global. Many commodity producers around the world, including emerging economies such as Chile, Mexico, Azerbaijan and Kazakhstan, have adopted similar fund constructions to be able to transform resource wealth into permanent wealth for their nations. As Zambia itself has large commodity resources – in the form of copper – my hope is that the Norwegian experience, in spite of some obvious differences between the two countries, may also be relevant to the economic policy of Zambia in the years ahead.

The extraction of oil and natural gas from the sea bed along Norway's coast has come to play a major role in the economy. The petroleum sector now accounts for 50 percent of our exports and more than 20 percent of GDP. Furthermore, tax payments by oil and gas companies[1] and direct government ownership interests in oil and gas fields ensure that economic rent largely accrues to the public sector. Petroleum income makes up 30 percent of government revenues.

In his book The Wealth and Poverty of Nations the historian David Landes describes how the Spanish empire went into a long period of decline when the flow of Latin-American gold dried up in the mid-17th century. According to Landes, the moral of this story is that *"easy money is bad for you. It represents short-run gain that will be paid for in immediate distortions and later regrets. "*[2]

As a country rich in natural resources, Norway has tried to learn from this experience. Windfall gains, whether in the form of large and unsustainable capital flows from abroad or substantial oil revenues, are double-edged. They provide short-term relief from hard choices, but may carry with them hardship in the longer term.

A rules-based approach was adopted after two turbulent decades of boom and bust economic cycles. The path towards the current regime was developed and supported by successive governments in the 1990s and early 2000s as it gradually came into place. The oil fund was established in 1990. In 2001, a fiscal rule for oil revenue spending and an inflation targeting regime were introduced.

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[1]Both ordinary income tax and an additional resource rent tax.
[2]David Landes (1998): The Wealth and Poverty of Nations, W.W. Norton & Company, Inc., N.Y

**Some Early Lessons**

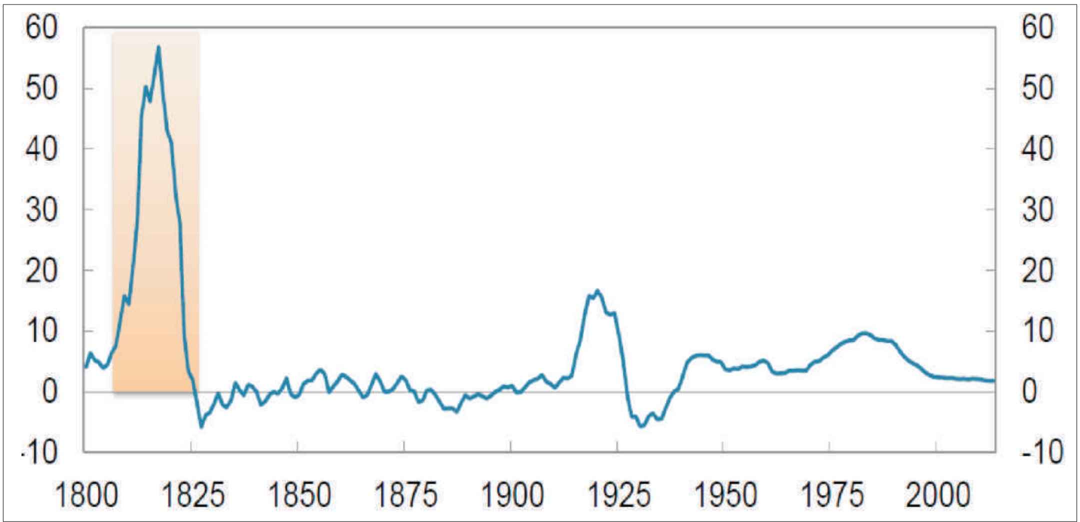
Both Zambia and Norway are this year celebrating history-making events in the building of their nations. This gives me the opportunity to start my speech today with some lessons learned from history in Norway. These lessons form part of the background for today's economic policy framework.

Norway's constitution was signed 200 years ago, in 1814. The constitution established Norway as an independent nation after 400 years under Danish rule. As a new nation, key nation-building institutions were needed. Absolute monarchy under the Danish king was to be replaced by the sovereignty of the people and the separation of powers. Institutions with clearly distinguished roles would prevent the misuse of power and foster confidence. One such institution was the central bank.

And in laying the foundations of an autonomous state, it was obvious that no state can exist without a well-functioning monetary system. Moreover, a currency of its own would be a symbol of Norway's sovereignty and independence.

But Norway was faced with the legacy of years of war. There had been little to prevent an absolute monarch in Denmark from cranking up the printing press in order to finance recurring wars and conflicts. The combination of commodity shortages and a high volume of notes in circulation led to hyperinflation and a lack of confidence in the value of notes. By 1814, prices had risen to a level twenty times higher than just a few years earlier. The monetary system was on the verge of collapsing (see Chart 1).

**Chart 1: Hyper Inflation Period 1 (%)**




**Sources:** Statistics Norway and Eitrheim et al. (2004): "Historical Monetary Statistics for Norway 1819-2003

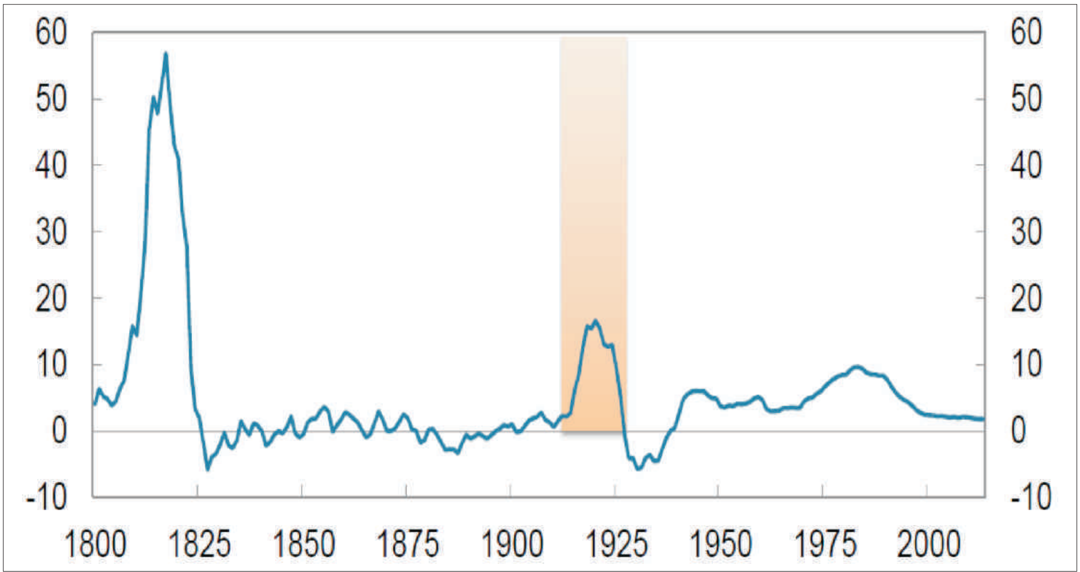
The people's elected representatives took responsibility for the monetary system. The task of supervising the monetary system was subsequently delegated to the central bank – Norges Bank – which was established two years later. The king would no longer have the authority to print money at will.

Getting the economy back on its feet was a matter of urgency. Norway's economic freedom would be severely restricted if confidence in the monetary system and the currency were not restored quickly. However, restoring confidence in the value of money would prove to take time. The economic foundation to ensure stability in the monetary system was not yet in place, and guarantees given were broken. As a consequence, when the government needed to borrow, lenders were difficult to find. Any loans that were granted had strict terms. For a young nation it was costly to break the promise of a stable value of money.

It would take more than 25 years after the founding of Norway's central bank before the central bank's reputation was fully consolidated. A period of prosperity and growth followed.

For Norway, as for many other countries, World War I brought a quick end to this era of stability. Although Norway did not take part in hostilities, its monetary and fiscal policy still spiralled out of control. As a neutral nation, Norway also experienced a surge in its export revenues. The speculative economy that followed resulted in strong credit growth. High inflation became a problem once more (see Chart 2).

**Chart 2: High Inflation Period 2 (%)**



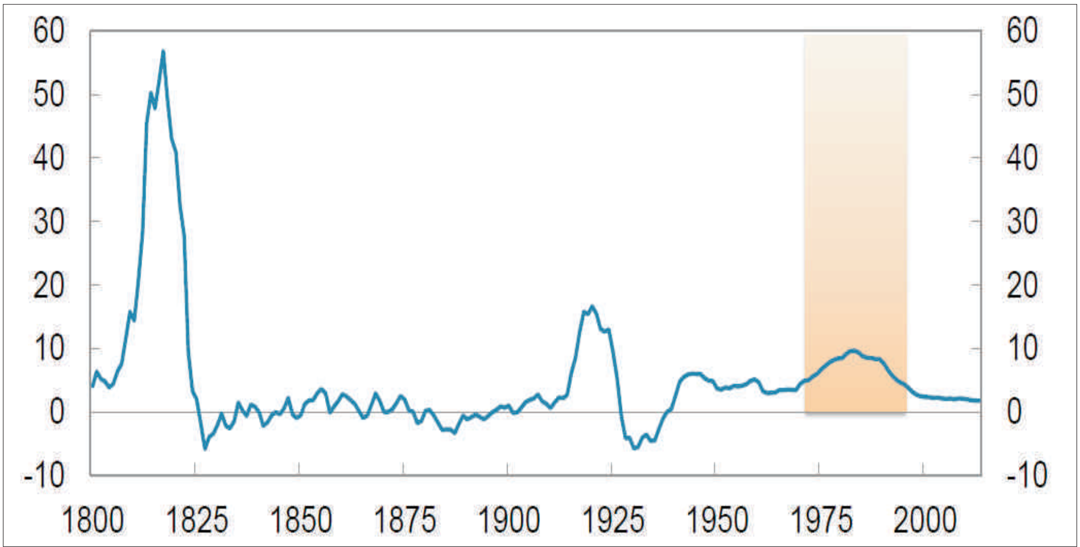

**Sources:** Statistics Norway and Eitrheim et al. (2004): "Historical Monetary Statistics for Norway 1819-2003

After the war, Norway would again experience the cost of rebuilding confidence in its currency. A strict monetary policy and a domestic currency that was overvalued against other currencies resulted in bankruptcies and unemployment in the 1920s and 1930s. The experience of the struggle to rebuild confidence offers an important lesson. Reducing inflation is costly once the anchor has slipped.

### Boom and bust economy

The two early episodes of high and unstable inflation I have mentioned so far are both linked to wars and crop failures. That story did not hold for the inflationary period of the 1970s and 1980s indicated in Chart 3. This time, the cause lay in the system for managing the economy.

**Chart 3: High Inflation Period 3 (%)**



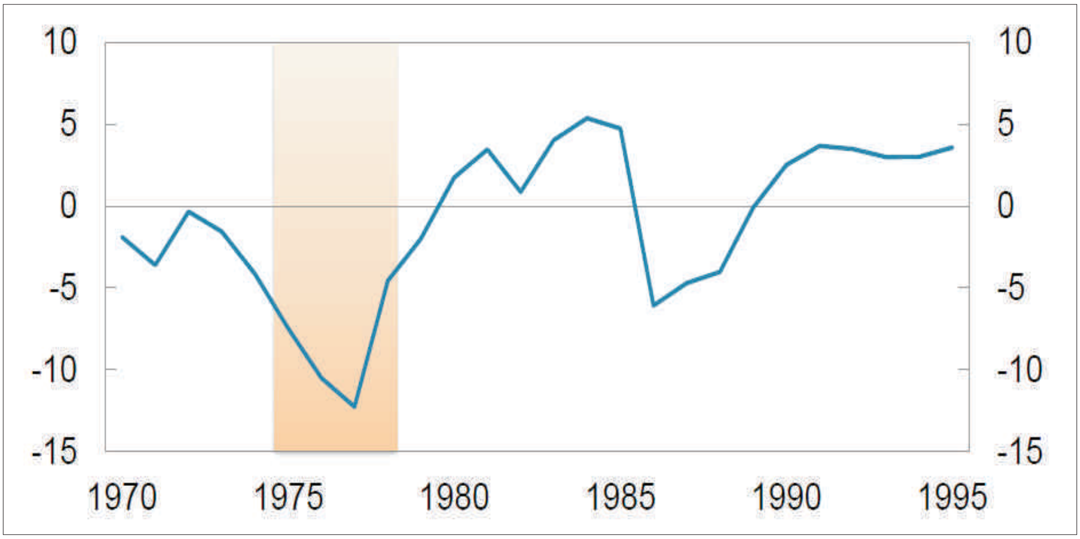

**Source:** Statistics Norway and Eitrheim et al. (2004): "Historical Monetary Statistics for Norway 1819-2003

Economic policy, not least in Norway, in the early 1970s was based on the belief that the economy could be fine-tuned. Many economists and policymakers were confident that low unemployment could be achieved at the price of higher inflation. Central bank independence was limited. Policy rates were primarily to be used to support investment and employment. The importance of price stability was lost from view. The 1970s also mark the beginning of Norway's petroleum age, when oil was discovered in the North Sea.

Back in the 1970s, policymakers' handling of the newly discovered petroleum wealth got off to a rather weak start. Public spending surged before export revenues had started to kick in. Fiscal policy fuelled a boom. Inflation soared to double digits. The non-oil tradable sector struggled with rising costs. The authorities had a declared objective for the value of the krone. But they quickly devalued the currency when relatively high wage and price pressures in Norway began to cause problems for our export industries.

By 1977, Norway's current account surplus had turned into a deficit of 12 percent of GDP (see Chart 4). Measured in these terms, the deficit was even larger than that of Italy and Spain after the recent financial crisis. The IMF was knocking on our door, delivering warnings.

**Chart 4: Current Account Balance (% of GDP)**



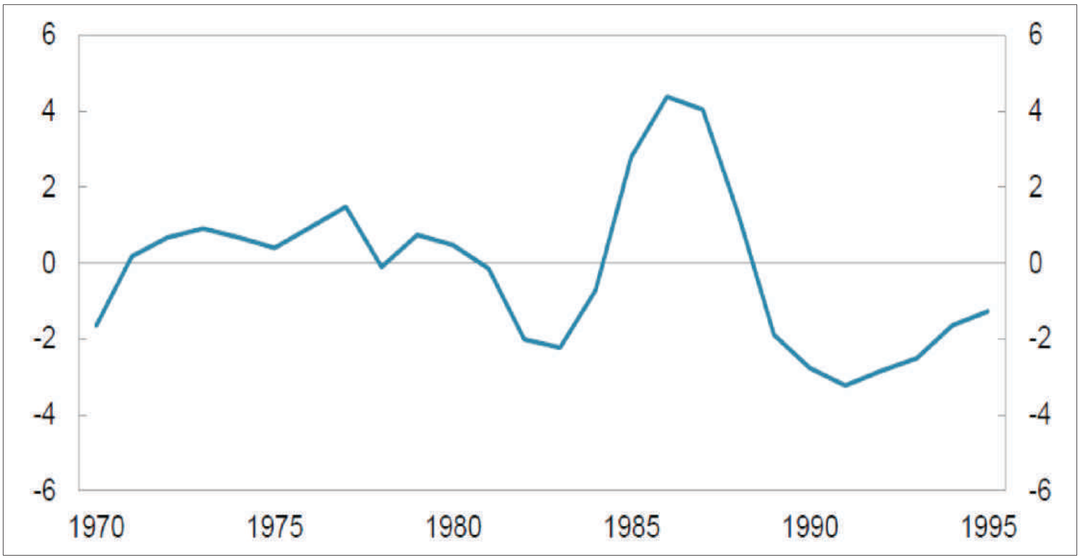

**Source:** Statistics Norway and Norges Bank

Would Norway ever be able to set aside some of our oil revenues or was this a utopian idea? Let me quote former central bank governor Skånland who said that "*In the light of the prevailing attitudes among both politicians and the wider population, it is difficult to imagine that hundreds of billions will be invested in foreign assets while there are domestic needs that have not been met (…)*"[3]

During the following years, the Norwegian economy went from boom to bust and back to boom again (see Chart 5). A much needed course correction came in the wake of the fall in oil prices in 1986. The authorities did everything in their power to gain control over the budget deficit that had built up. In spring 1986, Norway devalued for the last time, and the authorities abandoned the use of politically administered interest rates. The central bank was again given a more independent role in economic policy. The policy rate would be set with a view to maintaining nominal stability. The idea that low unemployment could be bought at the price of somewhat higher inflation had proved wrong. Instead we had learned that high inflation could lead to even higher inflation, which in turn is an obstacle to economic growth.

[3]NOU (Official Norwegian report) 1983:27 "Petroleumsvirksomhetens framtid [The future of petroleum activity], p.90

**Chart 5: Output Gap: A boom and bust economy (%)**




**Source:** Norges Bank

The Norwegian economy went through a hard course of treatment. The downturn in the early 1990s was the deepest that Norway had experienced since World War II. Short-term challenges needed to be tackled urgently. But the crisis also provided an opportunity to implement structural reforms. The commitment and the capacity of politicians and the social partners to carry out these reforms was a critical condition for renewed and sustainable growth.

## A new framework

Based on our experience, a new framework for economic policy evolved during the 1990s. The framework also took account of a changing economic climate.

With a globalised economy and deregulated credit and capital markets, our economy was more vulnerable to external shocks than before. Especially as Norway had become a petroleum-producing country. The revenues from the oil sector were growing more than expected. At the same time, investment in the petroleum sector gradually became more important as a driving force for mainland activity.

We know that commodity-producing countries tend to experience pronounced economic cycles. This is a challenge Norway has in common with other commodity-producing countries. However, as noted by Jeffrey Frankel (2011)[4],

*"We need to set up regimes ex ante which are more likely to deliver the right result ex post, in a world inhabited by human beings, not angels,"* The challenge can thus be reduced through well-chosen regimes for fiscal and monetary policy.

As human beings, we are easily tempted to spend money as it comes in, most of all when we expect more money to be on the way. We have experienced large and rapid fluctuations in oil prices. If the Norwegian government were to use the revenues as they arrived, government

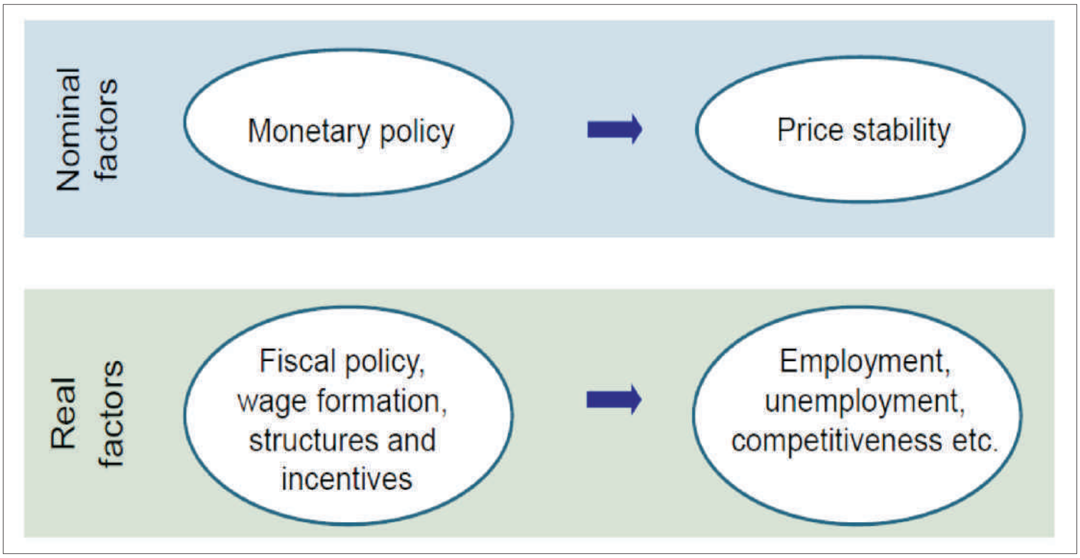
[4]Frankel, Jeffrey A. (2011), How Can Commodity Exporters Make Fiscal and Monetary Policy Less Procyclical? in *Beyond the Curse: Policies to Harness the Power of Natural Resources*, ed. by Rabah , Thorvaldur Gylfason and Amadou Sy, International Monetary Fund.

spending would have amplified the business cycle. In order to avoid a boom-and-bust economy, a buffer mechanism was needed.

In addition, petroleum reserves are not replaceable. Once they have been extracted, sold and the earnings spent, the wealth is gone. We confronted ourselves with the following questions: What right does one single generation have to expend resources that it has taken nature millions of years to produce? Should we leave our children and grandchildren with an economy suffering from previous generations' overspending, where internationally exposed sectors have been crowded out and the nation's coffers are empty?

These issues and the challenges created by large and fluctuating oil revenues had to be resolved. We did so by establishing our sovereign wealth fund, known as the oil fund, and introducing the fiscal rule. Together with an inflation targeting regime for monetary policy, they form the main components of the economic policy framework in Norway as indicated in chart 6.

**Chart 6: Division of Responsibility for Economic Policy**

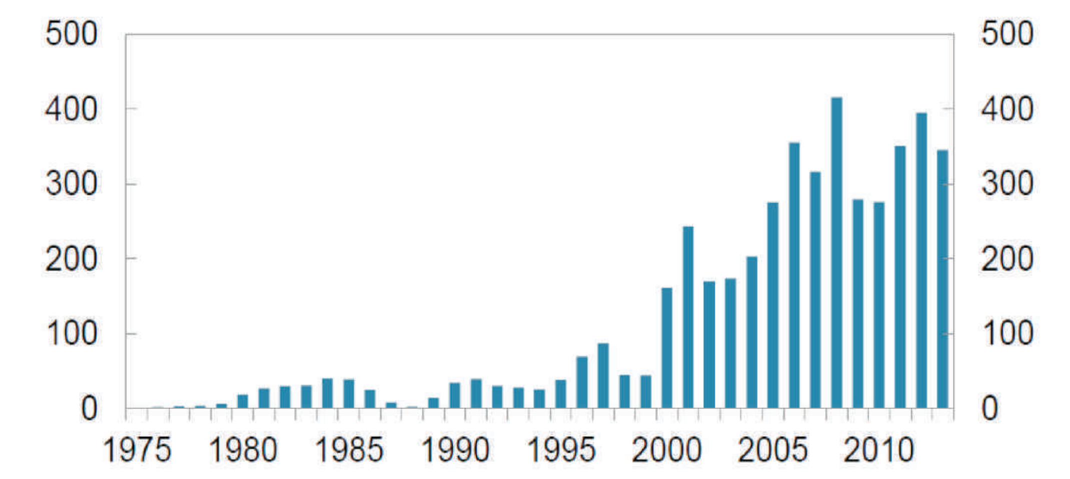



The framework enhances economic stability and makes the economy more robust to external shocks. It is rules-based and gives a clear division of responsibilities between monetary and fiscal policy. The primary objective of monetary policy is to keep inflation low and stable. Our politicians can build on Norges Bank's response pattern when drawing up annual budgets. They can also take into account that increased spending via government budgets may trigger an appreciation of the krone. The social partners can apply a low and stable rate of inflation when they negotiate the share of economic growth to be taken out as real wages and set their ambitions with regard to employment.

### The sovereign wealth fund and the fiscal rule

The act of parliament relating to the oil fund was passed in 1990. The first transfer to the fund took place in 1996. Soon after, the government's cash flow from the petroleum sector started to increase sharply (see Chart 7). The savings plan has since remained intact and the oil fund has now reached a size close to USD 900 billion, or roughly 160 percent of GDP.

**Chart 7: Cash Flow from Petroleum Sector (in millions of Norwegian Krone)**

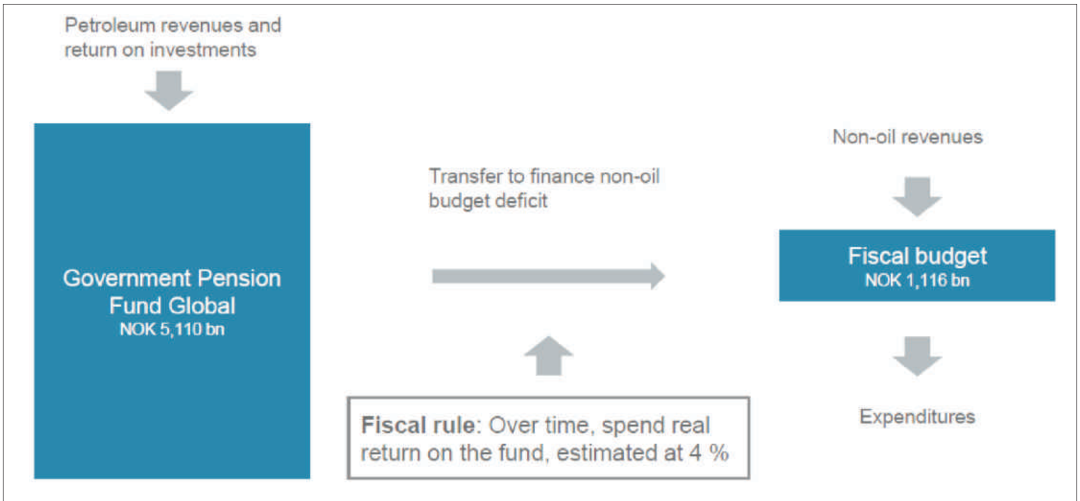



**Source:** Ministry of Finance Norway: National Budget 2014

Guidelines for the interaction between Norway's petroleum wealth and fiscal policy, as indicated in Chart 8, were established in 2001. These rules state:

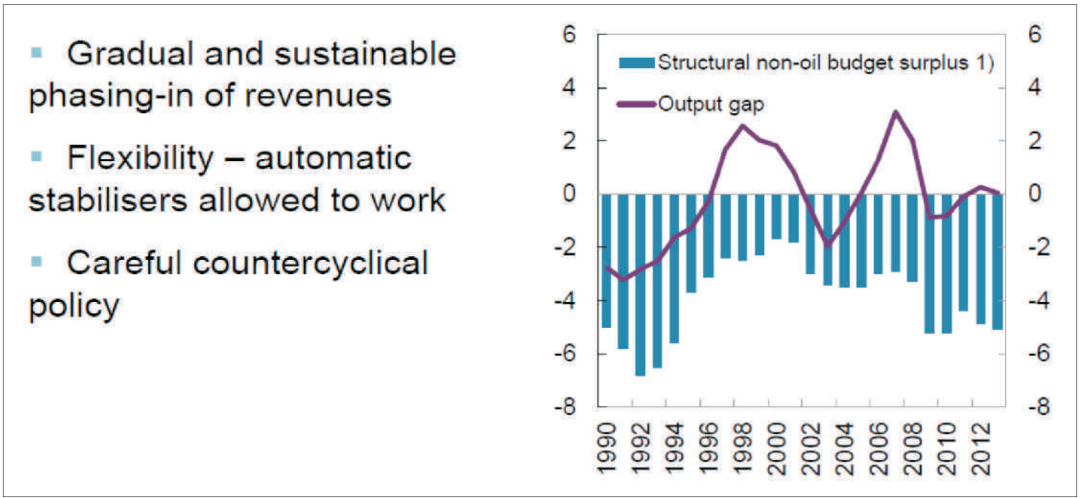
- All government revenues from the oil sector must be transferred to the fund.
- Government spending of oil revenues – measured as the non-oil fiscal deficit - must be limited to the expected real return on the fund – estimated at 4 percent. This is our fiscal rule. The aim is to spend only the return generated by the fund's investments, not the wealth itself.
- All of the fund's capital must be invested abroad.

**Chart 8: The Fund mechanism and the Fiscal rule**




As a result of the fiscal rule, economic policy is more robust. First, the fiscal rule decouples spending from current petroleum revenues. This provides for a gradual and sustainable phasing-in of petroleum revenue spending. Second, the rules ensure the necessary flexibility to allow automatic stabilisers to work. Third, they allow for careful countercyclical policy. Structural non-oil deficits have counteracted movements in the output gap since the fiscal rule was adopted (see Chart 9). In particular, reserves accumulated in the fund provided fiscal leeway during the economic setback in 2008 and 2009.

**Chart 9: Structural Non-Oil Budget Surplus**




**Source:** Ministry of Finance Norway and Norges Bank

At the same time, cyclical fluctuations in mainland production are strongly influenced by petroleum-related demand. There is thus a strong link between Norway's mainland output gap and the oil price.

The krone clearly responds to oil price shocks. However, the build-up of the fund and the fund mechanism has contained a real appreciation of the domestic currency during a period of high oil revenues.

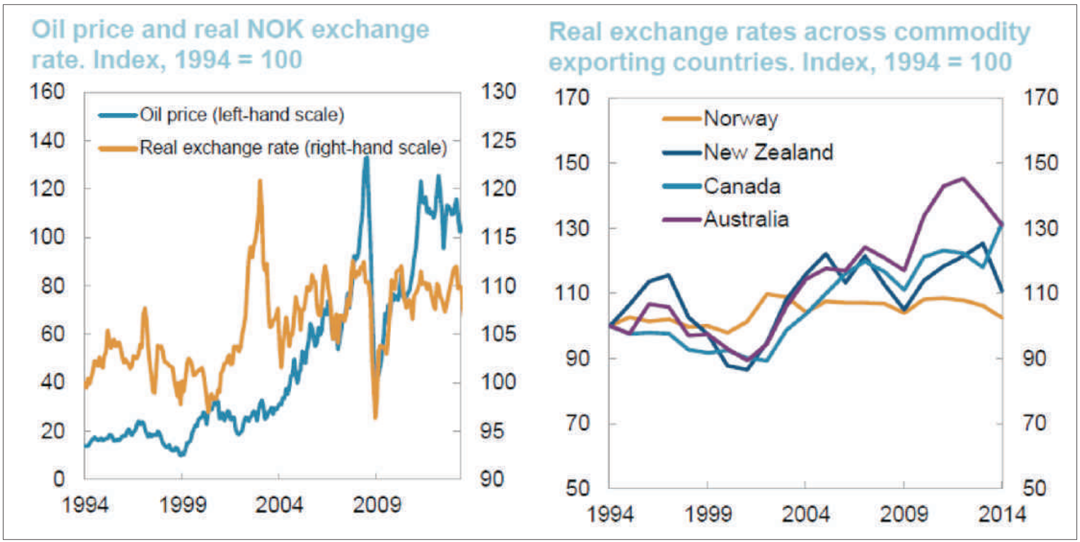
Oil and gas revenues are essentially government income in foreign currency. The government spends oil revenues by running a budget deficit. The deficit is financed by selling foreign currency for domestic currency in the market. The amount of domestic currency bought corresponds to the size of the deficit. Hence in the long run, the size of the deficit influences the real exchange rate in Norway.[5]

If more oil revenues had been spent domestically, the appreciation pressure would have been stronger. In an extreme case, if all Norway's oil revenues were spent as they came in, instead of using them to build up the fund, our domestic currency would need to appreciate dramatically. This would have a negative impact on internationally exposed industries in Norway. Hence the fund and its mechanism shield exposed industries from loss of international competitiveness and prevent excessive appreciation of the currency.

Compared with other commodity-based economies, such as Canada, Australia and New Zealand, fluctuations in the real exchange rate have been moderate. We believe the fund mechanism has contributed to this (see Chart 10).

[5]For more details on the fund mechanism, see E. Aamodt "The petroleum fund mechanism and associated foreign exchange transactions by Norges Bank", Economic Commentaries 2/2014 and E. Aamodt, "The petroleum fund mechanism and Norges Bank's foreign exchange purchases for the GPFG", Economic Commentaries 14/2012, both to be found on www.norges-bank.no.

**Chart 10: Real Exchange rate and Oil Price**

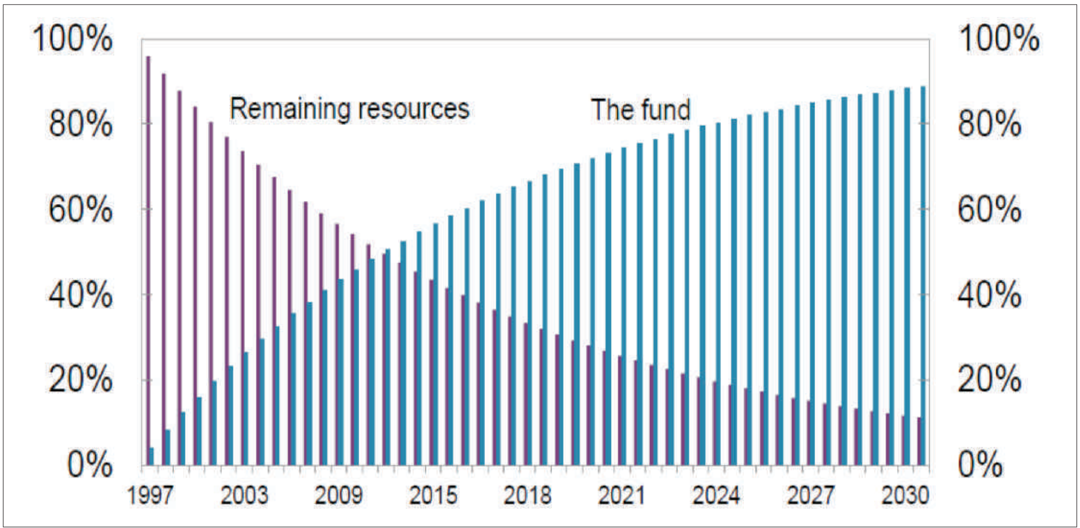



**Source:** Thomson Reuters

The lesson to be learned, in our view, is that the set-up of a fund such as our oil fund should not only focus on saving for future generations. The set-up also needs to focus on the fund's impact on the domestic economy in the long run.

As it has turned out, governments from different sides of the political spectrum have managed to save a substantial part of our national wealth for future generations. Natural resources have been transformed into financial wealth and the value of the fund has increased rapidly, especially over the past 15 years. Due to these substantial transfers, the value of the fund will soon be far higher than the value of the remaining petroleum resources (see Chart 11).

**Chart 11: Total Value of Remaining Resources and the Fund-Respective Proportions**

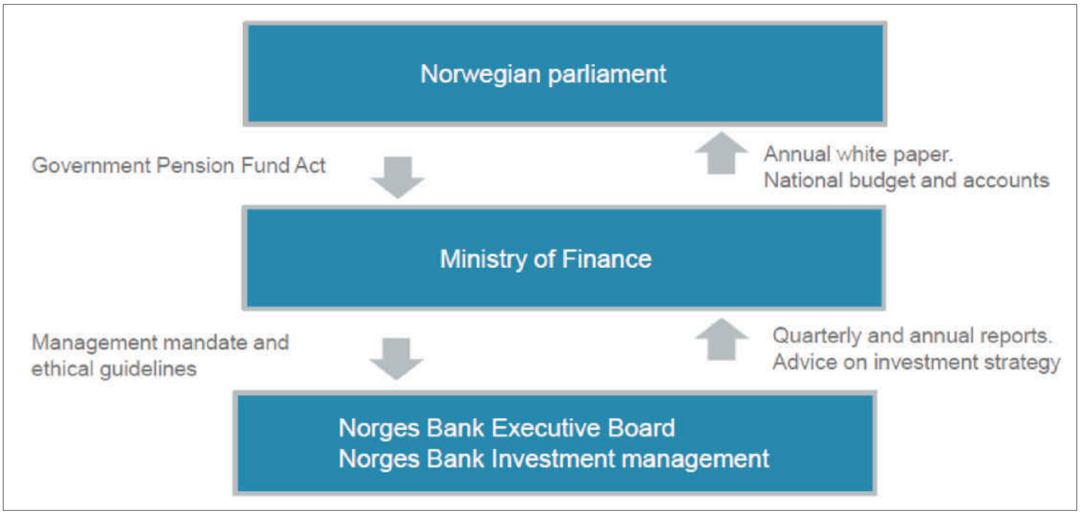



**Source:** Ministry of Finance and Norges Bank

Going forward, as revenues from the petroleum sector decline, the future path will depend on how well we manage these savings. And again, sound institutions with clearly defined responsibilities matter.

The fund is owned by the Norwegian people. The Ministry of Finance holds the political responsibility for the fund. The overall management principles and strategy are anchored in parliament and the Ministry reports to parliament at regular intervals. The management structure is indicated in Chart 12.

**Chart 12: Governance model of the Fund**




The management of the fund is fully delegated to the central bank – to Norges Bank. Our task as manager of the fund is strictly commercial: to maximise returns within the guidelines defined by the government. All investment decisions are made by Norges Bank Investment Management, a separate division within the central bank. Neither Norges Bank's Executive Board nor the Ministry of Finance is involved in any individual investment decisions. This governance structure was set up to ensure that the fund was not used as an instrument of foreign policy.

The purpose of the fund is to ensure that future generations receive their fair share of Norway's petroleum wealth. To achieve this, the fund was designed to be invested for the long term. The size of the fund and its long investment horizon are the fund's two key characteristics and form the backbone of the investment strategy.

**Final remarks**

The Norwegian economy has over the past four decades benefitted enormously from its rich natural resources. Lessons have been learned, and policy rules have been established for the management of our oil and gas reserves.

Together, the inflation target and the fiscal rule have resulted in a stable regulatory regime. The primary objective of monetary policy must be price stability. But without responsible public spending, this task may become too onerous.

For the moment, the petroleum industry both provides exposure to an entire global economy and shields us from the current low growth environment across the OECD area.

However, it is too early to say whether Norway has managed to establish a framework that makes the economy robust enough to withstand strong fluctuations in our terms of trade. Our present framework has yet to be tested against a large and persistent negative oil price shock. I believe the real test of our framework will come when activity in the petroleum industry declines. Norway's oil and gas resources, though rich, will not last forever. As in any other country, emphasis should be given to further development of human capital as the primary source of long-term prosperity and wealth.

# 3.5 The Role of Central Banks in Economic Development

**Christopher Adam***

## 1. Introduction

Central banking in Sub-Saharan Africa has come a long way since the Bank of Zambia was founded in August 1964. At the time of Independence, the Bank operated within the constraints imposed by the Bretton Woods' system of global 'fixed but adjustable' exchange rates and in an environment in which cross-border capital flows were negligible so that monetary policy, as it is conceived today, was vestigial. Over the subsequent half-century, the Bank of Zambia, along with central banks across Africa, has negotiated huge changes both in terms of the external economic environment – most notable the collapse of Bretton Woods' system and the enormous growth in cross-border capital flows -- and of the domestic political configuration that together shape the range and scope of monetary policy. The challenges confronting central banks, and the expectations placed upon them, have radically changed. At one level, contemporary research ascribes a more modest scope for monetary policy in guiding the path of the economy, over the short and medium term – a view encapsulated in the perceived primacy of 'rules' over 'discretion in the conduct of policy. But at the same time it places a much greater burden on central bankers to communicate with the private sector, to interpret current economic conditions and to articulate a clear and coherent set of macroeconomic policy responses. It is this latter obligation that has seen the status and authority of contemporary central banks – and central bankers – rise to a level shared by very few of their predecessors. Perhaps only the great financiers behind the creation of the US Fed in 1913 -- John Pierpont Morgan, John D. Rockefeller and Paul Warburg – and Montague Norman, who presided over the Bank of England for almost a quarter of a century from the end of the First World War, attracted the 'rock star' attention paid to contemporary senior governors such Ben Bernanke, Janet Yellen and Mario Draghi. This elevated profile is shared on the continent of Africa where, in many countries, central banks command more respect than the finance ministries to which they are ultimately answerable.

But behind the glitz is a serious purpose. For good or ill, the central bank remains a central institution in design and implementation of economic policy and, as such, plays a critical role in economic development, especially amongst rapidly-growing low-income countries. In this short paper I wish to explore the changing nature of this mandate. In doing so, I shall make three basic points. First, by way of background, I consider how the evolution of ideas over the last 50 years has been instrumental in transforming central banks in Africa from complex multiple-mandate institutions into narrowly-focused institutions and how the pendulum is beginning to swing back again as central banks are increasingly being prevailed upon to pursue a broader set of economic policy objectives. Second, I make a few observations about the operation of the new 'conventional' single mandate as it applies to the economic environments of sub-Saharan Africa. And finally, I examine the increasingly important question of the macroeconomic management of capital flows and the role of capital flow management measures in mitigating the adverse effects of volatility. Here I focus on recent work, referred to by Hélène Rey (2013) as the 'collapse of the trilemma'.

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## 2. From multiple to single mandates and back

It is instructive to start by recalling what textbook economics tells us of the scope and limits of monetary policy. We start from the observation that the core function of monetary policy is to provide a nominal anchor for prices in order to guide the path of average prices for the economy by fixing the local currency price of a commodity, such as gold, or of another currency (an exchange rate peg), or by acting to influence the evolution of some intermediate aggregate – the money supply, credit or inflation expectations – that is presumed to have a close causal link to the price level. With average prices thus anchored, relative price movements around this average can efficiently guide consumption and production decisions. Viewed from this perspective, we can then consider the limits of monetary policy. Clearly what monetary policy can directly influence is the path and volatility of inflation: everything else flows from this observation. Monetary policy cannot directly influence the medium-to-long run path of output which is determined by factor market conditions, by trade and policy shocks, both internal and external, and by macroeconomic policy choices in the areas of trade and fiscal policy that alter relative prices and hence resource allocation. Monetary policy impacts on these dynamics only to the extent that efficient resource allocation decisions are undermined by high and volatile inflation. This could be through the impact on the efficient operation of credit markets; as a result of adverse distributional effects as inflation transfers wealth from savers to borrowers and from the private to public sectors when assets and tax instruments are non-inflationindexed; or even by changing private agents' assessment of investment risk. Viewed from this perspective, the one thing monetary policy can do is 'mess things up': the challenge, therefore, is to deliver the primary objective of low and stable inflation in a credible, predictable manner that does not distort broader growth and development objectives.

### *The failure of multiple mandates*

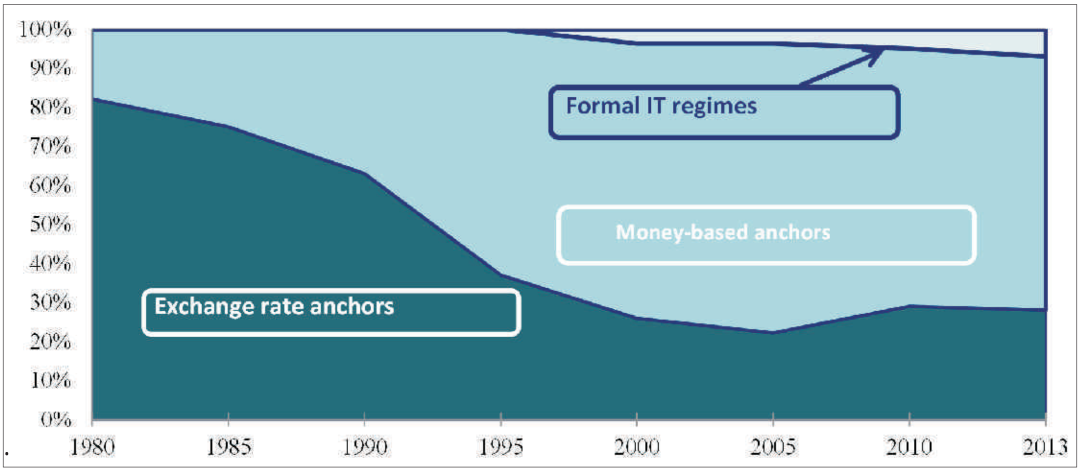
The last 50 years have seen a dramatic transformation of the macroeconomic landscape in Zambia, as elsewhere in Africa: this transformation is not just in terms of economic conditions, but also of perceptions of the scope and limits of monetary policy. As recently as the early 1990s, the prevailing orthodoxy across much of the African continent was that monetary policy could and should be deployed as a purposive instrument in the broader development process, doing much more than the textbook description just described would justify. Thus, for example, Honohan and O'Connell (2008) and Mason and Pattillo (2005) describe post-Independence monetary frameworks in Africa as being largely geared towards the (cheap) financing of government activities, the extension of subsidized credit to favoured sectors, and the active pursuit of an exchange rate target (more often reflecting the interests of powerful urban consumers at the expense of producers), rather than the control of inflation. Moreover, weak fiscal control – informed to a degree by the same orthodoxy – meant that monetary policy was conducted in an environment of substantial fiscal dominance, so that macroeconomic policy coherence was often achieved only by recourse to progressively tighter controls on the capital account and other policies that repressed the development of domestic financial markets. In Zambia, a by-product of this general strategy was that throughout the late 1970s and early 1980s, as the authorities became increasingly reluctant to allow exchange rate adjustment to support necessary macroeconomic adjustment, the precarious external balance was enforced by the application of strict exchange controls, quantity rationing on imports and domestic price controls. Combined with severe financial repression measures, the inevitable emergence of active black markets in foreign exchange badly distorted the structure of relative prices in a way that created an anti-rural and anti-export bias, exacerbating dependence on copper and thwarting diversification into non-traditional areas.

This cocktail of fiscal dominance and the overburdening of monetary policy with multiple objectives led to the inevitable outcome that African monetary regimes, geared to doing 'too much' ended up delivering on 'too little': they neither delivered on the core objective of low and stable inflation nor, however, did they post sustained gains on the other development oriented policy objectives (Honohan and O'Connell, 2008).

By the early 1990s, however, the evident failure of an (over)activist monetary policy encouraged moves to dismantle control regimes, liberalize foreign exchange markets, and establish more robust fiscal regimes across Africa, often with the explicit support of IMF stabilization programmes. For Zambia, the key episode in this transition occurred between 1992-94, and in particular in the 1994 Budget which saw the comprehensive liberalization of the capital account and the cash budget.

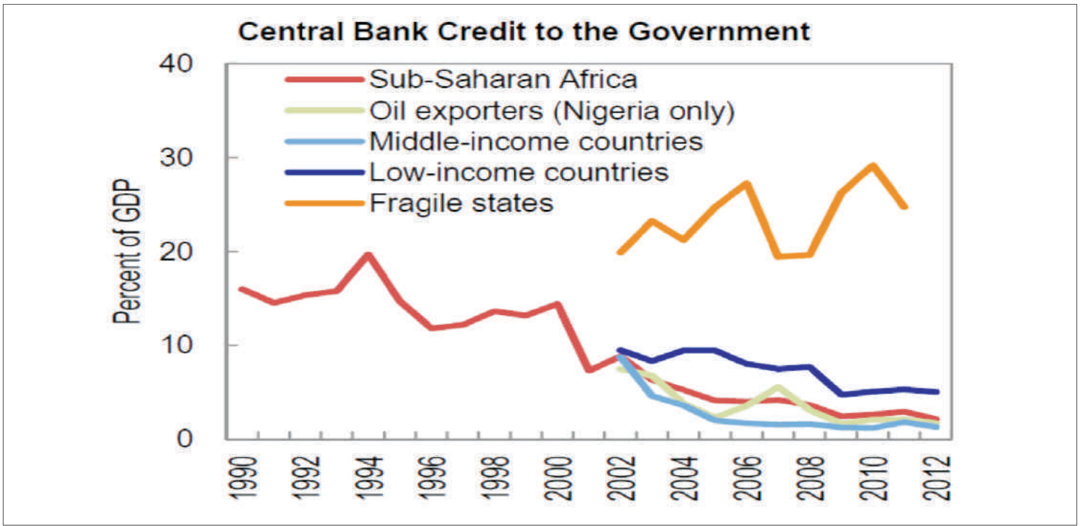
For Zambia, as for other African countries, the legacy of this revolution in thinking is that while macroeconomic instability has not been completely banished, most African central banks today are under much less pressure than before to accommodate large domestic fiscal deficits, while the dismantling of systems of financial repression, the widespread elimination of exchange controls, and a tendency towards the adoption of flexible exchange rates has opened up the space for genuinely independent central banks to function (See Figures 1 and 2). It is to this opportunity we now turn.

**Figure 1: The shift towards floating exchange rates in Africa**
Distribution of SSA countries by de facto exchange rate arrangement




**Notes:** Excludes CMA Franc Zone countries and members of CMA arrangement.
**Source:** IMF Annual Report on Exchange Rate Arrangements (2013).

**Figure 2: The Erosion of Fiscal Dominance**




**Source:** IMF Africa Regional Economic Outlook April 2014.
The new conventional wisdom

## The new conventional wisdom

A monetary regime defines the institutional framework to deliver monetary policy and the constraints under which monetary policy-makers operate. As the pendulum swung towards a 'single mandate' view (see for example, IMF 2014), most governments, and certainly most central bankers, would now tend to subscribe to the view that the role of monetary policy can be reduced to three core functions. The first and over-riding objective is the delivery of low and stable inflation. Exactly how low this should be is an unresolved question, especially in developing countries, but crucially, whatever the target, the prevailing consensus sees this function as being best pursued through some form of policy rule. The case for rule-based policy is twofold. First, as argued by Friedman, rules are desirable when the authorities do not have the information or capability to know when or how much to stimulate or dampen the economy. Rules reduce the risk that activist stabilization policies end up exacerbating the very economic volatility they seek to contain. The second is that rules tie hands and help to minimize or eliminate the incentives of the authorities to operate in a time-inconsistent manner[1].

The second function, conditional on targeting inflation, is to seek to moderate fluctuations in the path of domestic output by judicious tightening or loosening of the stance of monetary policy as circumstances dictate. The aim is to minimize deviations of actual output from its underlying potential. This is fundamentally a discretionary function and hence, to the extent that the output stabilization objectives may run counter to inflation stabilization objectives and vice versa, this potentially sets up a tension between rules and discretion at the heart of monetary policy. It is this tension that a coherent monetary framework must resolve. The management of this trade-off between inflation and output stabilization is

[1]The notion of time inconsistency dates back to the Nobel prize-winning work of Finn Kydland and Edward Prescott in 1977. In the context of monetary policy, the essential idea is that when the authorities set their policy instrument only after the private sector has formed its expectations about inflation (possibly based on some prior announcement about the stance of policy) they will have an incentive to renege on their announcement, for example to exploit the short-run Phillips curve and boost aggregate demand and employment in the short run. This may be for political reasons. Anticipating this incentive, the private sector will view the initial policy announcement as non-credible and will adjust their expectations accordingly. This creates an *inflation bias*, locking the economy into a higher long-run inflation rate. To make their announcements credible and eliminate, or at least reduce, the inflation bias, the monetary authorities may seek to commit to a fixed and verifiable policy rule.

much more challenging in low-income small open economies. In mature economies, underlying potential output tends to evolve along a smooth path over time and that deviations reflect demand-side factors that monetary policy is well-attuned to address. By contrast, in low-income open economies, potential output is much less stable, being prone to supply-side shocks, such as climate variation, term of trade shocks and so forth. The key point is that in these circumstances only part of the variation in output is amenable to smoothing by monetary policy. Knowing how much weight to place on monetary instruments in these circumstances is difficult. I return to this point shortly.

The final function of monetary policy is less direct.[2] It is to support the conduct of policy with a transparent and coherent communications strategy. The fundamental objective of such a strategy is to make public, in a timely fashion, the central bank's own information and analysis about the state of the economy and to ensure that its actions are verifiable and its own expectations of future developments are revealed. The aim is to resolve the problems of asymmetric information, which can create incentives for the time-inconsistent behaviour noted above so as to help anchor private agents' expectations.[3]

In practice, this new emphasis on communication has seen central banks across the world move decisively away from the earlier culture of 'dignified obscurity' – so celebrated by Lord Walter Cunliffe, governor of the Bank of England during the First World War whose tenure was characterized by the aphorism “never apologize, never explain” – to a more engaged stance. This has seen central banks publish the evidence and analysis that informs these rate-setting decisions; publish the voting records of the members of interest rate-setting committees; and devote substantial resources to public information and direct engagement with key stakeholders. This comprehensive communication strategy applies both when inflation is on target and, a fortiori, when it is off target, in which case additional disclosure requirements may be placed on the central bank to explain deviations and specify remedial action to return inflation to target.[4] An important element in establishing the credibility of this structure is the reliance on independent external membership of key decision-making bodies and the pressures these bodies exert on the national statistics offices to produce timely and accurate data.[5]

The move towards greater transparency is a worldwide phenomenon. Figure 3, adapted from a recent paper by Dincer and Eichengreen (2014), plots changes in an index of central bank transparency for a sample of countries between 1998 and 2010 (the latest year for which data are available). Transparency is a weighted average of measures including whether central banks have published objectives; whether their decision making committees include independent external members; how communication is structured; whether central banks reveal their own expectations etc. Two key messages come from the figure. The first is that on average African central banks score less highly on these indicators of transparency but the second is that while all central banks are becoming more transparent with time, there is some 'convergence'. Regimes are changing faster amongst lower-income countries, including those of Africa.

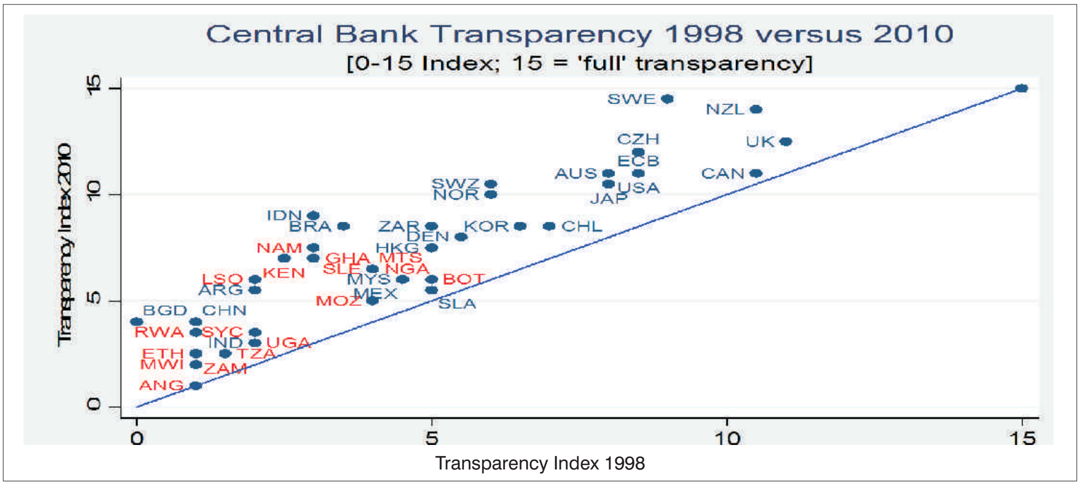
[2]In this section I focus on the objectives of *monetary policy* rather than the broader functions of the central bank and therefore do not discuss issues of bank supervisions and the integrity of the payments system. I return to these below.

[3]In modern inflation targeting regimes (and those where the authorities are moving purposively in this direction), the nominal anchor for inflation is *expected inflation*. The instruments at the disposal of the central bank (be they interest rates or quantitative instruments) *and its communication strategy* are set not to influence a tangible quantity or price but rather to *directly* influence the private sector's expected or forecast rate of inflation at some horizon. The rationale is that future expected inflation feeds into current price- and wage-setting behaviour; a credible inflation target thus leads to target-consistent price and wage-setting behaviour today, thereby validating the forecast. The essence of a transparent and credible communication strategy is that the authorities' policy actions and announcements credibly influence the evolution of the private sector's inflation expectations.

[4]The Bank of England Governor's obligation to write an 'Open Letter' to the Chancellor (Minister of Finance) if inflation strays outside its target range is a good example of this approach

[5]Members of the Bank of England MPC have also stressed the importance for policy credibility of developing a 'culture of intellectual dissent', in which the central bank governor and his or her executive can find themselves in a minority on interest rate decisions.

**Figure 3: Convergence towards global norms in central bank transparency**




**Source:** Dincer and Eichengreen (2014)

The empirical evidence on the performance of modern monetary regimes suggest that when these three characteristics are present – the explicit inflation target, the rule-based balancing of inflation targeting against output stabilization, and the associated public disclosure and explanation of policy decisions and outcomes – in other words when central banks are 'Inflation Targeters', outcomes are good (see Carlos et al, 2008, Lin and Ye, 2009 and IMF, 2005). Such regimes tend to deliver lower inflation, lower inflation volatility and, critically, lower output volatility (suggesting that central banks adopting IT regimes are not just revealing a preference for lower inflation volatility over output volatility). The key mechanism appears to be that the time inconsistency problem inherent in monetary policy is being defused: private sectors believe that the central bank will (eventually) bring inflation back on track and will do so in a transparent manner. As a result, the pass-through from current price developments to expected future inflation reduces, allowing the authorities to use monetary instruments to pursue other ultimate targets of policy, which may include competitiveness or stabilization of short-run output around its potential.

The textbook description of a full-fledged IT regime sets the bar high and, in practice, only a few countries demonstrate all these characteristics. Countries around sub-Saharan Africa are moving in this direction, though with Ghana and South Africa being full-fledged IT regimes and a number of other countries, including Zambia, Uganda and Kenya moving decisively in that direction (see IMF, 2014a).

This transition is far from straightforward, though, and in the next section of this paper, I look at some of the challenges in implementing this 'conventional wisdom' approach in African environments. Before doing so, let me conclude this section by discussing the emerging reaction against the narrowly-focussed 'single mandate' for monetary policy.

## The pressure towards a broader mandate

Arguably, the mid-2000s represented the high water mark of 'single mandate' thinking[6] and while no country that has adopted an IT regime has yet abandoned it in favour of an alternative, the period since the global financial crisis has seen calls for the core mandate for central banks to be widened. Critics of the conventional single-mandate structure have

[6]See for example, Olivier Blanchard's infamous (2008) paper on the state of macroeconomics which, on the eve of the global crisis, celebrated the unquestioned success of modern central banking in the West.

argued that the narrow mandate and relatively short horizon over which targets were defined led policy-makers to pay insufficient attention to asset price inflation and to the build-up of financial imbalances that preceded the crisis. From this followed calls for reform, ranging from the operational, for example, that central banks should seek to 'lean against the wind' of asset price movements, to the radical redesign of the framework of monetary policy, including even calls to abandon IT regimes in favour of more discretionary regimes that focus directly on growth and employment.

On the former, reflecting the origins of the global financial crisis, and the failure of central banks to adequately predict it, central banks are beginning to develop frameworks that allow them to respond directly to the evolution of asset prices (as opposed to the prevailing view that has banks responding only to the extent that asset prices feed into consumer prices) and simultaneously provide for 'macro-prudential' instruments that take it beyond its conventional 'banking supervision' role -- to focus on systemic financial risks. These risk may arise from the presence of 'too-big-to-fail' institutions (where the anticipation of future bail-out by the state represents a subsidy for excessive risk taking); from excessive credit growth, particularly when this is skewed towards financing real estate as opposed to other forms of capital accumulation that augments aggregate supply; and from the growth in cross-border banking activities that may, in part, be driven by 'regulatory arbitrage' (where activities migrate to jurisdictions with the lightest regulatory regimes).

There is less enthusiasm for the idea that central banks' monetary policy should pay more explicit and more direct attention to the ultimate objectives of macroeconomic policy namely employment and growth. This particular view has found strongest support amongst some policy makers in developed countries, especially those in the Eurozone languishing under protractedly high unemployment who argue that the vigilance against inflation is excessive and a looser more employment-focused strategy should be pursued (see Jacome and Mancini-Griffoli, 2014). While most central banks, including those in Africa, recognize that they will necessarily have to develop macro-prudential measures over the coming years, there is less enthusiasm for a broader growth and employment agenda. The pushback against this form of mission creep can correctly be framed in terms of the desiderata of the single mandate view. First, in terms of coherence and communication, the accumulation of more and harder-to-evaluate objectives makes it more difficult for the public to monitor central bank behaviour and makes it correspondingly harder for the bank to communicate policy. Second, it generates an 'instruments and targets' problem: the broader the mandate the more the central bank is required to pursue objectives for which it either lacks sufficient instruments or for which its own monetary instruments are inappropriate or distinctly second-best. Issues of growth and employment can only be addressed my monetary instruments in the short-run; the relevant instruments to promote growth and employment are real instruments – supply side measures and fiscal policy – that lie outside the central bank's domain. Third, as has been seen in the context of the Eurozone, the accretion of power in the hands of the unelected technocrats that run central banks raises serious concerns about democratic accountability for policy.

## 3. Risk and challenges facing modern monetary regimes in Africa

The arguments for African countries to move towards the single-mandate IT-based framework described in the previous section are compelling and are made with force in recent IMF publications (2014a, and 2014b). But in making the transition, African countries must confront a number of challenges. O'Connell (2010) outlines some of the key challenges:

Can the framework be deployed successfully when supply shocks are dominant and the

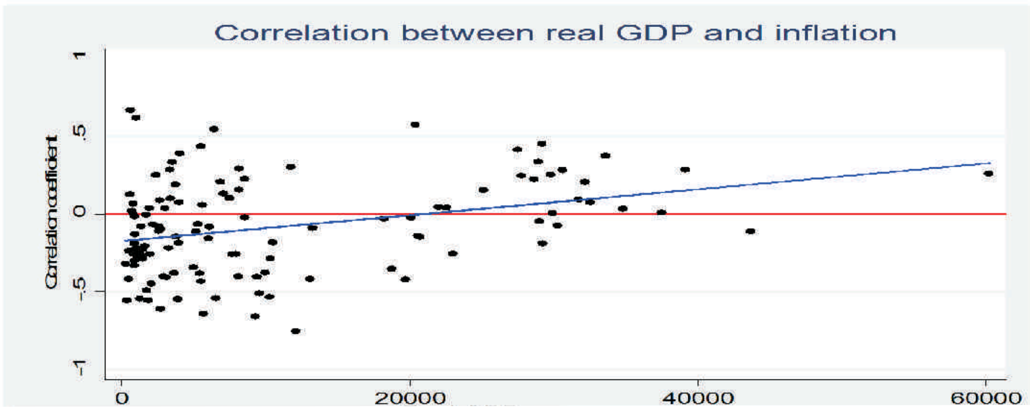
GDP gap is difficult to measure? Does it make sense to target an average inflation index when exchange rates, food prices, and public-sector prices (utilities, fuel, and public sector wages) play a much more totemic role in the public eye? Given imperfect capital mobility and the importance of export promotion and competitiveness, should exchange rate targets still play a more prominent role than is admitted under conventional inflation targeting? What operational policy rules can be used when there is not a strong transmission from policy interest rates to aggregate demand, and where central banks still use balance sheet instruments rather than interest rates?

We consider some of these in turn.

**Monetary policy when supply-side shocks dominate**

All economies are exposed to both aggregate demand and aggregate supply shocks. For demand-side shocks – for example, unanticipated public expenditure – the impact on the output gap, on the one hand, and inflation on the other are positively correlated (excess demand drives up both the output gap and inflation). For supply-side shocks – for example, a rise in the cost of imported oil or variations in agricultural yields -- this correlation is negative (output falls but prices increase).

**Figure 4: output and price shocks**




Real GDP per Capita, PPP
Each observation is a country correlation for the period 1990-2010

Figure 4 shows the correlation between output shocks (deviations of output from trend) and inflation shocks (deviation of inflation from trend) for a set of developing and developed countries, plotted against per capita income. What the figure shows is that as per capita incomes rise the correlation of output and inflation flips from negative to positive, consistent with the view that the more developed the country the more demand-side shocks predominate, whereas in developing and emerging market countries, supply-side shocks tend to play a much larger role. It turns out that this simple distinction poses a major challenge for the conduct of monetary policy, as it undermines one of the features that have made inflation targeting so attractive to industrialized economies. Moreover, pursuit of aggressive inflation targeting in the presence of supply-side shocks may, in fact, be counterproductive by leveraging up this output volatility. And to make matters worse, the obvious solution to the problem – the one adopted in other settings – turns out to be quite unattractive for low-income countries.

The essential problem is as follows: with demand shocks moving output and inflation in the same direction, a policy reaction, for example an interest rate rise, designed to bring inflation back on track will simultaneously serve to eliminate excess demand. This 'divine coincidence' – the fact that demand shocks dominate and that a policy reaction targeting inflation also targets output – goes a long way to explaining the attraction of IT in industrialized countries. With supply-side shocks – for example an increase in the cost of imported oil, which drives up production costs, thereby reducing output, and simultaneously adds to inflationary pressures – output and inflation will move in opposite directions. One instrument is now no longer sufficient: acting to stabilize the inflationary consequences of a supply shock risks exacerbating the adverse output effects and vice versa. This brings to the fore the essential problem of monetary policy: with a single instrument, policy-makers must confront the trade-off between competing objectives (in this case inflation and output stabilization).

It is certainly not the case that the tension thrown up by supply-side shocks is restricted to developing countries only. It is just much more pervasive. The conventional argument for handling supply shocks – which was employed in industrialized economies in 2008 – recognizes that such shocks typically emanate from developments in markets whose prices are outside the direct control of the domestic authorities. In most small open economies, these are the markets for food and fuel, where prices of the former are driven to a large extent by weather conditions and of the latter by world market conditions. The appropriate response of (IT) policy-makers, therefore, is to distinguish between 'core' components of inflation – those where domestic policy has leverage – and these 'non-core' components of inflation and to bring to bear the apparatus of IT only on the core component of inflation, reacting to movements in non-core prices only to the extent that they have second-round feedback effects on core inflation.[7] This leads to a strategy of accommodating the first-round effects of non-core price movements but bearing down on any second-round effects.

This approach makes sense in developed countries where non-core components account for a relatively small share of the overall CPI, so that focusing monetary policy on the stabilization of core inflation goes a long way towards stabilizing overall inflation without drawing the authorities into destabilizing responses to supply-side shocks. In most African countries, however, non-core items account for a much larger share of the CPI, anywhere between 40 percent and 70 percent. In other words, targeting core inflation would mean that the authorities may end up targeting less than half the overall consumption basket. Even if an IT regime was extremely successful in stabilizing core inflation, this may still co-exist with high volatility in headline inflation if the evolution of prices of non-core items is volatile. If, as seems reasonable, we believe that private agents set prices and wages not in terms of the evolution of expected core inflation but on actual headline inflation, the efficacy of monetary policy is likely to be undermined as inflation expectations will be less securely anchored by any given policy action. Stated slightly differently, trying to control overall inflation in these environments would require the authorities to lean much more heavily on their policy levers, with the attendant risk of greater volatility in output and interest rates.

These are uncomfortable but unavoidable truths and indeed are exactly the challenges the countries of East Africa grappled with when food prices spiked in 2008 and again in 2011.

[7]The argument for excluding these items from the target derives from the view that the role of monetary policy is to influence 'sticky' prices to bring the economy as close as possible to its notional real business cycle path (i.e. the path that would be followed if all prices were perfectly flexible). By this argument, prices that are in fact fully flexible, as is the case of imports where variations in world prices are allowed to pass through instantly to domestic prices, should be excluded from the target. Failure to exclude them would lead to placing excess weight on the policy levers. For example, seeking to lean against a positive oil price shock – which would be the case if policy was geared to targeting headline inflation – would lead to an inefficiently tight squeeze on the non-oil price component of the headline index, serving to 'overdeflate' the economy.

But, taking a longer perspective, it is reasonable to expect that over time the process of economic growth and structural transformation will ease the severity of this trade-off, both as the share of non-core goods in total consumption declines and as diversification and innovation reduce the likely scale and frequency of supply-side shocks.

**Reconciling exchange rate objectives**

As stressed in the introduction, the incoherence brought about by the overburdening of monetary policy with multiple objectives meant that monetary regimes often delivered on none of them. But, even though a new understanding of the limits of monetary policy has emerged, the multiple objectives have not entirely disappeared, with concerns about the path and volatility of the exchange rate still playing a dominant role. One strand of the IT literature (for example, Batini and Laxton, 2007) argues for a clear and unambiguous prioritization of the inflation target with the authorities forgoing any attempt to manage the exchange rate. This argument does not imply that they should ignore the exchange rate – not least because it plays a central role in forecasting inflation – but rather that it should be made clear that the authorities are not beholden to any specific value of the currency. Moreover, the argument goes, a non-interventionist stance creates the positive incentives for the private sector to develop the capacity to price and manage exchange rate risk. A growing body of evidence suggests otherwise. As Edwards (2007) and others have shown, intervention in support of the exchange rate is the norm rather than the exception among IT as well as non-IT countries.

Responding at least indirectly to movements in the exchange rate is unavoidable in an IT setting in small open economies, even if stabilizing the exchange rate is not a separate policy objective. With imports accounting for around 30 per cent of total absorption, there is inevitably a strong pass-through from the exchange rate to domestic prices and output (see for example, Adam et al 2012). Any framework that focuses on inflation and the output gap will therefore respond indirectly to exchange rate movements, even when the authorities profess adherence to a pure float. But navigating these considerations requires coherence both at the level of policy and in terms of communication. The key issue for the success of IT is probably not that the authorities pursue a pure float but rather that they establish a credible commitment that the inflation target will take precedence when there is a conflict. The recent history of low global inflation combined with the steady fall in velocity in many post-stabilization economies allowed unsterilized exchange rate intervention aimed at limiting the appreciation of the domestic currency to be absorbed by rapid non-inflationary growth in money demand, so that the two objectives were rarely in conflict. With global inflation now rising more rapidly and fiscal pressures emerging, the risk of conflict between objectives is again on the rise. But as O'Connell (2010) notes, the literature offers very little guidance on how multiple instruments, e.g. a policy interest rate and foreign exchange intervention, ought to be deployed to reconcile domestic with external objectives.

**Guarding against the re-emergence of fiscal dominance**

A major achievement of many African governments over the last decade, including over the period of the global financial crisis, has been the elimination of fiscal dominance, allowing a coherent monetary policy to emerge. The dragon of fiscal indiscipline is, of course, never completely slain, so an important consideration becomes the capacity of the monetary regimes to offer an effective bulwark against recurring fiscal indiscipline. Under conventional monetary targeting and particular that practised in many Africa countries under the aegis of IMF-monitored programmes, this disciplining role centred on quantitative ceilings on the domestic credit to government component of reserve money growth and was policed by IMF programme performance criteria. But as the IMF's role in Africa changes, with fewer countries engaged in prolonged lending arrangements, debate has turned to the question of how best to fill the external agency of restraint role played by the IMF. Here, a well-established IT regime may contribute in a positive manner. First, and most obviously, the explicit commitment to an agreed inflation target – especially one that the authorities are seen to converge towards – combined with an increasingly transparent public role for the MPC in explaining policy choices helps to reinforce the credibility and independence of the central bank. But this may be reinforced by another mechanism, first described by Bean (1998) in the context of the UK. Bean characterized the relationship between the central bank and the ministry of finance as a so-called non-cooperative 'Stackleberg game', in which a credible monetary policy regime allowed the central bank sets monetary policy so as to deliver the inflation target, given the fiscal policy stance being adopted by the Ministry of Finance. Understanding the central bank's reaction function, the fiscal authorities would not be tempted to over-expand the economy, as it would know that if it did the monetary authority would just raise interest rates and activity would not actually increase: more precisely, the central bank's interest rate action would ensure that a fiscal expansion directly crowded out private activity. The key point here is that this 'Stackleberg' arrangement seeks to transparently locate the cost and cause of high interest rates firmly at the fiscal authorities' door.

Appealing though the logic of this disciplining perspective is, it must be tempered if the underlying political economy factors generating excessive fiscal pressures have not been fully addressed. As countries such as Ghana and Zambia are currently experiencing – and which many nascent revenue-rich countries are likely to find in the near future – the political pressures for expansionary fiscal policies are hard to resist, especially when there are demonstrable spending needs and when global capital markets seem prepared to lend in large amounts. When underlying spending pressures are not reined-in and are inconsistent with inflation targets, the results are often inefficient fiscal adjustment – where the wage bill and transfers are protected by deep cuts to operations and maintenance expenditures – and by cripplingly high domestic interest rates which directly hurt the private sector and substantially raise the domestic debt servicing costs of government. The lesson is clear and is the one that I started this paper with: monetary policy, however configured, cannot on its own 'solve' structural problems of fiscal control. This requires deeper political considerations, even though a credible and transparent monetary regime may play an important role in securing fiscal discipline on an ongoing basis.

## 4. Capital controls and the drift from 'trilemma' to 'dilemma'

I conclude with some reflections on how the rise of private capital flows is beginning to change the monetary policy environment for African economies. Since the collapse of Bretton Woods in the mid-1970s, cross-border private capital flows have risen substantially faster than world GDP. Between 1980 and 2010 world GDP grew by approximately 1.7 percent per annum. Over the same period private capital flows grew by 6.6% per annum (see Lane and Milesi-Ferreti, 2007). While developed economies still account for the bulk of outward capital flows and the bulk of inflows, with much of this accounted for my intra-firm flows, the last decade has seen a significant increase in net flows to developing countries, including, for example, the rapid increase in sovereign borrowing by African countries. Since 2011, for example, African government have issued almost US$9bn in sovereign Eurobonds alone, with Zambia alone accounting for US$1.75bn of this total.

The emergence of these high-volume flows reflects both pull factors (the solid growth performance of the debtor countries and, crucially, the prospect of sustained natural resource revenues in the future) and push factors (in particular global investors' appetite for yield). Arguably, the years since the global finance crisis, which have been characterized by historically low interest rates in the developed world, has been an extended 'risk-on' period during which global investors have been willing to buy 'frontier market' debt instruments and that this demand has driven down yields for African Eurobonds and hence stimulated high capital inflows. One conventional argument for capital flows to developing countries, from the investor perspective has been risk diversification, in other words investments in economies or sectors whose correlation with market fundamentals in the investor's home economy is low. However, as a recent paper by Hélène Rey argues, this diversification motive appears to have been eclipsed by a stronger 'co-movement' phenomenon which seems capital flows to all developing countries being increasingly driven by a common set of 'push factors', namely market sentiment and risk tolerance in markets in the core economy of the world, namely the US (Rey, 2013).

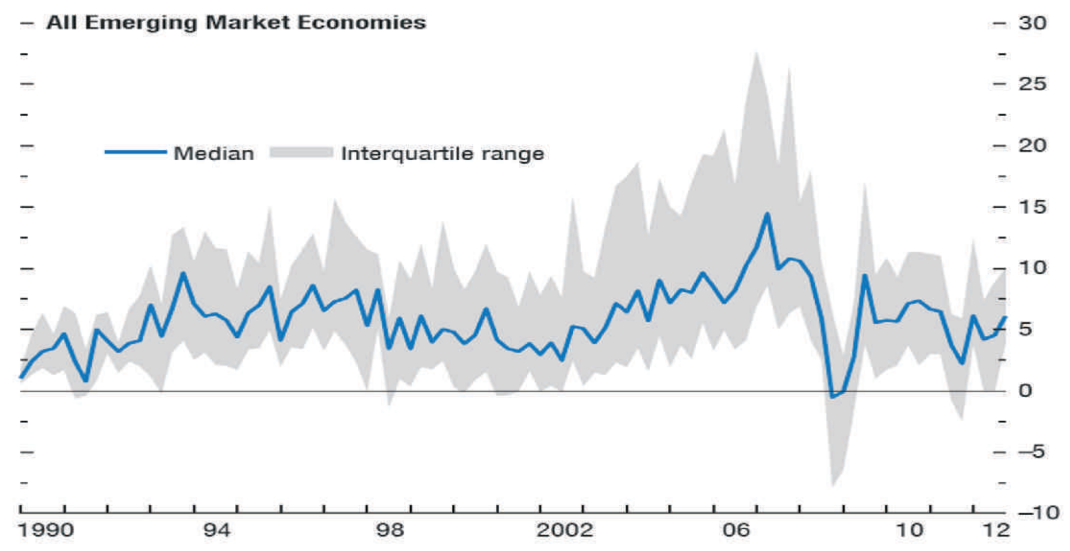
Rey refers to this phenomenon as the 'global financial cycle' and demonstrates how its pattern is driven primarily by conditions in the US[8] but is rapidly transmitted to the rest of the world. The key point here is that this shifts the balance between the 'push' and 'pull' determinants of capital flows decisively in favour of the former; 'pull' factors matter for access to capital markets but increasingly it is the 'push' factor – those that are out of the control of the debtor – that determines the volume and price of capital flows. As figure 5 shows, capital flows to developing and emerging markets have long been volatile but the importance of Rey's argument is that as the global financial cycle strengthens conventional monetary policy configurations are less able to protect countries from the adverse short-run volatility effects of capital flows.

The argument can best be understood in the context of the 'impossible trinity' or 'trilemma' which states that, beyond the short run, no country can simultaneously maintain an open capital account, target the exchange rate, and pursue an independent monetary policy. One of the three must be abandoned even though each is desirable in its own right: open capital accounts to the extent that they support the efficient global allocation of capital to high-return investment opportunities; exchange rate targeting to support trade and sustain a stable external value of the currency; and an independent monetary policy to pursue domestic output stabilization objectives.[9]

[8]Specifically, she shows that the Chicago vix index – a measure of the implied volatility in S&P500 index options, often referred to as the 'fear index' and viewed as a measure of forward-looking expectations of volatility – is a powerful leading indicator of cross-border capital flows.

[9]Consider a positive external shock which raises the ex ante return to domestic assets (this may be an exogenous fall in the country risk premium or some technology shock that improves prospects in the domestic economy). With an open capital account, foreign private capital will flow in, thereby generating an incipient appreciation of the currency. Attempts to stabilize the exchange rate will draw the central bank into foreign exchange intervention, thereby undermining the autonomy of domestic monetary policy through the effect of intervention on the domestic money stock. Restoring monetary autonomy through bond sterilization may work but only by driving up domestic interest rates relative to world rates, thereby exacerbating the original pressure on the exchange rate. Eventually one of the objectives must be abandoned.

**Figure 5: the volatility of private capital flows to developing countries**




**Sources**: IMF, Balance of Payments Statistics; and IMF staff calculations

Although many African economies have reconciled the trilemma by abandoning earlier commitments to targeting the exchange rate, the reality is that many African countries were able to dodge the bullet of the impossible trinity. Small market size and high transactions costs meant that capital accounts were de-facto closed so that central banks were able to simultaneously pursue both a degree of exchange rate targeting and domestic monetary objectives, at least over the short-run.

What Rey's analysis reinforces is that as the global financial cycle strengthens this constrains the conduct of monetary policy in non-core countries (both developed and developing) even under a float. The reason is that with open capital accounts, interest rate cycles are increasingly driven by the co-movement in risk perceptions (determined by market sentiment and the regulatory environment in the US) which do not necessarily coincide with purposive domestic policy actions by the central bank. The consequences for cross-border capital flows to emerging markets around the time of the so-called 'taper tantrum' in May 2013 when Governor Bernanke hinted that the Fed's programme of bond purchase (quantitative easing) would be tapering off over the coming months, underlined the strength of the global financial cycle. Capital flows to developing countries reversed sharply as foreign investors sought to re-invest in US assets, with the sudden stop and reversal of flows putting stress on domestic interest rates and exchange rates.

Rey (2013) describes this in terms of the 'trilemma becoming a dilemma', in other words, that in the face of deeper capital market integration a floating exchange rate is no longer sufficient to allow for independent monetary policy. Independent monetary policy, she argues, is only possible if capital flows are constrained.

Whilst the full force of the global financial cycle is likely to be felt initially in larger emerging market economies (Brazil and India for example), those African countries that are becoming increasingly integrated in global markets, countries such as South Africa, Nigeria, Ghana and Kenya are likely to find themselves in very similar positions over the near future. The policy implications are clear. It is clearly naïve and impractical to assume that US monetary and regulatory policy will adjust to accommodate the concerns of those countries affected by its policy actions, countries seeking to retain a credible and effective domestic anchor for monetary policy must individually and collectively look to measures that limit or otherwise inhibit disruptive cross-border capital flows.

In the context of the theme of this presentation, namely the developmental role of central banks, the line of argument developed by Hélène Rey and others underpins the importance of central banks in the region taking steps towards developing appropriate capital flow measures. In other words, this analysis provides a further rational to embrace the broader mandate for central banks discussed above. This is a challenging agenda, however, and one where international best practice is still being worked out (see, for example, IMF 2011, 2013 and 2013 and Jeanne et al, 2012). The broad objective, however, is to strike a balance between limiting the adverse effects of short-run volatility in capital flows, so that monetary policy can effectively focus on the legitimate concerns within its domain, and discouraging medium- and long-term flows that support growth. This will require the design of a coherent framework of international policy coordination – something that, at least at the level of Basel III, remains too narrowly focused on the particular concerns of advanced economies -- and, at the domestic level, the development of a set of credible and effective instruments and an institutional regime capable of applying these in an effective manner.

## 5. Conclusion

The achievement and maintenance of macroeconomic stability across much of Africa since the 1990s owes much to the quality of macroeconomic policy reform implemented in ministries of finance and central banks across the region. These reforms have helped to lay the foundations for the structural change and innovation in financial markets that is beginning to support sustained growth in incomes across the continent. This is, however, an ongoing project: central banks are still in the process of consolidating these reforms and anchoring them in robust and coherent institutional structures. New and formidable challenges, particularly associated with the rapid growth in cross-border capital flows, have also arisen. The success with which central banks can meet these will play a decisive role in ensuring that the macroeconomic gains of recent decades can be consolidated into the future.

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# 3.6 A Perspective on Economic Reforms in Zambia: Rationale and Impact on Economic Growth

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## 1.0 Introduction

1991 marked a watershed year for a comprehensive set of economic reforms undertaken by authorities aimed at putting the economy on a path of sustainable economic growth and development. In the early 1990s, the economy was characterised by a number of macroeconomic problems arising from prolonged periods of sluggish growth and external shocks in the 1970s and 1980s. Annual inflation was well over 100%, economic growth stagnated at around 0.8% while per capita income was shrinking at -3.6%, and external debt stock stood at 223.0% of GDP during the 1991 to 1995 period.

As a result of the poor macroeconomic environment that characterised the economy in the early 1990s, authorities undertook the necessary economic reforms aimed at correcting these macroeconomic imbalances and put the economy on the trajectory of sustainable economic growth. This paper discusses the reforms undertaken since the early 1990s, outlining their rationale and impact on the county's economic performance. In addition, the paper offers some suggestions on further policy reforms required to sustain macroeconomic stability and growth which has been achieved since 2000s.

The paper is organized as follows; the next section presents the background to the economic reforms while section 3 outlines the economic reforms undertaken since 1991 and highlights the rationale behind the reforms. Section 4 discusses the impact of the reforms on the performance of the economy, section 5 outlines some of the policies required to keep the economic momentum going forward. Lastly, concluding remarks are presented in section 6.

## 2.0 Background to the Reforms

Zambia attained its political independence from Great Britain in 1964 with a relatively rich economy compared to other newly independent African States (Mwanza, 1995). According to Andersson and Kayizzi-Mugerwa (1985), in the first six years of her independence Zambia had one of the highest economic growth rates in Sub-Saharan Africa with an average of 2.5% per annum while its per capita income stood at US $900 by 1970. However, by 1991 Zambia's per capita income had fallen by two thirds to US $290, after registering negative growth rates for long periods. In addition, the country's other macroeconomic fundamentals such as inflation, balance of payments (BoP), and debt were out of control. For example, Zambia's external debt stood at US $7.3 billion or 2.5 times the country's GDP while inflation reached 153.2% in 1989 and the country's balance of payments were usually in deficit.

This state of affairs was attributed to two main reasons. The first one was Zambia's over-dependence on copper as sole foreign exchange earner. In 1970, the mining sector

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accounted for 95% of foreign exchange earnings with minimal improvement to 88.3% by 1981 and 87% in 1991 (Mwanakatwe, 1994). This meant that the country's economic performance was susceptible to external commodity price shocks. In this regard, the oil price shocks of the 1970s as well as the crash of copper prices in 1978 meant that the country was in dire shortage of foreign exchange to import its consumer goods and capital equipment required to sustain the mining industry.

Another reason for the poor macroeconomic conditions obtaining in the early 1990s was generally government policies. Firstly, the government introduced an industrialisation strategy based on import-substitution with a heavy reliance on imports of inputs which further exposed the country to external shocks, and only helped to entrench a mono-economy of dependence on copper. Secondly, government policies such as price controls limited private sector participation in the agriculture and manufacturing sectors, thereby constraining the economy's productive capacity. Lastly, the government policy of nationalisation saw an emergence of a large number of state owned enterprises (SOEs). This meant a heavy involvement of government in the running of businesses and industry which later proved to be highly inefficient (Mwanakatwe, 1994).

The overall impact of the factors noted above was the continued deterioration in the country's economic performance, which prompted authorities to embark on a comprehensive set of economic reforms to halt the country's declining economic fortunes.

## 3.0 Economic Reforms of the 1990s

Towards the end of 1991, the authorities made a bold decision to adopt and implement a series of economic reforms. These reforms were primarily aimed at reducing the role of the state in the economy by creating a robust private-sector driven market-oriented economic system. The macroeconomic framework adopted to underpin the reforms was centred on three main goals; to restore macro-economic stability through monetary and fiscal policy reforms; to facilitate the growth of the private sector through the liberalisation of commodity prices and exchange rate as well as liberalising trade; and, to remove state monopolies in the industrial and agrarian sectors (Ranker, 2003). Thus, some of the reforms undertaken include liberalisation of external and domestic trade; removal of exchange controls and freeing the exchange rate; removal of interest rate controls and credit ceilings; tax policy and administration reforms; privatisation of the state owned companies; and removal of food subsidies.

### 3.1 Macroeconomic Stabilisation through Monetary and Fiscal Policy Reforms

Attainment of macroeconomic stability in order to revive economic growth was one of the authorities' first objectives, especially with regard to the control of inflation to restore macroeconomic equilibrium (McPherson, 1995; Ranker, 2003). In this regard, the authorities instituted rigorous monetary and fiscal policy reforms aimed at reducing the growth in money supply and cut fiscal deficits to stem run-away inflation which had reached well over 180% at the end of 1991. In order to cut fiscal deficits, the authorities embarked on a gradual removal of subsidies on most commodities which were seen as a drain on the budget. For example, in December 1991, subsidies on mealie-meal were removed, a situation that resulted in the price increase from K22.50 to over K1,800.00 (Seshamani, 1996).

To further reduce the fiscal deficits, authorities decided to strengthen budgetary control through the introduction of the cash budget system in 1993. This institutional innovation implied that the Bank of Zambia (BoZ) would not accommodate any government spending in the absence of revenue in government accounts. Thus, the government could no longer resort to printing money to meet its budget shortfalls. With the new budgetary arrangements, the government could only finance its extra-ordinary expenses through higher taxes or expenditure cuts on other budget lines (Budget address; 1993). To ensure that this new institutional arrangement worked, the Ministry of Finance and BoZ formed a Joint Committee to monitor fiscal and monetary conditions on a weekly basis to oversee virtually all disbursements by the Ministry of Finance (Bonnick, 1997).

Changes in the conduct of monetary policy were also instituted to underpin macroeconomic stability. Prior to 1991, monetary policy had multiple objectives, which included promotion of economic growth through directed allocation of credit to selected sectors of the economy, financing government operations as well as inflation control. During this era, monetary policy was conducted mainly through the use of direct instruments such as credit ceilings, interest and exchange rate controls as well as statutory reserve requirements. In the period after 1991, it became clear that changes were required in monetary policy to align monetary policy with a market-oriented economic system that the authorities desired to put in place. Hence, the BoZ Act was amended through the enactment of BoZ Act No. 43 of 1996, which narrowed down the central bank's objective to price and financial system stability. Consequently, the focus of monetary policy was on creating a stable macroeconomic environment to support sustainable economic growth.

In addition, the BoZ started to increasingly rely on indirect rather than direct instruments in the conduct of monetary policy. The indirect instruments included primary auctions of Treasury bills and government bonds as well as auctions of short-term credit and term deposits to and from commercial banks. These instruments were aimed at reducing growth in money supply as well as providing a mechanism for the market determination of interest rates. Overall, the reforms to monetary policy were aimed at improving the control of money supply and inflation as well as promoting a more efficient allocation of credit and financial market development in general.

Other significant reforms in the domestic money market[1] were undertaken to further enhance the participation of the private sector and reduce government involvement in the economic affairs of the country. In this regard, in 1993 the BoZ removed all restrictions on lending and deposit rates (Ranker, 2003). The liberalisation of the money market resulted in the growth of the financial sector in Zambia with more commercial banks and other non-bank financial institutions such as insurance companies being set up.

Furthermore, to make the domestic revenue system more sustainable and accountable the government introduced a semi-autonomous Zambia Revenue Authority (ZRA) in 1994 to collect tax revenue on its behalf. In addition, the Value Added Tax (VAT) was introduced in 1995 to replace the distortionary sales tax aimed at broadening the tax base.

Broadly, the important fiscal and monetary policy reforms undertaken in the early 1990s laid a solid foundation for macroeconomic stabilisation, and the subsequent economic growth and development.

### 3.2 Liberalisation of External Trade, Domestic Trade and Exchange rates

Another set of reforms undertaken were in the area of international trade, domestic trade and the foreign exchange market. Extensive reforms within the external trade regime were commenced in earnest in 1992. Within the first two years, the authorities completed the liberalisation of the external and domestic trade regimes by eliminating tariffs and price controls (Ranker, 2003). The first set of the reforms under the Structural Adjustment Program (SAP) supported by the International Monetary Fund (IMF) and World Bank saw

[1]In addition to the introduction of the Treasury bill and government bond auctions

the maximum external tariff reduced to 50% from 150% in 1991 (Ndulo and Mudenda, 2004). Furthermore, the 1993 national budget announced new rationalised nominal trade tariffs of 0, 10, 30 and 40%. However, the greatest external tariff reform was undertaken in 1996 when the tariffs where further reduced to 0, 5%, 15% and 25% (see Table 1 for a sequence of trade reforms). Despite several external shocks that the country faced, it still maintained an open trade regime; and it is noteworthy that Zambia was one of the first countries to put the COMESA Free Trade Agreement (FTA) into effect in October 2000.

**Table 1: Main Trade-related Policy Measures**

| Year | Policy Measures |
|---|---|
| 1991 | Nominal tariff levels reduced to a range of 0 – 50 per cent. |
| 1993 | Nominal tariff levels reduced to a range of 0 – 40 per cent. |
| 1994 | All controls on current and capital accounts abolished |
| 1995 | Import sales tax changed to import VAT |
| 1996 | Nominal tariff levels reduced to a range of 0 – 25 per cent. SADC Trade Protocol signed. |
| 2000 | COMESA FTA signed, with zero duty for traded goods among the nine members. SADC tariff reduction phase begins with the objective of establishing SADC FTA by 2012. AGOA Agreement Signed. |
| 2001 | 2001 EU's EBA established, offering duty-free access to LDCs' exports, except for armaments and three sensitive products. |
| 2003 | Zambia Export Processing Zone Authority established. |

**Source:** Adapted from Ndulo and Mudenda (2004)

In domestic trade, the government removed price controls on all commodities while most sectors of the economy which were previously dominated by the parastatals were opened up to the private sector. The opening up of sectors previously dominated by the state sector marked the beginning of the government's desire to create a vibrant private sector-led economy. In addition, the liberalisation of domestic trade included the abolishment of subsidies in the agriculture and commodities market which had been introduced to cushion people from the high cost of living.

Further, in order to encourage foreign investments as well as enhance the confidence of the local business community, the government started to remove exchange controls. To this effect, a bureau de change system for foreign exchange was introduced in October 1992, and by December 1992 the official exchange rate was unified with the bureau rate (Ranker, 2003; Budget Address, 1993). With these changes, the exchange rate was fully determined by market forces. In addition, through the Budget address of 1994 the government repealed the Exchange Control Act, thereby allowing non-bank residents to open foreign currency accounts. As one the earliest African countries to undertake IMF and World Bank supported reforms, Zambia made its currency, the Kwacha, fully convertible from early 1994. This meant that the foreign currencies were allowed to freely flow in and out of Zambia. However, the last impediment in the foreign exchange market remained, a requirement that all exporters such as Zambia Consolidated Copper Mines (ZCCM) surrendered 100% of their export earnings. This restriction was removed in April 1997, allowing ZCCM and other exporters to retain 100% of their foreign exchange earnings and directly sell them to the foreign exchange market (BOZ, 1997; Kani, 1997).

### 3.3 Privatisation of State Owned Enterprises

In 1991, more than 80% of companies in Zambia were state owned enterprises (SOEs), ranging from mining, transport, manufacturing, financial services, hotels and bakeries. Generally, these SOEs were characterised by low levels of productivity and were under-capitalised. In addition, they were a drain on the limited resources of the government. For example, in 2000 the bailing out of the ZCCM cost the Treasury approximately US $1 million daily or 4.1% of GDP (IMF, 2012).

In order to improve the productivity of the SOEs as well as free limited Government resources from running these inefficient companies, the authorities embarked upon the privatisation program. A structured privatisation program started in earnest in July 1992 following the enactment of the Privatisation Act of 1992, which gave a legal basis for the program and gave the responsibility for the privatisation program to the Zambia Privatisation Agency (ZPA). To allow for the citizens' participation in the privatisation program, the Act allowed for a deferred payment of the privatisation price for Zambians. In addition, the Ministry of Finance created the Privatisation Trust Fund where some designated shares of the privatised companies were held for future floatation on the Lusaka Stock Exchange.

**Table 2: Privatisation in Zambia**

| Progress Date | Companies Privatised |
|---|---:|
| January-December 1992 | Privatisation Act passed in Parliament, ZPA formed |
| January-June 1993 | 2 |
| July-December 1993 | 4 |
| January-June 1994 | 6 |
| July-December 1994 | 3 |
| January-June 1995 | 3 |
| July-December 1995 | 27 |
| September 30, 1996 | 108 |
| November 30, 1996 | 166 |
| December 30, 1996 | 200 |
| December 30, 1998 | 223 |
| August 31, 2000 | 244 |
| July 31, 2001 | 254 |
| April 30, 2002 | 257 |
| Total Portfolio | 280 |

**Source:** Compilation from ZPA Progress Reports (various)

As at 30th April 2002, a total of 257 SOEs had been privatised by government out of 280 working portfolio of SOEs (see Table 2 above). Of all the SOEs privatised, 65 per cent were sold to Zambian individuals, 29 per cent to foreigners while 6 per cent were wound up. Although, this presents a relatively sizable number of SOEs that remained under state control, most of these companies were in key economic sectors of utility and oil sectors. In 2007, the government partially privatised the Zambia National Commercial Bank to RABO bank of the Netherlands by selling a 49% stake in the company while in 2010 government privatised the Zambia Telecommunications Company (Zamtel) to Lap Green of Libya, which was later repossessed in late 2011.

## 4.0 Impact of the Reforms on Economic Performance

The economic reforms that have been undertaken since the 1990s have had a positive impact on many macroeconomic variables. In this section, we outline the outcomes of the economic reforms undertaken since the liberalisation of the economy in the early 1990s.

### 4.1 Performance of Key Domestic Macroeconomic Indicators

Zambia's economic performance has generally picked up on all macroeconomic variables since the reforms of the 1990s (see Table 3 below). Real GDP growth has shown a strong recovery, rising from an average of 0.8% per annum in the 1990s to 5.6% per annum in the 2000s. This continued favourable economic growth performance has helped to grow real per capita income from the downward trend registered prior to 2000s to a positive growth of 2.8% over 2001 - 2010. In 2012 and 2011, real economic growth was 7.3% and 6.8% while real per capita incomes grew by 19.0% and 7.0%, respectively. In 2013, real GDP growth remained robust at 6.5% while per capital GDP rose by 13% to US $1,783.7.

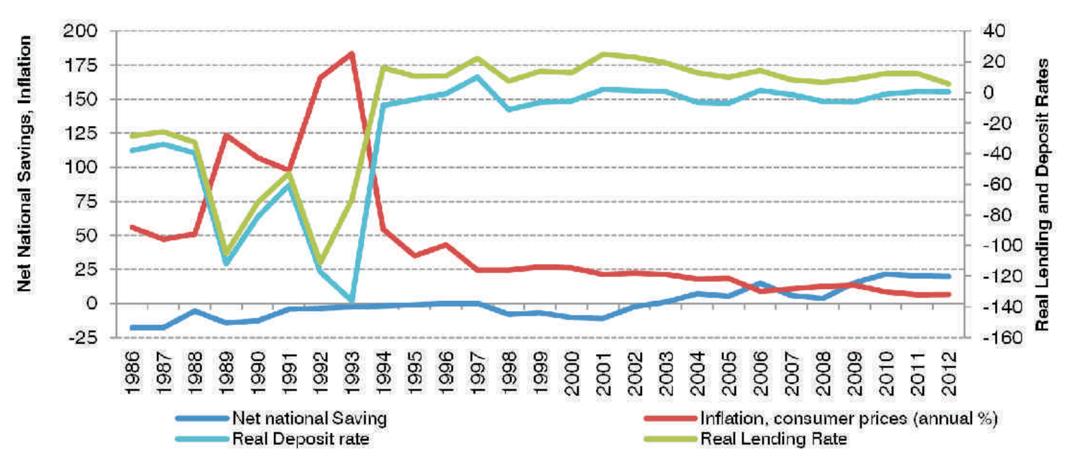
**Table 3: Trends in Key Macroeconomic variables (in per cent)**

| Indicator Name/Period | 1961-1970 | 1971-1980 | 1981-1990 | 1991-2000 | 2001-2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| Real Per Capita GDP growth | 0.8 | -1.9 | -1.8 | -1.7 | 2.8 | 19.0 | 7.0 | 13.0 |
| Real GDP growth[2] | 3.9 | 1.5 | 1.1 | 0.8 | 5.6 | 6.8 | 7.3 | 6.5 |
| Inflation | - | - | 76.9 | 68.1 | 15.5 | 6.4 | 7.3 | 7.1 |
| Real interest rate (lending) | - | - | -15.5 | 3.1 | 11.3 | 17.6 | 8.8 | 9.3 |

**Source:** World Bank Database; CSO 2013 GDP Estimates and computations by author

Furthermore, other macroeconomic variables have also shown a marked improvement over the last two decades. Inflation has declined from an average of 76.9% per annum during the period 1981 – 1990 to 68.1% and 15.5% during 1991 – 2000 and 2001 – 2010, respectively. In 2011, 2012 and 2013, end-year inflation was correspondingly recorded at 6.4%, 7.3% and 7.1%. In addition, real interest rates which were mostly depressed in the 1980s started showing an upward trend in the 1990s and 2000s, although they started to stabilise in 2011 and 2012. In the 1980s, as a result of interest rate controls real interest rates remained mainly below inflation, thereby discouraging savings and hence limited the role of intermediation of commercial banks. Furthermore, the net national saving which had consistently been negative have shown great recovery and they are now positive.

**Figure 1: Trends in Net Savings, Real Deposit Rate, Inflation, and Real Lending rate**



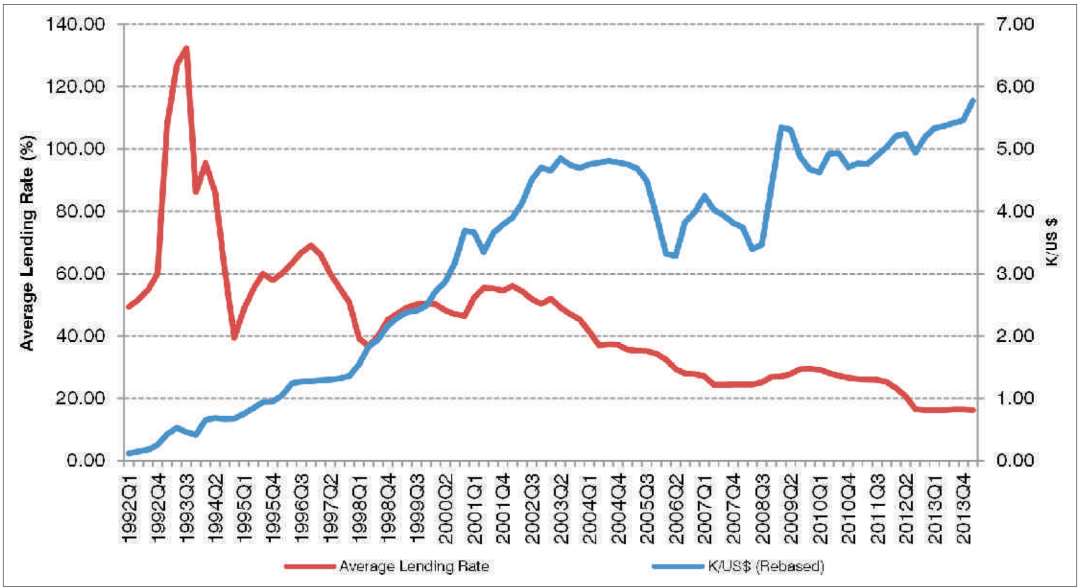

**Source:** World Bank and computations by author

Developments in the exchange rate and nominal interest rates have also been positive following the reforms. The period 1992 to early 2000s was generally characterised by a

[2]Real per capital GDP growth rates from 2011 to 2013 are based on rebased GDP, whose base is 2010

depreciating trend in the exchange rate, probably a reflection of the macroeconomic imbalances of the late 1980s and early 1990s. However, as the reforms took root and the economy stabilised and started to grow at the turn of the millennium, the exchange rate started to show signs of stability, with episodes of appreciation and depreciation becoming a dominant feature (see Figure 2 below). As regards lending rates, the relative macroeconomic stability engendered by the reforms induced a downward trend with the average lending rate declining from 63.1% during the period 1992 - 1999 to 37.5% for the period 2001 - 2010 and to 20.4% during the period 2011 - 2013. This positive development in lending rates provided economic agents to access credit facilities at relatively lower cost, thereby boosting investments and promoting economic growth. To this effect, the banks' provision of credit to the private sector as a proportion of nominal GDP rose from an average of 5.6% during 2001 – 2010 period to an average of 8.2% during the period 2011 – 2013.

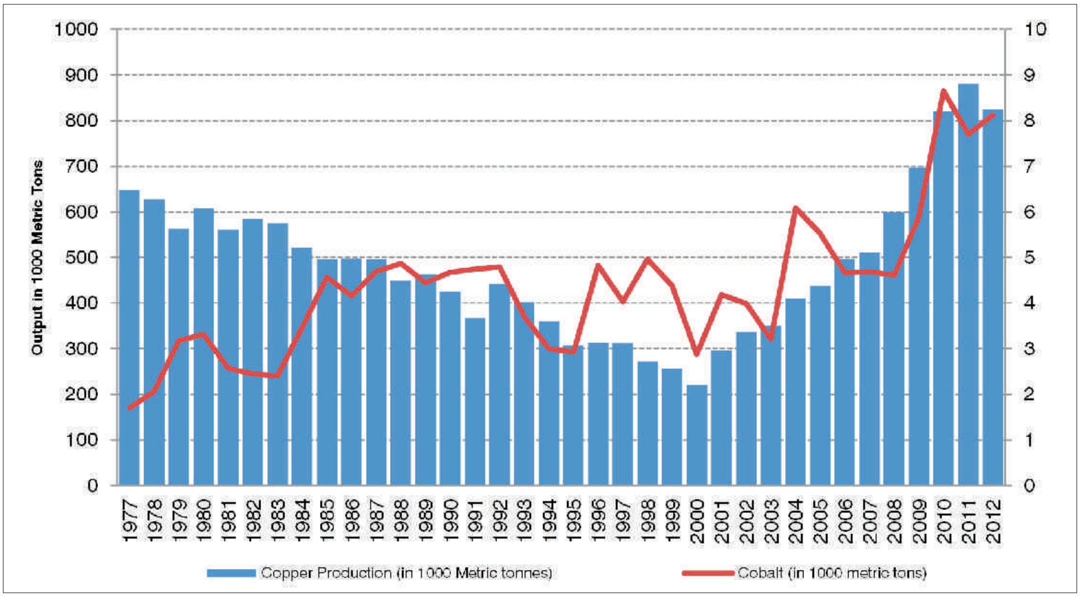
**Figure 2: Developments in the Exchange and Average Lending Rates**




**Source:** Bank of Zambia

After years of declining mineral production, the years following privatisation saw a major boost in production. Copper production rose from less than 221,000 metric tons in 2000 to over 800,000 metric tons in 2012. Further, the production of cobalt increased from 4,961 metric tons in 1998 to over 8,000 metric tons in 2012 (see Figure 3 below). As at end-December 2012, a total of US $3-4 billion in foreign investment had been made in the mining sector while employment had increased from 25,000 to above 60,000.

**Figure 3: Trends in Copper and Cobalt Production**

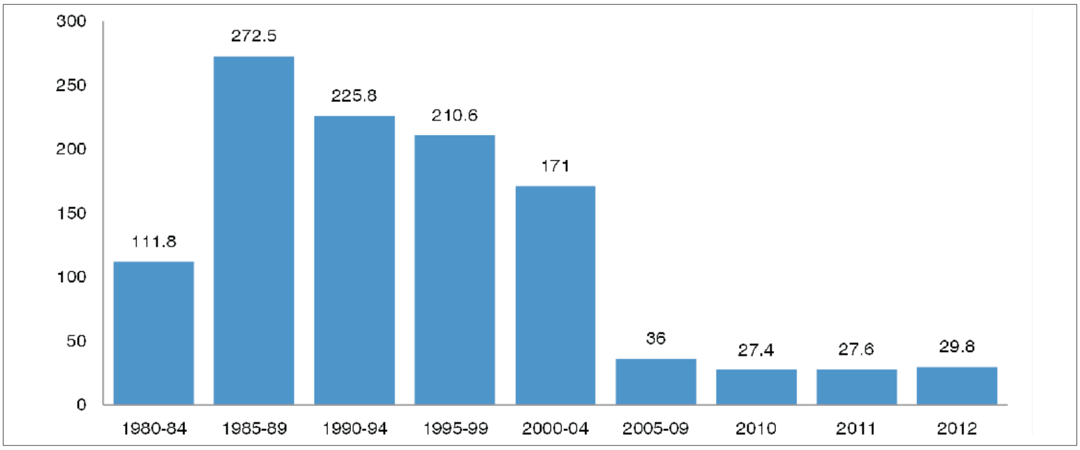



**Source:** USGS Mineral Production Database

## 4.2 External Sector Performance

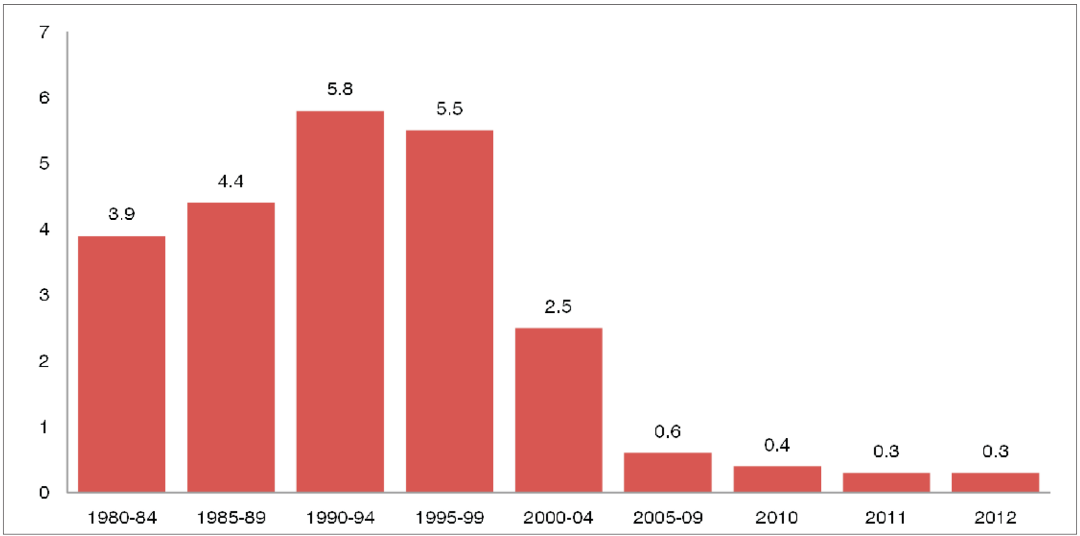
The country's external sector indicators have also shown an improvement over the last two decades. The level of external debt has shown a downward trend since the early 1990s while the level of debt service has been declining. Specifically, debt as a per cent of GDP fell from over 272% in the 1985 to 1989 period to 171.4% during the 2000 to 2004 period and subsequently to 36% in the period 2005 to 2009; as at the beginning of 2014, it was less than 20% of GDP. On the other hand, debt service as a percent of exports has fallen from 30.8% in the period 1990-1994 to 5% in the period 2005 to 2009 (see Figures 4 and 5 below). Although the reduction in external debt is mostly attributable to Zambia's attainment of the HIPC completion point and the subsequent debt forgiveness that followed, it is noteworthy that attainment of HIPC was incumbent upon the reforms that government undertook in the 1990s.

**Figure 4: Trends in External Debt Stock to Gross National Income since 1980**




**Source:** Constructed from Word Development Indicators (WDI)

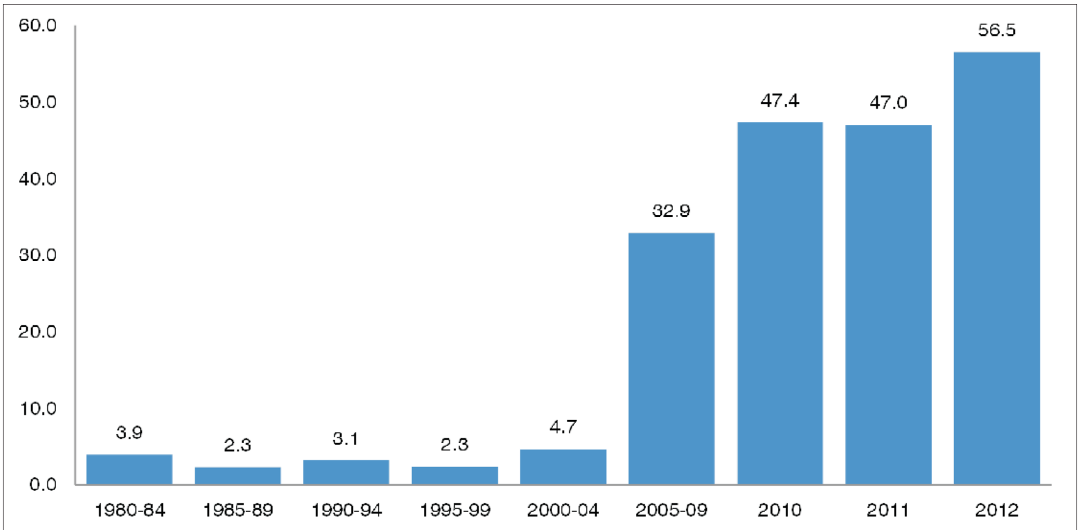
**Figure 5: Trends in External Debt service to Gross National Income since 1980**




**Source:** Constructed from WDI

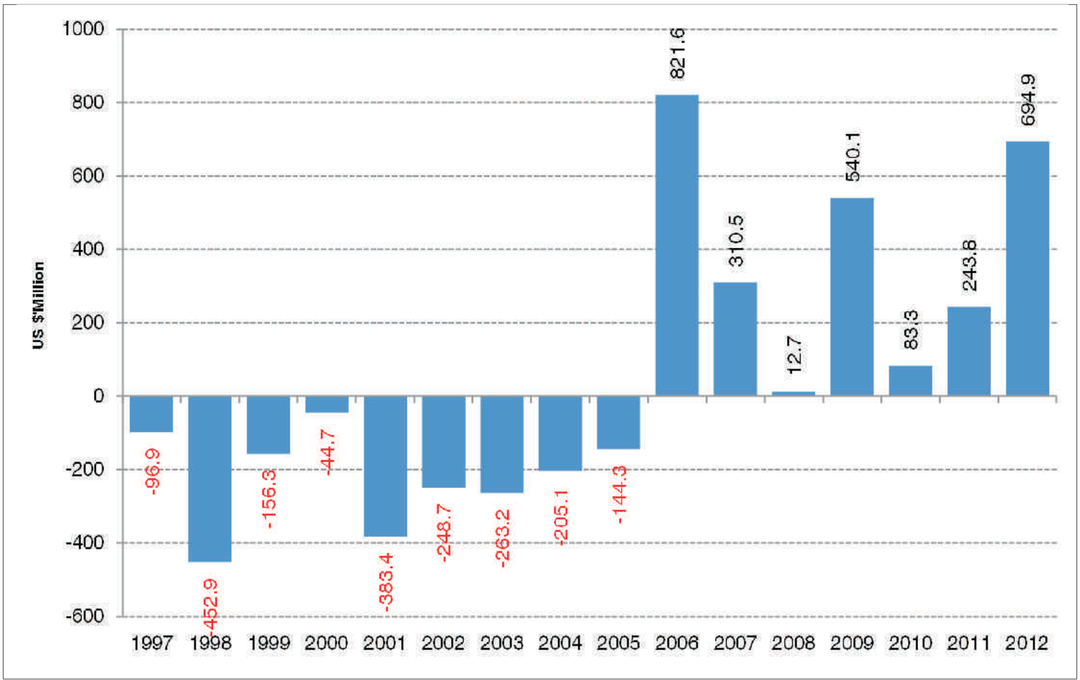
The improving debt situation as well as the increasing levels of exports has helped to raise the country's foreign exchange reserves. In this regard, total reserves as a percentage of total external debt has risen from 2.3% in the 1985-1989 period to 4.7% during the 2000-2004 period, and reached 56.5% in 2012. The improvement in the level of reserves overtime can be partly attributed to the country reaching the HIPC completion point in 2005, which resulted in reduced debt servicing obligations to creditors thereby helping to save foreign currency. In addition, Zambia has been recording favourable balance of payments positions for some time as a result of increased exports as well as inflows of foreign direct and portfolio investments. These have provided the country with an opportunity to purchase foreign exchange from the market for the purpose of accumulating foreign reserves (see Figures 6 and 7 below).

**Figure 6: Trends in Total Reserves as a % of External Debt**




**Source:** Constructed from WDI database

**Figure 7: Trends in Balance of Payments**

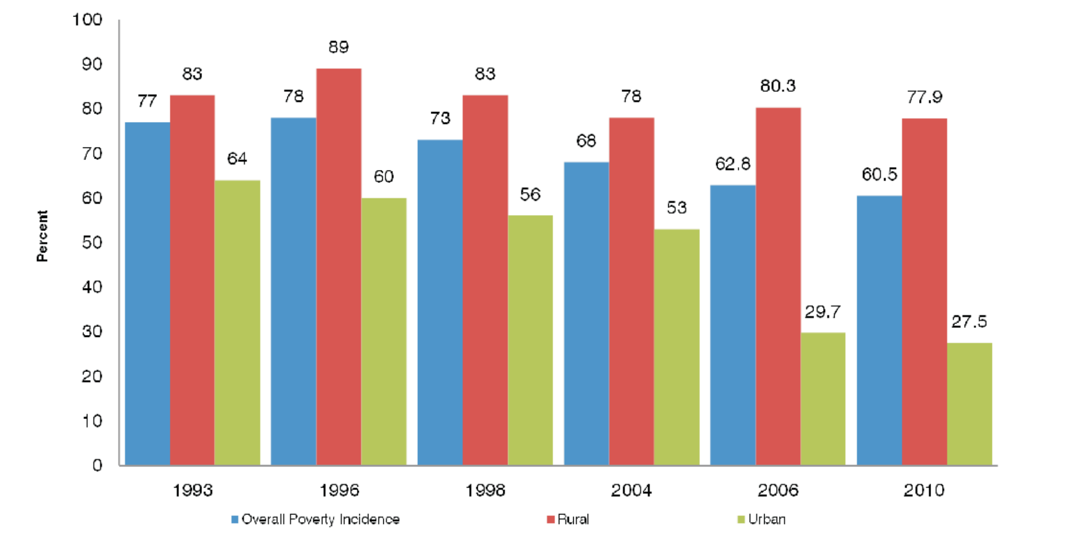



**Source:** Constructed from WDI data base

### 4.3 Impact on Poverty

The improvement in economic performance resulting from the economic reforms undertaken in the early 1990s has had a positive impact on the incidence of poverty in the country overtime. The overall incidence of poverty has declined from 77% in 1993 to 60.5% in 2010. The greatest decline in the incidence of poverty has been registered in the urban areas compared to the rural areas, indicating that opportunities for income generation have been growing faster in urban areas as opposed to rural areas. Poverty in urban areas has more than halved over the last two decades falling from 64% in 1993 to 27.5% in 2010 while in rural areas it has dropped marginally from 83% to 77.9% over the same period (see Figure 8 below).

**Figure 8: Trends in the Incidence of Poverty in Zambia**




**Source:** Central Statistical Office

## 5.0 Forward Looking

Going forward, maintaining the momentum of the improving economic prospects made so far will require authorities to continue with the economic reforms started two decades ago and come up with appropriate policies that will ensure robust and sustainable economic growth. It should, however, be noted that despite improvements in the performance of the economy over the past decade, the high incidence of poverty particularly in rural areas is indicative of the fact that the vast majority of the population is yet to benefit from the country's growing prosperity. In this regard, authorities should focus on enhancing the participation of the vast majority of the population in the economy by implementing measures that enhance job creation and job opportunities.

Given the pro-poor approach of the current authorities in economic management, policies that focus on areas that were previously marginalised such as rural areas will go a long-way in turning around the economic fortunes of rural areas, thereby helping in reducing the high incidences of poverty that characterise rural areas. In addition, there is need to deal with several supply and demand side constraints to sustain the growth momentum.

One of the important policy focus of the authorities is infrastructure development aimed at expanding the economy's productive capacity and encourage inclusive economic growth. In line with this policy focus, the authorities have been allocating around 20.0% of the total national budget to infrastructure developments in key economic and social sectors in recent years. An important component of infrastructure development is the improvement of the country's road and rail network. Improvements in transport systems will not only enable rural areas to have access to markets, but will also open up such areas for investment that can create employment opportunities. An efficient transport system will lower travel and transportation costs as well as promote economic growth poles, thereby increasing the economy's competitiveness. In addition, there is need to enhance telecommunication systems as well as increase the country's power generation capacity to supply energy for the manufacturing, agricultural and the growing mining sector. The overall effect of these actions will be increased production and employment opportunities as well as enable businesses to achieve economies of scale.

Sustaining robust and inclusive economic growth, going forward, will also require continuing with the reforms aimed at improving the business environment to allow the private sector to thrive. In this regard, the implementation of private sector reforms aimed at making the sector competitive should be expedited. In addition, there is need to continue or even accelerate the economic diversification program to reduce the economy's dependence on copper as the country's major export earner as well as create new employment opportunities. Export-led growth policies such as multi-facility economic zones should be encouraged for enhanced economic diversification. Reducing the country's dependence on copper will help to reduce the country's exposure to external shocks such a sudden slump in the prices of copper. At the same time, economic diversification will help to create jobs, especially in the rural areas to help combat the high levels of poverty.

Furthermore, there is need to enhance the revenue generation capacity of the country's revenue system. In this regard, it is essential to enhance the tax base and improve tax compliance among small and large businesses. This will help to reduce the government's fiscal deficits and reduce its involvement on the domestic money markets. This will help to reduce the interest rates even further and help to spur investments and enhance economic growth.

Finally, there is need to continue with reforms pertaining to the financial sector aimed at financial deepening in the country as this would help to enhance liquidity in the financial markets and help to lower the of cost credit. In addition, there is need to improve the registration of land and other assets as well as improve the national registration system for individuals and businesses. This will help in lowering the risks associated with borrowers, thereby lowering the risk premium for borrowers. On its part, the BoZ is expected to continue with the pursuit of appropriate monetary and financial sector policies aimed at maintaining price and financial system stability, which are critical to the overall promotion of economic growth and development.

## 6.0 Conclusion

Since the early 1990s, far reaching and comprehensive economic reforms have been implemented in Zambia. These reforms include the liberalisation of domestic and international trade; exchange rate liberalisation; liberalisation of the current account and capital accounts; reducing government's involvement in the economic activities of the country through privatisation; and financial reforms aimed at removing financial repression and creating a competitive financial sector.

An assessment of these reforms suggests that the reforms have started bearing fruits. The country's economic performance has improved with the country registering positive economic growth in excess of 5.5% over the last 15 years. Further, the per capita incomes have been improving since 1999, growing at an average of over 2.8% over the last 15 years. Furthermore, other macroeconomic conditions have also improved with inflation declining from over 150% in the early 1990s to a single digit since 2006. However, despite the improvements in the performance of the economy over the past decade or more, significant gains in social and human development are yet to be achieved and poverty levels remain high, particularly in rural areas.

Therefore, the challenge going forward is to sustain the improved macroeconomic environment and enhance the participation of the vast majority of the population in nation's growing prosperity through job creation and expansion of job opportunities. In this regard, the current focus on improving the country's infrastructure (transport systems, power generation and telecommunications) will help to sustain economic growth by enhancing the productive capacity and promoting economic growth poles in rural areas going forward. In addition to this, there is a need to expedite reforms aimed at creating a conducive business climate that is supportive of private sector participation and improve economy's competitiveness. This should go hand in hand with efforts aimed at economic diversification. From the fiscal side, there is a need to improve the country's capacity to generate domestic revenues through effective and efficient tax administration to reduce the fiscal deficits and thereby reducing government's involvement on the domestic financial markets. From the central bank's perspective, the focus should be on the pursuit of appropriate monetary and financial sector policies that will ensure the maintenance of a stable macroeconomic environment, necessary for sustainable economic growth and development.

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# 3.7 Capital Markets – Lost Opportunities to the Zambian Economy

**Dr E. D. Wala Chabala***

**Abstract**

On the occasion of celebrating the 50th anniversary of the Bank of Zambia at a symposium organised on the Copperbelt, in Ndola, a reflection was given of the "lost opportunities to the Zambian economy" due to the poor formation and development of Capital Markets. The paper outlined these lost opportunities and used some case examples to demonstrate this. The paper contended that the biggest reason for these lost opportunities from Capital Markets was due to the fact in the Financial Markets, the Capital Markets remain an anaemic leg, compared to Money Markets and that this created unhealthy imbalance in the system. And some of the reasons for this structural imbalance include aversion to change at national level and the poor knowledge of the role and significance of Capital Markets in the economy. The paper went on to propose measures that should be put in place to address this imbalance and turn around the significance and role of Capital Markets in the economy. Specifically, the paper proposed that a Capital Markets Development Programme be established.

## 1.0 Introduction

Capital Markets in Zambia have been in existence for just over twenty years. However, even as we review the achievements that Capital Markets have made over this period of time, the listing of 22 companies, including the amount of money that has been raised by these same few companies, it is more beneficial to address the issue of lost opportunities of Capital Markets to the Zambian economy. For indeed, Capital Markets remain an anaemic leg of the nation's financial markets, and thereby exert undue pressure on the money markets aspect of the financial markets when it comes to resolving some economic challenges the country faces. For instance, this pressure is felt in the interest rate management, the exchange rate volatility, the lack of direct contribution to easing the fiscal deficit, the lack of private capital formation and finally, the loss to the economy of critical data and information for effective economic management.

The lost opportunities to the economy are discussed below, with the view to highlighting how indeed Capital Markets can contribute more positively to the different aspects of the Zambian economy.

## 2.0 The Lost Opportunities

A number of challenges in the economy point to the lost opportunities of Capital Markets to the economy. One such challenge is the budgeted for fiscal deficit; yet we have huge multinational corporations operating in our country with business operations that are of global sizes, but the tax they pay, if ever they pay any tax at all, is not even equivalent to funding required to build a single school. If these multinational corporations contributed

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their fair share to Zambia's tax revenue, the Zambian government would not have experienced the deficits that it has endured over the years.

Another contributor to the adverse fiscal deficit is the poor returns of institutional and statutory funds, particularly pension funds for government employees. The lost opportunity here via Capital Markets is that these funds are partly in deficit because there are not sufficient instruments in the market for them to invest in to achieve optimal performance congruent with their obligations.

And yet, the Government of the Republic of Zambia continues to be the major provider of Capital, not only for Capital Formation, but even for capitalising going concerns whose business operations should be contributing to the Fiscus. For instance, Zambia National Commercial Bank Plc (ZANACO), used to be wholly State owned. In 2008 it was partially *publicised* and listed on the Lusaka Stock Exchange. When GRZ owned the bank 100%, it *nominally* received K31 million in dividends over the six years just before the partial listing. After the partial listing, GRZ has owned only 25% of the bank, but received K32 million in dividends over four years. In other words, the value of dividends generated by ZANACO went up 400% over four years compared to the six years before partial listing. But the biggest gain to GRZ has been in tax receipts. ZANACO tax contribution went up more than 800% in the four years after partial listing.

If as a country we had more examples of ZANACO handsomely contributing dividends and tax to the Fiscus, given the commitments government has for infrastructure spending, etc, there could either be no deficit, or it would be much smaller than it is.

Also, if there were more public entities performing like ZANACO, and in which institutional and statutory funds had an opportunity to invest, these funds would potentially perform better than they currently perform.

What the case of ZANACO demonstrates, is that if more State Owned Enterprises (SOEs) were to be partially publicised, and listed on the Exchange, their performance would turn around, and they would positively start contributing to GRZ coffers, as opposed to the current situation where they depend on GRZ to fund them and thereby contribute to worsening the fiscal deficit. An adverse fiscal deficit position has the consequence of lowering the sovereign credit rating of the country, because the rating agencies project that the country would struggle to pay back obligations. A lower sovereign rating results in the cost of borrowing in international markets going up, and thus making the debt burden even worse, and exacerbating the fiscal deficit position even more. Therefore, by bringing more SOEs to Capital Markets, the continuing obligations and corporate governance practices that these entities would have to adhere to would force them to perform positively and stop being a burden to the Fiscus.

The same goes for the multinational corporations that under-declare tax, and syphon profits out of the country through transfer pricing mechanisms. By having these multinationals publicised through listing on the Exchange, the reporting of their operations will be in the public domain, in Zambia, and they can therefore be directly confronted by the public regarding the performance numbers they put out. Such “public scrutiny” would compel these multinationals to behave and to contribute positively to the national coffers through appropriate tax payments. The public protesting that some people engage in overseas against some business operating here in Zambia, would happen at home, in Lusaka, or in Ndola, or in Solwezi, at shareholders' annual general meetings. Such normal shareholder activism, feasible through Capital Markets, would go a long way to ensuring proper accountability of some multinationals to the Zambian people.

But fiscal deficit is not the only economic challenge that can be addressed through Capital Markets. We currently have, and have had, stubbornly high interest rates and volatile

Kwacha Exchange rate against major international currencies. And to address the latter, the former has had to get even more adverse.

It is therefore a lost opportunity to the economy of the country not having fully functional Capital Markets because if Capital Markets were more established and favourably comparable to Money Markets, the former would be used as an alternative to raising capital by businesses. This alternative would provide competition and complementarity to the lending via Money Markets, and potentially lower interest rates would result. The other significant aspect of Capital Markets borrowing is the longer tenors that are applicable in comparison to Money Markets. Such longer borrowing tenor can contribute to improved performance of the economy, particularly by helping businesses become more efficient in their operations due to ability to plan more effectively over longer periods of time.

There is also a lost opportunity in the performance of the exchange rate of the Kwacha. One of the dynamics affecting the exchange rate is the supply versus demand of the foreign currency. If there were opportunities via the Capital Markets for foreign fund managers to invest in the Zambian Economy, this would bring a supply of foreign currency into the market. And there are a lot of fund managers out there looking to invest in Zambia as one of the emerging economies that is doing well, but there are no opportunities to invest in on our Capital Markets. And it is feasible in fact that as the Kwacha exchange rate depreciates, foreign portfolio investors would see an opportunity to move in because the shares on the Zambian Capital Markets would become relatively cheaper. This supply of foreign currency into the economy would help to mitigate the exchange rate depreciation.

What this scenario presents is the fact that as an economy, there is need to have multiple options for dealing with challenges in the economy, and that the challenges that impact Money Markets may be best solved with solutions from Capital Markets. In fact, simply put, the lost opportunity is that there isn't a forum that seeks to consider transient or structural challenges that the economy may be experiencing and using such a forum to come up with multiple and different options for addressing the identified economic challenges.

Other headline economic challenges we have had as a nation, include the fact that we do not have access to critical data that are necessary not only for our economic planning, but potentially as a measure for mitigating against some of the major transient economic challenges we experience. As an economy, we do not have access to critical data such as the futures contract prices of copper, which would give us an indication of the future trend of the price of the metal since futures contract prices tend to converge with spot prices. We would be able to use this information for more effective planning, or understanding better the dynamics affecting our economy. It may be necessary for us to establish a metals trading platform or exchange in the country to get first hand access to this kind of data or information.

This has been clearly demonstrated by the benefits the country is deriving out of the auctioning of emeralds in Zambia. And for the first time in the history of gemstone mining in Zambia, the government has been able to receive a dividend from the mining activities of these stones. And this is simply because we have had first-hand access to critical data such as prices at which those emeralds are sold. By Comparison, there appears to be more transparency in the way proceeds from gemstones are being declared to Zambia now than when the auctioning was done outside the country. But prices of emeralds are only a small fraction of other economic activities in the country, whether mining or agriculture.

Not having a fully functional and properly regulated agricultural commodities exchange and all its attendant infrastructure is a significant lost opportunity because farmers and growers have no formal platform that they can use to realise value by locking in prices ahead of the harvest. Such futures contracts would go a long way to ensuring that both farmers and agro-processors are able to lock-in prices ahead of time and be more effective in planning their business activities. Simply put, there is tremendous lost opportunity in both extent of agricultural activities and processing capacity and effectiveness in the economy due to the absence of a properly functioning and regulated agricultural commodities exchange.

Therefore, as we have seen the transparency in having emeralds auctioned in Zambia, there is merit in setting up exchanges to trade all commodities in the country. From trading the commodities in the country, the next step would be to move into more beneficiation being done within the country. This is exactly what has happened with the migration of diamonds trading into Botswana. This has now been followed up with the cutting and polishing being done in that country.

And finally, the last but not least opportunity lost to the country due to poorly formed Capital Markets is the tremendous marketing opportunities, not only of the potential investment opportunities, but of the country as a whole. Again, the fact that the Capital Markets are currently as small as they are with so few listed entities, implies significant loss to the economy to market investment opportunities to international fund managers looking to invest in emerging markets. It is these foreign investment managers analysing opportunities to invest in Zambia that would also be marketing the country overall as an investment destination.

## 3.0 How come Capital Markets Remain so Insignificant?

There are several reasons for this.

Firstly, as a nation, we do seem to have a severe aversion to change. We also have a tendency to think that we have a capitalism that means laissez faire economics, and so we should just leave things to the markets or “to sort themselves out”.

But other reasons include the limited knowledge and reach of Capital Markets, and being a preserve of an exclusive club of individuals. On top of that, there have been perceptions of lack of safety of the same markets, compared to Money Markets, or banking.

However, the biggest challenge is that of the imbalance between Capital Markets and Money Markets, with the former being anaemic and sub-scale and therefore unable to effectively contribute to the economy of the country.

## 4.0 Ensuring Capital Markets Play a Significant Part

The 50$^{th}$ anniversary of our independence should be occasion for both celebrating where we have come from, but also for acknowledging our short-falls and putting measures in place to address these. As regulator for Capital Markets, charged with the mandate of supervising and regulating Capital Markets on the one hand, but also for the orderly development of the same markets, the Securities and Exchange Commission is determined to drive the effective establishment of Capital Markets in Zambia as a viable and effective leg of the country's financial markets. We contend that what is required is true transformation in Capital Markets to resolve the imbalance in Financial Markets. Such transformation would for instance require that deliberate public ownership or public accountability of specific sectors of the economy, whether the entities operating there are state owned or multinational corporations, is embarked upon.

But the issue of the imbalance between Capital Markets and Money Markets should be addressed *de jure*, for the health and better performance of the Zambian economy as outlined above. Thirdly, deliberate policy and possibly legislative measures should be put in place to ensure that the bulk of SOEs and multinational corporations get partially listed on the local exchange.

Another deliberate policy measure could be to ensure that SOEs assume debt on their own balance sheets, and thus free up fiscal space for government to be able to take on more investment in public goods. As mentioned earlier, this would contribute to significant reduction of the fiscal deficit.

There should be a deliberate aim to have some infrastructure investments undertaken through public-private partnerships, with Capital Markets used not just for raising capital, but also potentially for listing the concessions on the exchange for public accountability.

A deliberate path should be charted for migrating the trading of all significant commodities onto exchanges in Zambia. As demonstrated earlier, if we can do it for stones like emeralds, there is no reason why we can't do it for metals and for major agricultural commodities.

But specifically, a Capital Markets Development Programme (CMDP) needs to be established to drive the transformation required in Financial Markets.

Some of the objectives that the CMDP will need to deliver include an awareness drive mostly targeted at officials and management that exhibit limited knowledge and significance of Capital Markets in their businesses; corporate finance skills to provide initial advice for balance sheet restructuring of SOEs for instance, and for concepts of structured finance for infrastructure projects. The latter objective would also stop payment of millions of US dollars to foreign advisors and creates local capacity.

## 5.0 Conclusion

Although Capital Markets remain small and insignificant in the Zambian economy, yet they have demonstrated, as in the case of ZANACO, that they can be used as a platform for SOEs to be successively removed from government balance sheet and go on to perform even better. Therefore, lost opportunities to the economy are precisely in the sense that there are not more examples such as ZANACO contributing positively to the economy, and ceasing to be a burden to the Fiscus. This paper has highlighted many such lost opportunities and proposed measures that should be put in place for Capital Markets to play a more significant role in the economy of the country.

It is proposed that a Capital Markets Development Programme be deliberately embarked upon to be able to drive the realisation of the significance and relevance of Capital Markets to the economy.

# 3.8 The Foreign Exchange Market in Zambia: How it Works and Prospects for the Future

**Lishala C. Situmbeko***

**Abstract**

This paper discusses the current workings of the Zambian foreign exchange market by first highlighting traditional approaches to exchange rate determination. The foreign exchange market is placed in the context of the Lyon (1997) model where it is argued that in addition to considering the fundamental determinants of exchange rates, a discussion of the foreign exchange market should also consider the actual workings of the market as advocated by microstructure theory which includes 'order flow'; a variable derived from the actual transactions within the market mechanism itself. The players, rules, actions and informational considerations are discussed to highlight how an actual dealer operates within the Zambian foreign exchange market. In was concluded that the market mechanism is still the most viable option for price discovery in the foreign exchange market now and into the future. Diversity in foreign exchange supply was cited as desirable going forward.

## 1.0 INTRODUCTION

According to the Bank for International Settlements (BIS) Triennial Central Bank Survey of 2013, foreign exchange (FX) trading globally averaged US $5.3 trillion per day. Most of the trading was in foreign exchange swaps at US $2.3 billion followed by spot foreign exchange at US $2 trillion. This makes the foreign exchange market the largest financial market in the world. In Zambia, a spot[1] foreign exchange turnover of 40% of GDP arguably makes the foreign exchange market the largest financial market in Zambia. Stock market turnover is under 1% of GDP and fixed income market turnover data is limited and not yet very significant. Table 1.1 below attempts to put into context the size of the foreign exchange market in Zambia over the past few years.

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[1]Globally, the foreign exchange market has what is commonly referred to as a 'spot' market. This market essentially covers transaction with a settlement of T+2, thus a transaction agreed today is settled after 2 working days. Spot settlement is a convention of the professional interbank markets. Settlement of 'same day' and 'next day' do occur with mutual agreement with or without price adjustment. Customer (non-bank) transactions are usually on a 'same day' basis however.

**Table 1.1: Foreign Exchange Turnover Indicators, 2010 - 2013**

| | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| Annual FX Turnover (US $ 'm)* | 7,126.81 | 7,335.13 | 10,198.59 | 10,897.22 |
| Annual FX Turnover (K'm) | 34,187.01 | 35,652.53 | 52,388.57 | 58,767.87 |
| Annual Nominal GDP (K'm) | 97,215.90 | 115,352.80 | 128,370.10 | 144,722.40 |
| Exports (f.o.b) (US $) | 7,261.70 | 8,512.30 | 9,204.60 | 10,398.50 |
| Imports (f.o.b) (US $) | -4,709.90 | -6,454.20 | -7,925.50 | -9,234.80 |
| Av. Exchange Rate ($/K) | 4.7970 | 4.8605 | 5.1368 | 5.3929 |
| **Percentages** | | | | |
| FX Turnover/GDP (%) | 35.2% | 30.9% | 40.8% | 40.6% |
| Exports/GDP (%) | 35.8% | 35.9% | 36.8% | 38.7% |
| Imports/GDP (%) | -23.2% | -27.2% | -31.7% | -34.4% |

**Sources:** Bank of Zambia, Ministry of Finance Annual Economic Reports, and author's computations
*FX turnover computed from Table 5 of Bank of Zambia Fortnightly Statistics as an average of 'Purchases from Others' and 'Sales to Others' columns. All customer transactions in the foreign exchange market are captured in these columns. Bureax de Change obtain the majority of their foreign exchange from commercial banks as net purchasers.

The main outcome of the interaction of demand and supply forces within the foreign exchange market is the exchange rate. While it is commonly understood that the exchange rate in Zambia is 'market determined', what actually goes on in this market is little known to a wider audience. Who is involved and under what rules of convention or regulatory oversight do players operate? What makes one player bid the exchange rate lower or higher? These are some of the questions we hope to address in this paper. Essentially, we aim to answer the broader question of how the foreign exchange market works in Zambia.

After 50 years of independence, it is perhaps an opportune time to reflect on the nation's exchange rate policies and the mechanisms that have been used to determine the exchange rate. This discussion is important to also help put into perspective the various choices that were made at particular episodes in history. While this paper is primarily aimed at discussing how the current foreign exchange market works in Zambia, a review of the history will be important as prospects for the future will be drawn from the discussion. Additionally, any historical discussion of the exchange rate inevitably traverses the path of Zambia's economic policy choices and regimes.

A discussion on how the current foreign exchange system works in Zambia is important for a number of reasons: firstly, scanty literature exists which documents how the current foreign exchange market operates beyond stating that it is determined by the forces of supply and demand. Secondly, it is important to make the connection between the current system and where Zambia has come from in terms of exchange rate regimes. Thirdly, the current foreign exchange market is arguably the longest exchange rate mechanism Zambia has maintained since independence. And lastly, the author believes that having experienced both the regulatory and market participant sides of the market, a unique perspective could be gained and brought to the attention of interested stakeholders.

This paper will therefore proceed as follows: firstly, a review of exchange rate policies over the past 50 years will be conducted. Focus will be placed on the mechanisms in place for allocating foreign exchange and determination of the exchange rate. This discussion will be followed by a presentation of the theoretical underpinnings of the current foreign exchange market. A discussion on how the interbank foreign exchange market (IFEM) works in practice will follow. Given the workings of the foreign exchange market, prospects for the future will then be considered. The paper will then conclude.

## 2.0 50 Years of Exchange Rate Policy in Zambia: 1964 - 2014

In discussing Zambia's exchange rate policy episodes, we distinguish between the pre- and post-liberalization episodes. In the pre-liberalization episode, the exchange rate was a controlled price with a floating system introduced as part of the broad macroeconomic reforms introduced after 1991. Making this distinction also allows us to discuss other associated changes in the economy such as command and liberal approaches to economic management.

### 2.1 The Pre-liberalization era: 1964 - 1991[2]

At independence, the Zambian Pound was pegged to the British Pound Sterling on a fully convertible basis. With the introduction of the Zambian Kwacha on 16th January 1968, the official rate was placed at K0.71 to a US dollar. The Kwacha still maintained the peg to the Pound until 3rd December, 1971, when this peg was severed and the Kwacha linked to the US dollar. The Kwacha's link to the US dollar was a de facto devaluation following the reduction of the gold content of the Kwacha to 7.89 percent and the devaluation in the US dollar, the Kwacha remained at K0.71/US $. The exchange rate appreciated to K0.64/US $ after the dollar devaluation of 15th February 1973. The peg to the US dollar remained until 1976 when the Kwacha was tied to the Special Drawing Rights (SDR) on a controlled floating basis characterised by periodic devaluations (See Table 2.1 for various parity changes). From 1983, the Kwacha was delinked from the SDR (and the basket determining the value of the SDR) and linked to a basket of currencies of major trading partners through a crawling peg. A one percent monthly depreciation was initiated and further increased to 2.5 percent in 1984. However, this system proved unsatisfactory together with the accompanying manual foreign exchange allocation system.

**Table 2.1: Exchange Rate Episodes in Zambia 1964 - 2014**

| Period | Policy |
|---|---|
| 1964 – 71 | Rate fixed to the Pound Sterling. |
| 1971q2 – 76q2 | Rate fixed to the US dollar. |
| 1976q3 – 83q3 | From July, pegged to the SDR with occasional devaluations. |
| 1983q3 – 85q3 | From July, the SDR link substituted by a crawling peg on a basket of currencies of trade partners |
| 1985q4 – 87q2 | Foreign exchange auction; Dutch Auction; two tier auction. |
| 1987q3 – 89q4 | From May, a fixed rate to the US dollar with occasional devaluations under Foreign Exchange Management Committee (FEMAC). |
| 1990q1 – 91q1 | From February, a dual exchange rate system introduced; initial FEMAC abolished and Open General License (OGL) introduced managed by new FEMAC. |
| 1991q2 – 92q4 | In October 1992, Bureax de change licensed and determined 'market rate'. From December 1992, OGL official and 'market' rate unified.<br>OGL list expanded and non-traditional exporters allowed to retain 100% of forex earnings. |
| 1992q4 – 1993q4 | ZCCM allowed to retain 55 percent of export earnings. BoZ dealing system introduced. |
| 1994q1 – 1994q4 | January 1994 Exchange Control Act suspended and Kwacha made fully convertible. December 1994 OGL abolished. |
| 1994q4 – 2000q4 | In April 1996, ZCCM allowed to retain 100 percent of forex earnings. |
| 2001q1 – 2003q1 | In January 2001, BoZ introduces forex guidelines for suppliers.<br>In March 2001, new guidelines applied on forex dealing window. |
| 2003q2 – Date | July 2003, broad based interbank foreign exchange market system introduced. |

**Sources:** Aron and Elbadawi (1992) and Bank of Zambia

[2] This discussion relies heavily on the work of Aron and Elbadawi (1992).

### 2.2 The Post-Liberalization Era: 1992 - 2014

Up to 1985, the approach to foreign exchange management and allocation could be described as heavily relying on administrative tools with forces of demand and supply playing a very limited role. The period after 1985 effectively commenced the initiatives towards the reliance on a price criteria. As a first step, the foreign exchange auction system was introduced in October 1985 (Appendix 11.1 shows details of the auctions in terms of bids and allocations). Following rapid depreciation in the Kwacha and the attendant inflationary pressures it created, the auction system was replaced by an administrative system managed by a Foreign Exchange Management Committee (FEMAC) (Box 11.1 in the Appendices). With the advent of the 1990's, the open general license (OGL) system was introduced. This system was also an administrative one.

Despite the introduction of the auction system in 1985, a multiple exchange rate regime prevailed. Foreign exchange allocations for state companies and institutions in charge of crude oil procurement and refining, the national airline, Zambia Consolidated Copper Mines (ZCCM), fertilizer imports, and government operations were done outside the auction system with the official rate being lower than the 'market' rate. After the introduction of economic liberalization, the ZCCM (as the largest foreign exchange supplier) was allowed to sale to the market through commercial banks after the OGL system was abolished. The system of letting ZCCM supply the market directly created problems as commercial banks that did not have a banking relationship (mostly local banks) with ZCCM were not sold foreign exchange.

In 2001, the Bank of Zambia introduced a new system where major suppliers of foreign exchange were required to sale foreign exchange to BoZ which then auctioned it at the dealing window to all commercial banks on a competitive bidding basis. With effect from 23rd July, 2003, a new system based on an interbank market was introduced. It must also be noted that following the privatization of the major mining assets of ZCCM in 2001, the copper mines now supply the market without having to go through BoZ.

## 3.0 DETERMINANTS OF THE EXCHANGE RATE: AN OVERVIEW OF THE THEORY

At the broad policy level, we have two extremes in exchange rate determination: the fixed exchange rate regime and the flexible exchange rate regime. The former involves administrative controls on the value of the nominal exchange rate. The demand and supply of foreign exchange is subsidiary to what is fixed administratively. The latter regime, on the other hand, lets the forces of demand and supply of foreign exchange interact in the market to determine the nominal exchange rate. Below we conduct a brief and selective review of what is generally thought to make the nominal exchange rate move up or down thus depreciate or appreciate, respectively[3].

We begin with the purchasing power parity (PPP)[4] theory which postulates that the price of one good should be equal in Zambia with the price of the same good abroad. Essentially this is the law of one price. Formally, we should have:

[3]The mechanism used to determine the exchange rate is by no means a closed debate; neither is that of an optimal exchange rate regime. As an example, it is a simple matter to establish that China and the United States of America (USA) follow different exchange rate regimes. Closer to home, Namibia, Swaziland, and Lesotho have their currencies pegged to the South African Rand. The Rand itself is by-and-large market determined albeit supported by some forms of exchange controls. Therefore, one will find that globally, exchange rate regimes range from the polar ends of a hard peg to a free float and various intermediate regimes' which combine some elements of the two extremes (Bubula and Ötker-Robe, 2002).
Implicit in the PPP is the assumptions of a risk-neutral world with no transaction costs such as transportation or trade barriers such as tariffs and quotas. With appropriate assumptions on transaction costs, relative PPP can be derived. The case described can be cited as the absolute PPP case if we assume that the baskets of goods in the price indices and their weights are equal between the two countries.

(3.1) $Pi = ePi^*$

Where $Pi$ and $Pi^*$ denote, respectively, the price level of good i in the home country which in our case is Zambia, and the foreign currency such as the United States dollar. The symbol e denotes the nominal exchange rate that expresses the price in foreign currency in terms of the domestic currency such as Kwacha per US dollar. The exchange rate is therefore determined as the relative price level in the Zambian economy to the price level abroad or in the United States for the Kwacha-Dollar nominal exchange rate. In practice, PPP is unrealistic, impractical and with restrictive assumptions.

Under the balance of payments (BOP) approach to the exchange rate, the main thrust is that any imbalance (surplus or deficits) in the accounts of the BOP are brought to equilibrium by an appreciation or depreciation in the exchange rate. Thus goods, services, financing and capital flows drive movements in the exchange rate. For example, a positive trade balance means that merchandise exports exceed imports in which case more foreign exchange will flow into an economy relative to foreign exchange flowing out with imports.

Asset market approaches yield essentially two views on exchange rate determination: the monetary approach and the portfolio balance approach. The cardinal distinguishing feature being the assumption of perfect capital substitutability for the monetary approach while the portfolio balance approach rests on imperfect capital substitutability.

The building blocks of the monetary approach are absolute PPP holding, stable money demand functions in both countries, uncovered interest arbitrage and rational expectations[4]. With these conditions, the theory states that an increase in domestic money supply results in increased demand for foreign commodities which ultimately leads to a depreciation in the exchange rate. Similarly, increased income appreciates the exchange rate while increasing interest rates depreciates the exchange rate according to this approach.

Following empirical volatility being higher than the real and monetary models underpinning the monetary approach and the violation of the PPP, the sticky price variant of the monetary model was proposed by Dornbusch (1976). The argument was that with prices being sticky in the short run (stated as PPP holding only in the long run with price stickiness in the short-run), you then have a situation where the exchange rate can depreciate by more than is implied by the fundamentals in the monetary model. The adjustment of the PPP assumption holding continuously induces a situation where the exchange rate can depreciate and 'overshoot' its fundamental determinants due to sticky short run prices. Essentially, the influence of foreign income, foreign money supply and foreign interest rates is muted in the short run.

In a situation where domestic economic agents do not perceive domestic and foreign bonds as perfect substitutes, the result is that the global bond market assumption breaks down. In this case, referred to as the Portfolio Balance approach to exchange rate determination, asset holdings will also matter in determining the exchange rate in addition to relative money supply. Risk premia will therefore intrude into the uncovered interest parity assumption. Generally, relative money supply, relative interest rates and relative bond holdings are said to depreciate the exchange rate while an increase in relative income appreciates the exchange rate.

Given the above discussion of the various approaches to the exchange rate, we present

[4]Use is made of the Quantity Theory of Money relationship $MV = PY$ where $M$ is money demand/supply, $V$ is velocity of circulation, $P$ is the price level, and $Y$ is national income.
Uncovered interest parity departs from the covered interest arbitrage condition through the treatment of the forward exchange rate as the expected exchange rate giving the whole condition as: $1+i_t/1+i_t^* = E(e_{t+1}/e_t)$. $i_t^*$ is the foreign rate of interest and $e$ is the nominal exchange rate. Investors are thus risk neutral and only concerned with returns received.

below a general fundamental equation (monetary flavoured) that can be subjected to data and empirical testing:

$$\Delta e_t^{\$/K} = \beta_0 + \beta_1 \Delta(m_t - m_t^*) + \beta_2 \Delta(y_t - y_t^*) + \beta_3 \Delta(i_t - i_t^*) + \beta_4 \Delta(\pi_t - \pi_t^*) + \varepsilon_t \quad (3.2)$$

Where $e_t^{\$/K}$ is the logarithm of the nominal exchange rate of the Kwacha to the US $ (or another foreign currency), $(m_t - m_t^*)$ is the logarithm of relative money supply, $(y_t - y_t^*)$ is the logarithm of relative income, $(i_t - i_t^*)$ is short term interest rate differential, $(\pi_t - \pi_t^*)$ is long term interest rate differential proxied by CPI inflation differential and $\varepsilon_t$ is an error term with standard assumptions. $\beta_0$ is a constant and $\beta_i$ are coefficients. ? is the first difference operator in the event of first order stationary.

Mixed results continued to be obtained in the literature on versions of equation (3.2). The findings by Meese and Rogoff (1983) produced serious doubts on the validity of the fundamental approach to exchange rate determination. In essence, the theories presented above where put in doubt as models constructed from them could not forecast the exchange rate. The fundamental models where compared to a random walk model which was essentially the current exchange rate being explained by its own past values and the random walk model outperformed the fundamental equations. Additionally, most models of exchange rates started to treat the exchange rate as efficient in the informational sense. The exchange rate was now assumed to include all publicly available information on interest rates, money supply, inflation, gross domestic product (GDP), budget deficits and external sector imbalances (King et al, 2012).

Given the forecasting failures of the traditional models discussed above, other researchers focused their attention on microstructure theory. The argument was that the traditional models focused exclusively on fundamentals while ignoring the market microstructure which is the process and outcomes of exchanging assets under explicit trading rules (O'Hara (1995)). According to King et al (2012) the microstructure approach incorporates analysis of the agents that trade in financial markets, the incentives and constraints that emerge from the institutional structure of trading, and the nature of equilibrium. The essence of this approach in the Zambian context means that it is not only the money supply, inflation, interest rates, balance of payments and income considerations that are important in determining the exchange rate, the Authorised Dealers in the foreign exchange market and the structure of the Interbank Foreign Exchange Market (IFEM) are also important in determining the exchange rate.

## 4.0 MICROSTRUCTURE MODEL OF THE FOREIGN EXCHANGE MARKET

The modelling of the exchange rate from a microstructure perspective has benefited greatly from Lyon (1997). Below we sketch Lyon's model as it is fundamental to gaining an appreciation of the current foreign exchange market in Zambia.

Lyon (1997) presents a model of multiple dealers with simultaneous trading. The entry of foreign exchange dealers in the Zambian foreign exchange market (banking licenses can be given on application and meeting of appropriate requirements) is not restricted and dealing amongst dealers is not done sequentially. In fact one dealer can simultaneously trade with two other counterparties.

The key features of the model are:

1. Dealing amongst dealers: banks trade with one another on the interbank market where price discovery actually takes place.
2. Dealers have an informational advantage by observing customer order flow: the trading which is done between the bank and its customers cannot be observed by other banks. Therefore, the transaction between the bank and the customer is private and a source of private information for the bank.
3. Dealers are risk averse: inventory is less attractive to dealers who then have the inventive to actively manage it. Essentially, this attribute states that perpetual holding of foreign exchange positions is not viewed as an advantage as the market can easily move against the dealer and his position.

Based on the above features of the model, it can be noted that:

- Dealer inventory levels (the FX positions) and customer dealing intentions to buy or sell FX are sources of private information which drives dealer behaviour.
- Private information and strategic dealer behaviour interact to reduce the amount of information revealed by the trading price. A dealer is rational with a motive to create positive value. Dealer behaviour is considered strategic in that the dealer will act in a manner that takes into account what other dealers on the interbank market are doing.
- Private information and risk averse dealer preferences interact to reduce the amount of information revealed by the trading price. In essence a dealer will protect his information as revelation to the market could result in negative value creation; in essence losses.

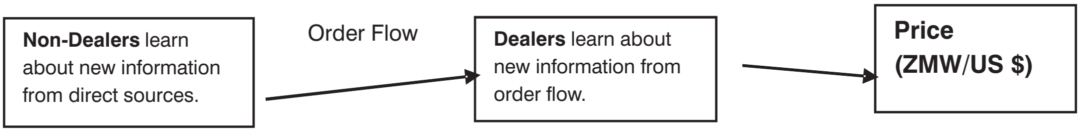
In a two period game with n dealers, Lyon (1997) models the following four aspects representing the whole trading process before, during and at the end of the game:

- Customer orders and information;
- Dealer quoting and trading;
- More information following each dealing event; and
- Dealer objectives and information sets.

Lyon proceeds to solve his model where he derives the following:

- Equilibrium quoting strategies;
- Equilibrium trading strategies;
- 'Hot-potato' trading; and
- The informativeness of price.

In essence, Lyon (1997) asserts that FX dealers acquire private information from customer activity. Because the dealers are risk averse, they will quote and trade strategically on the interbank market in such a manner as not to reveal their information advantage which is a source of profit. Thus the information value of a price on the interbank market is distorted by the need to create value by the dealer. The dealer is an inefficient broker of information. The need for the dealer to manage inventory (the open position) creates a situation of 'hot-potato' trading where positions are repeatedly passed on from one dealer to another on the interbank market until it finds a resting home with a dealer that can accommodate it. Lyons (2001) sketches the information flow process as:




**Source:** Lyon (2001)

From an exchange rate determination perspective, Lyon (1997) contributes the variable of 'order flow' to the theory of nominal exchange rate determination. Being the pressure to either buy or sell, customer order flow will determine what the dealer does in the interbank market by clearly influencing her quoting and trading strategy to make profit and manage inventory. The conclusion therefore is for models that attempt to explain the determinants of the exchange rate to also include customer order flow (positive or negative) to the fundamental factors that we reviewed in the last section. Thus a potential estimation model with order flow could take the form:

$$e_t = \textit{fundamental determinants} + \textit{customer order flow} + \varepsilon_t \qquad (4.1)$$

Where $e_t$ is the logarithm of the nominal exchange rate and $\varepsilon_t$ is the error term.

The advantage of incorporating the role of the dealers is that macroeconomic variables in-and-of themselves do not take part in the market. Dealers take into account publicly available information which usually includes the fundamental determinants in quoting and trading on the interbank market. Fundamentals work their way into exchange rates through dealers who incorporate that information when quoting and trading. Additionally, it is a recognized fact that for exports, the figures are recognized in official statistics before the foreign exchange is received and for imports, the figures are recorded after the foreign exchange demand has already passed through the foreign exchange market. Similar arguments can also be made for other parts of the balance of payments and the inherent lags. However, in the long run, it is further recognized that the exchange rate reflects all available information.

In the next sections, we now focus on the structure of the Zambian market highlighting the regulatory framework and what dealers actually do.

## 5.0 STRUCTURE OF THE ZAMBIAN FOREIGN EXCHANGE MARKET

In this section we provide an overview of the players that are found in the Zambian FX market and their role. Additionally, we also briefly look at the currencies that are traded in the market in addition to the instruments mostly used.

### 5.1 Currencies and Instruments

Most trading on the Zambian FX market is for what are referred to as 'G-7' currencies with the pair between the US dollar and the Zambian Kwacha dominating. Another important currency pair traded is the South African Rand (although not 'G7') and Zambian Kwacha followed by the Euro and British Pound. Occasionally, some customers have transactions in Swiss Francs, Australian Dollars and Japanese Yen against the local currency. It is not very common to trade regional currencies for various reasons such as structures and market factors. The market has started seeing some Chinese Renminbi. Essentially, any convertible currency can be traded once sufficient demand and supply exists to warrant a profitable business in that currency. Most commercial banks provide exchange rates even for currencies that they do not trade as an information service to customers.

The most popular instrument is the spot FX instrument which is the plain vanilla buying and selling of foreign exchange between banks and their customers. The turnover figures discussed in the introduction reflect activity over spot FX. FX hedging using forward contracts is still a low volume activity compared to spot. For instance, BoZ reported in its Annual Report of 2012 that FX forward turnover was US $520.5 million in 2012 compared to US $253.5 million in 2011[5]. The development of the derivatives market remains a challenge until the money market and yield curve are developed to the same level as the foreign exchange market since the money market is the place where time value of money is essentially derived. Foreign exchange swaps are typically undertaken amongst professional counterparties although some customers have been known to use this instrument. Option contracts are few and far between but can be large and highly bespoke. Options are usually managed off-balance sheet as no active options market (essentially a market trading Kwacha volatility) exists.

### 5.2 A Two-Tier Market

The FX market can readily be described as a two-tier market. The first tier of this market is the interbank market which involves trading between banks or Authorized Dealers. The second tier involves individual banks and their customers and other counterparties. In the interbank market, two-way pricing rules and the spread is theoretically the benefit. In the second tier, prices for this market are derived from the interbank market with spreads for Board Rates. Board rates are the exchange rates typically displayed in most commercial bank branches. Most retail customers will typically trade at the Board Rates which are the retail end of the segment.

Each Authorized Dealer has its own customers who buy and sell foreign exchange. These customers typically call into the Dealing Rooms by telephone seeking prices for either buying or selling a particular amount. If the Authorized Dealer has exclusivity with this customer, then this deal is known only to this Dealer without the other players in the market knowing. The customer may place an order with the Authorized Dealer to either purchase or sell foreign exchange. Each bank can mismatch its foreign currency denominated balance sheet up to the regulatory limit which is a percentage of regulatory capital. Should assets exceed liabilities, the Dealer is said to be 'overbought' or 'long' and vice-versa 'oversold' or 'short'[6]. In essence, an Authorized Dealer would report being long US dollars in a situation where he has an excess of dollar assets over liabilities. In an inventory sense, one would state that a player has US dollars on hand. The opposite is short US dollars.

Therefore, the arrival of a customer order is weighed against the limit to which an Authorized Dealer can be long or short. If a customer would like to sell US $5 million and the Dealer is already long at the limit of US $4 million, it entails that the Dealer will have to find a customer to buy off the whole US $4 million or enter the interbank market to be able to accommodate the customer order. If a customer is found to buy US dollars, the Dealer proceeds to sell and also buy from the other customer with whom she has an order. The key issue here is that the Authorized Dealer faces two markets: the interbank market where she is informed of activity based on how other players respond to her two way prices and the

[5] The author computed turnover based on the reported FX forward sale and purchase figures on page 20 of the report.
[6] The terms Long or Short are used as is commonly referred in the FX market by Dealers and not in the regulatory sense as defined in the Basel Accord under Market Risk.

customer side of the market which is a source of private information about what is going on in the market. This information gathering is a continuous job as the Dealer's position presents her with 'blind spots'. While information on macroeconomic news is public and generally available to all Authorized Dealers, customer activity information is limited and not market wide. Thus, it is possible, and occurs frequently, for a particular inventory position to go round in the market bidding the exchange rate higher without accompanying flows due to lack of information or adverse positioning amongst banks.

If the Dealer keeps receiving buying pressure from customers without any other customers wishing to sell US dollars, this leaves the Dealer with the interbank market as a way of managing the position (inventory). Buying pressure without supporting inflows from other customers will result in a depreciation of the exchange rate and vice-versa. Large market transactions tend to be distortionary at the point they come to the market. It is in these instances that the regulator's hand is sought to normalize the market.

### 5.3 The Role of Brokers

Brokers, as the name suggests, are middle men. They operate in the interbank market intermediating various transactions across various asset classes. Unlike market makers, brokers do not take positions. They are rewarded a commission for connecting two interbank counterparties. The benefit to the market maker or dealer is anonymity when placing a trade on the interbank market. Accordingly, a dealer's price can be 'taken' or 'given' without initially entering the market. Brokers do not make money because of a movement in the exchange rate; they are rewarded usually for the volume they 'push' on behalf of their principal. Therefore, one will find that a broker will also quote a price showing a buying and a selling rate. The buying and selling rates will represent the best buy and best sell rates the brokers has been provided by different principals.

### 5.4 Determination of Each Dealer's Exchange Rate Quote

If an Authorized Dealer is long, and based on information on hand, believes that the market will be receiving dollars that day, the bank will set the exchange rates to encourage customers and other interbank players to buy from them. This is because with a long position and an anticipated inflow of dollars, the Dealer can lose money should the currency appreciate. Therefore, the private information that a bank has about what its customers intend to do in the market and its own position (long or short) determine how it will price according to the market. Additionally, fundamental information regarding the economy which could come from data releases, policy changes, activities in related markets or other announcements can provide indications of the likely direction of the economy and be taken into account when providing a two-way quote.

Out-of-market exchange rate quotes do not remain permanent as they are cleared by market participants who see an opportunity.

## 6.0 REGULATORY FRAMEWORK FOR THE FOREIGN EXCHANGE MARKET

The Zambian foreign exchange market is principally regulated by the Bank of Zambia through licensing of foreign exchange dealers referred to as Authorized Foreign Exchange Dealers. For the foreign exchange market as a whole, the BoZ also licenses Bureax de Change and commercial banks. The key segment of the FX market we shall be describing subsequently is the market for foreign exchange balances held within the banking system. At this point, readers may wish to note that in this context, a distinction is made between foreign exchange and foreign currency where foreign exchange refers to foreign denominated balances held in the banking system and foreign currency is actual cash and a bearer instrument.

We focus on the market which involves commercial banks and the BoZ whose role as regulator also involves the determination of the official BoZ exchange rates based on activity on the interbank market. The key market for price discovery is the interbank market which is governed by the Interbank Foreign Exchange Market (IFEM) framework. While the Banking and Financial Services Act, Cap 387 of the Laws of Zambia, licenses bank and non-bank entities to deal in foreign exchange, the IFEM further sets the rules. All commercial banks are also signatories to a Foreign Exchange Code of Conduct. Appendix 11.1 details the basic requirements for an Authorized Dealer under the IFEM.

Under the IFEM, all Authorized Dealers are obligated to maintain a continuous presence on the market between the market operating hours from 08:30 – 15:30hrs on every working day. Thus, the interbank market is open during this period with players providing two-way prices to one another. Commercial banks are also mandated to educate their clients on foreign exchange and derivative trading. All players are expected to engage in trading and conduct that promotes market stability. As an oversight measure, all players provide the BoZ with any market information requested including deals concluded and with which counterparties, open positions, and two-way prices at any time including the stipulated data collection times of 09:30, 12:30 and 15:30hrs.

The BoZ regulates market practice. Each firm two-way quote is currently good for US $500,000. A player answering to a 'call' can state whether his price is indicative[7]. The default is a firm price. Therefore, when one player 'calls' another player on the electronic dealing system during market hours asking for a two-way price on US dollars, the counterparty responds with a two-way price on which the asking party can either buy US $500,000 or sell US $500,000 at his option within 30 seconds. If there is delay in responding to a price (practically 30 seconds is very long in this world), the party providing the price can amend the two-way price before the requesting party accepts the quote. All of these conversations cannot be erased by either party and remain on the system for future reference by regulators or management checking Dealer conduct. The BoZ can and does intervene at any moment without notice or announcement and frequently check on the market by asking for firm two-way quotes.

All Dealing Rooms (front office and customer facing) and Back Office (operations) personnel are required to possess an ACI Dealing Certificate and an ACI Operations Certificate respectively. All Dealers must study and pass the requisite examinations conducted by the Paris-based ACI – The Financial Markets Association. The local Zambian chapter is ACI Zambia to which all Dealers must subscribe. All Dealers subscribe to the ACI Model Code which is a global code of conduct.

As regards the role of the BoZ in the market, the IFEM stipulates that the BoZ shall facilitate and regulate the foreign exchange market so as to ensure the orderly functioning and stability of the market. The BoZ carries out inspections from time-to-time on IFEM compliance. Intervention in the foreign exchange market is through Authorized Dealers and exclusively at the option and discretion of BoZ. The BoZ also sets the open position limit by which a commercial bank can mismatch its foreign currency denominated assets and liabilities as a percentage of regulatory capital. Individual commercial banks can set their own limits as an inner limit of the regulatory open position limit.

[7]Generally, frequent indication of indicative pricing erodes market confidence with other dealers losing confidence in the pricing capacity of a particular bank.

## 7.0 INSIDE THE DEALING ROOM: A DAY IN THE LIFE OF A FOREIGN EXCHANGE DEALER

In this section, we highlight the structure of the Dealing Room, the players and interaction between the players. This is done with a view to shed more light or demystifying the trading 'black box' in the whole process generating exchange rates or other financial prices in the Zambian financial market. Broadly, one can define three species of dealers within a Dealing Room: Foreign Exchange dealers, Money Market (MM) dealers and Sales dealers. In other Dealing Rooms, FX and MM Dealers are readily combined into one unit or done by the same person. For our purposes, we shall take the case where FX and MM are separate and focus on their usual roles in the conclusion of an FX trade and its pricing.

In brief, FX dealers manage the FX position of the bank or more technically manage foreign exchange risk. FX dealers provide all two-way pricing on the interbank market and provide prices to Sales dealers. The MM dealers manage the local currency position of the bank; they manage liquidity risk and interest rate risk. MM dealers provide interest rates to Sales dealers. Sales dealers are the ones that deal with customers; they are the customer facing side of the dealing room. Sales dealers make and take customer calls and negotiate with buying or selling customers on their FX requirements.

Through the Sales desk, customer information in terms of nature of trade, amount of FX required, purpose of FX - if importing, sources of FX - if an exporter, expected pricing and all manner of information is provided. Some information can have trading value while some may not. The Sales desk passes on relevant information to the FX and MM desks. The MM desk will usually come in when a customer requests a variation of settlement condition which might impact the foreign exchange liquidity position of a bank. In practice, the FX dealer negotiates with the Sales dealer while the Sales dealer trades with the customer as principal based on wholesale pricing provided by the FX desk.

In terms of overall setting, the Dealing Room will typically have all dealers sitting close to each other in one large room. In larger and more advanced markets, dealing rooms the size of the Mulungushi International Conference Centre main hall are quite common. A television set with running business news and developments in international markets for news on the major traded currency is usually a feature. The main tool for electronic communication is the Reuters® dealing station which can be shared with the MM desk. Most or all dealers in the Dealing Room will have access to the Reuters® information screens which also act as a closed communications group. With Reuters® dealing, the FX desk communicates with all interbank players. This is the primary means of transmitting and concluding interbank deals. Two-way prices are sought and given over Reuters® dealing. The BoZ is also connected to Reuters® dealing and uses it to collect exchange rates at the appointed collection times and also to intervene in the foreign exchange market. While FX dealers communicate on pricing, they cannot come together to execute a transaction or agree on a price. This is unethical, unprofessional and illegal.

The day in a typical dealing room starts as early as 07:30hrs with preparation of exchange rates and review of position and profit and loss reports from the trading and banking system(s). The FX dealer will establish her positions in all currencies and the aggregate and establish whether he is long or short. At 07:45hrs, a meeting of all dealers in the dealing room is called to review FX, MM, and Sales activity the previous day and expected activity for the current day. Expected customer deals are discussed and any relevant information is shared. Official business commences at 08:00hrs at which point the meeting is closed. The market opens at 08:30hrs and FX trading begins.

Let's take the case where a Sales dealer receives calls from a large exporter wanting to sell FX and an importer wanting to buy. The exporter calls the Sales dealer looking for Kwacha from US dollar sales of US $5 million but what the exporter tells the Sales dealer is not always the amount he will off load. Large exporters usually call various banks looking for the best exchange rate for the dollars. An exporter selling US $30 million can call various banks indicating to each that he intends to sell US $5 million and transmit this same information to all players. If the US $5 million is all that is on offer, then the bank with the best rate wins. If however more is on offer, then the best rate possible out of each bank will prevail to exhaust the whole amount on offer. The dealers do not always know what the exporters are doing. But the critical issue is that the intended exporter transaction is communicated to the FX desk who checks for wholesale pricing on the interbank market. If the FX dealer would like to take the whole US $5 million position on his book, he would offer the Sales dealer more aggressive pricing. Should the FX dealer be asked on Reuters to give a two-way price, that two-way price will take into account the US $5 million on the market and any other deal known to the Dealing Room at the time. The purchase of the US $5 million takes into account the maximum amount the bank call take on given the market environment. This maximum amount is the open position limit specified by the regulator with additional internal adjustment (always lower) in some cases.

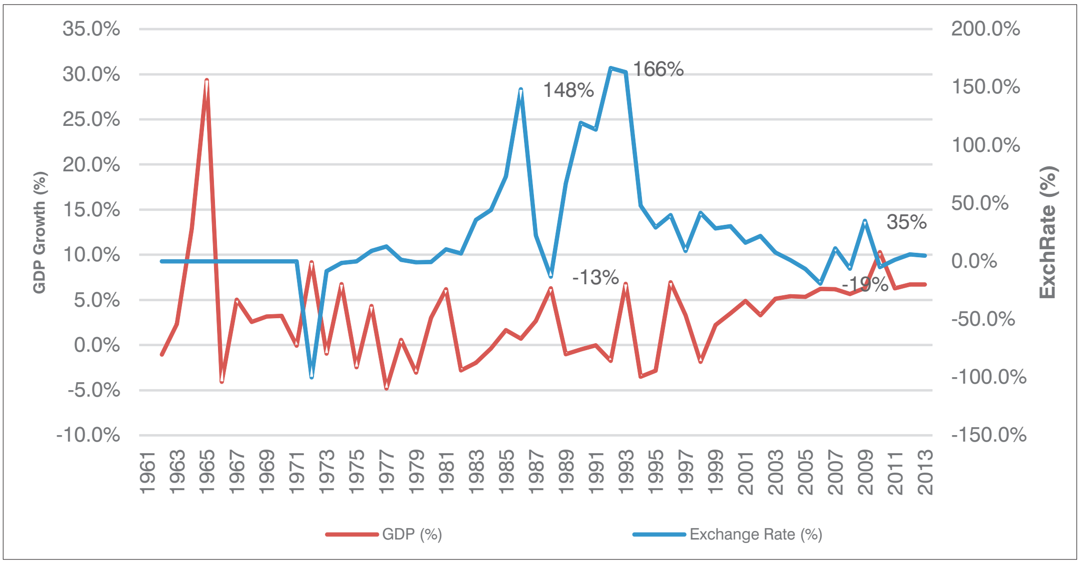
From the above scenario, the FX trader is always managing his inventory through the interbank market as Sales dealers and buying and selling customers interact. The FX dealer relies on the Sales desk for information on customer intentions and actions for both deals won and lost. In practice, large customers are very well informed and do prove valuable in the trading process. In managing her inventory through the interbank market, the other dealer at the other bank may not desire the inventory so acquired and will engage in another round of passing the position to another player in the market. This can go on until a dealer is found who either would like this position or who is positioned in the opposite and gains from acquiring this position. During these times of position passing, volatility is usually at its highest with the market being very sensitive and tense. These are the occasions when the BoZ is called upon to intervene – of course at their option and time of their choosing! Thus, FX dealers will always indicate to the interbank market whether they would like to buy or sell based on their two-way price. If a dealer does not wish to be sold FX, she will ensure that the bid is lower than most market players. If they are sold even at this seemingly lower bid, then the FX trader will quickly adjust further downwards thus appreciating the currency if this tendency goes on over various rounds in the market or vice versa for a depreciation.

## 8.0 A GRAPHICAL RELATIONSHIP BETWEEN FUNDAMENTALS AND ORDER FLOW AND THE EXCHANGE RATE

In the figures that follow, we show the graphical relationships between the exchange rate changes and GDP growth, money supply growth, interest rates, changes in foreign exchange reserves and inflation.

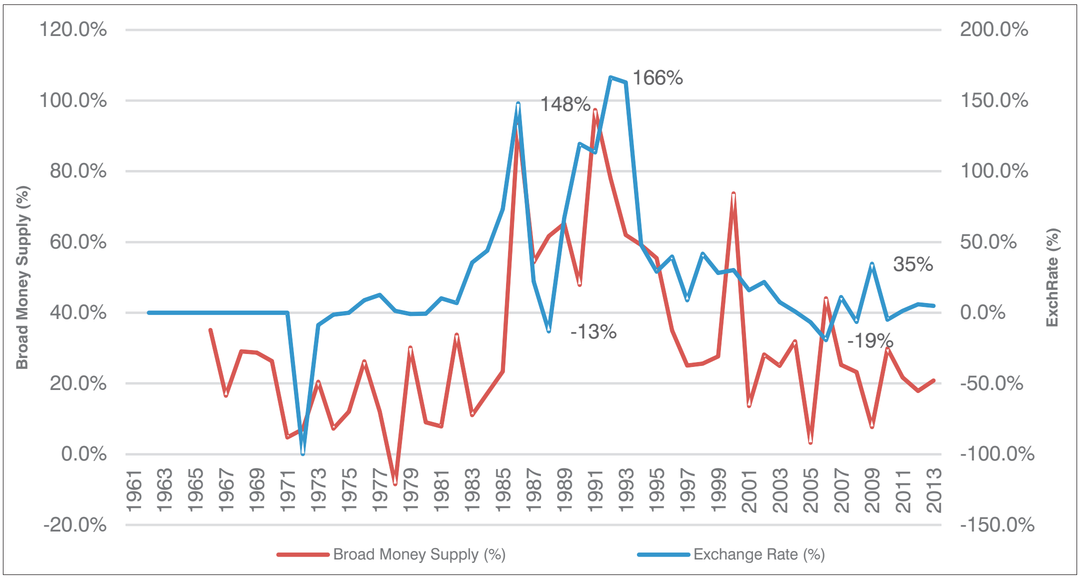
From figure 8.1, it can be discerned that the exchange rate depreciated in times the economy was experiencing negative growth. While an exact correlation cannot be established, it can be argued that negative growth is in line with a depreciating exchange rate.

**Figure 8.1: GDP (%) and Changes in ExchRate (%)**



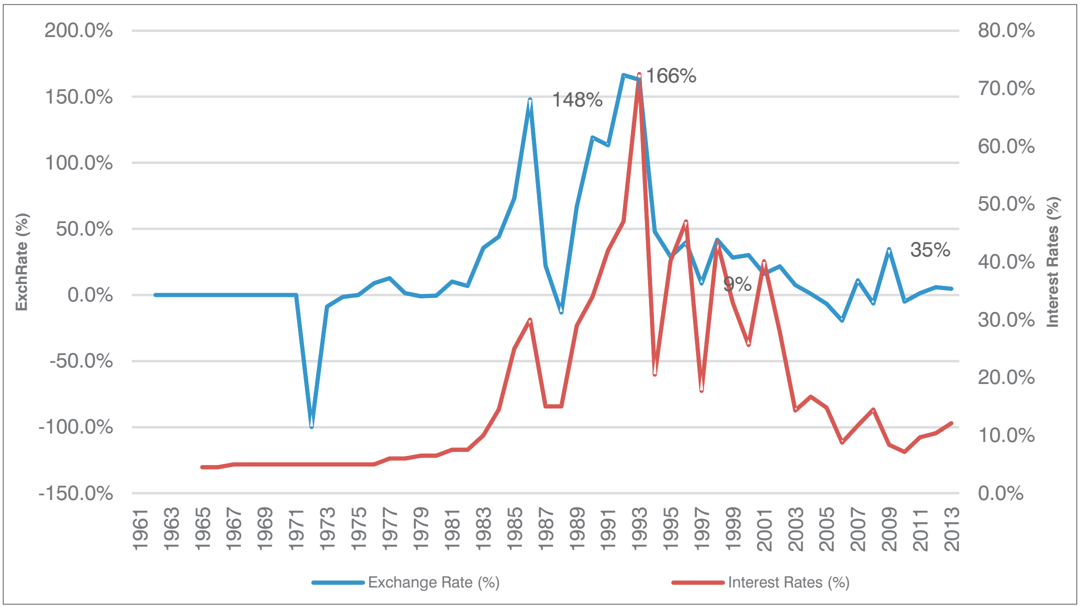

Growth in money supply appears to move in tandem with a depreciating Kwacha overtime. The episodes that have witnessed the largest rates of depreciation such as in 1993 also coincided with the highest money supply growth rates. Post 2000, this relationship does not appear to be very well supported at least from visual inspection as shown in figure 8.2 below.

**Figure 8.2: Money Supply (%) and ExchRate (%)**



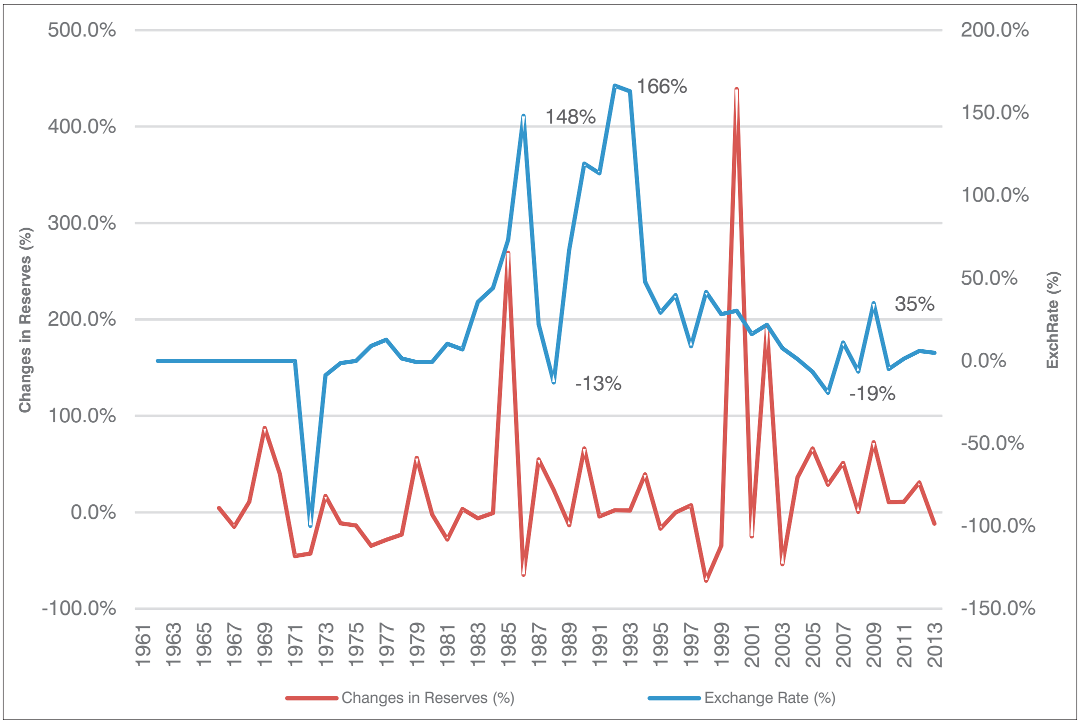

Prior to the liberalization era, interest rates in Zambia where controlled under the general umbrella of a command economy. From figure 8.3 below, a clear-cut graphical relationship is difficult to observe. However, in some instances post-2006, increases in interest rates coincided with an appreciation of the exchange rate but this does not appear to be a long run phenomenon.

**Figure 8.3: Interest Rate (%) and ExchRate (%)**



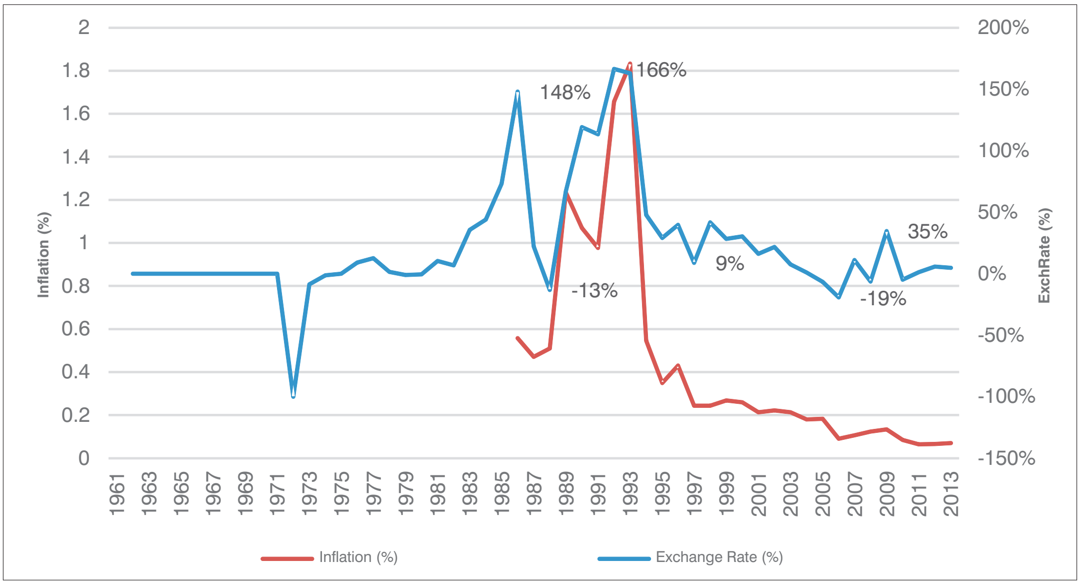

Increasing foreign reserves have been known to boost exchange rate performance with appreciations in the exchange rate when these reserves are export driven. In other instances, even reserves accumulation driven by non-current account transactions do initially result in currency appreciation. Some observed behaviour in figure 8.4 suggests counter-intuitive notions where increases in foreign exchange reserves have been met with exchange rate depreciation thus the relationship is not conclusive.

**Figure 8.4: Changes in Reserves (%) and ExchRate (%)**



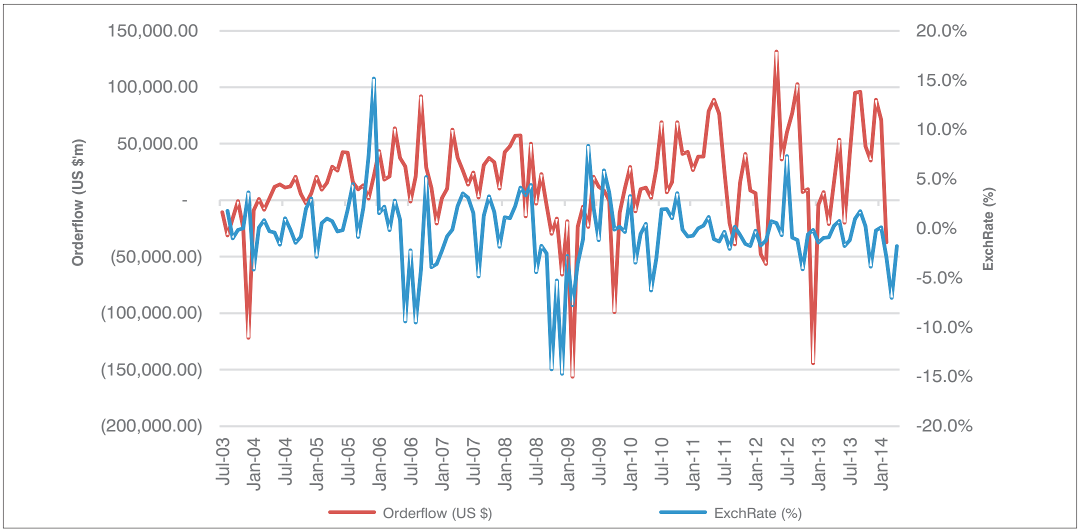

The period 1987 to 1995 witnessed some of the most stringent application of economic measures in the Zambian economy. A breakaway by Zambia from the International Monetary Fund (IMF) and the suspension of debt servicing obligations was accompanied with a revaluation of the currency. This was temporary as efforts towards exchange rate realignment necessitated massive devaluation which also moved in tandem with inflation. While not coincident (figure 8.5), a general relationship can be observed where lower inflation has been moving together with generally reduced rate of depreciation in the Kwacha. It has been observed though, that inflation could be strongly influenced by the exchange rate due to the large amount of consumer goods imports into Zambia. This is an empirical issue however.

**Figure 8.5: Inflation (%) and ExchRate (%)**




Based on the definition of 'order flow' provided earlier in section 4.0, data published in the Bank of Zambia Statistics Fortnightly was used as it suited the definition of order flow being the pressure to either buy or sell foreign exchange[8]. The data used to plot changes in the exchange rate in figure 8.6 was adjusted to reflect an upward movement as an 'appreciation' and a 'downward' movement as a depreciation for better comparison with order flow. From the graph, it would appear that movements in order flow tended to be coincident, at several points, to changes in the exchange rate. While not conclusive at this stage, we leave the statistical analysis of this relationship to future research.

**Figure 8.6: Orderflow (US $'m) and ExchRate (%)**




[8]The columns for 'Purchases from Others' and 'Sales to Others' are netted under the label 'Net' in Table 5. This 'Net' data seems suitable for our purposes as approximating order flow as has been defined in the literature. This data is available from July 2003 when the IFEM was introduced.

## 9.0. CONCLUSION AND PROSPECTS

We sought to discuss the current workings of the Zambian foreign exchange market. We took cognizance of the path Zambia has taken from an exchange rate policy standpoint. It was established that the manner in which the exchange rate has been determined closely maps the 'peaks and valleys' traversed by the economy itself from the pre-liberalized to the liberalized era.

Following a review of the fundamental determinants of the exchange rate, we arrived at the conclusion that fundamental determinants have been discredited in the literature for performing poorly in forecasting the exchange rate in many economies. This was because variables resulting from the market mechanism itself where missing. The issue on the importance of order flow as a determinant remains an empirical issue for the case of Zambia. Our hope was merely to highlight this fact given the 11 years of operating under the Interbank Foreign Exchange Market (IFEM) where order flow is now generated. The structure, rules, players and incentives of the current foreign exchange market was sketched wherein it was established that the Lyon (1997) theoretical treatment is a plausible framework to discuss the IFEM.

If we were to gather again at the 60th Anniversary of the Bank of Zambia in 2024, the current policy trajectory gives the author comfort of continued use of the market mechanism in allocating foreign exchange. The IFEM would still be trying to answer fundamentally the same questions but albeit in a completely different fashion where individuals would have dealing terminals and trading the currency like current professionals do on the interbank market.

In 2039 when we would be celebrating 75 years of the Bank of Zambia's existence, it would be gratifying to make a statement that Zambia needs to diversify its foreign exchange earnings away from agricultural exports; a positive and welcome sign of progress from current times.

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## 11.0 APPENDICES

| | BASIC REQUIREMENTS FOR AUTHORIZED DEALERSHIP IN FOREIGN EXCHANGE | PURPOSE |
|---|---|---|
| 1. | A bank should be registered under the Banking and Financial Services Act (BFSA) | To ensure that an Authorised Dealer is amenable to regulation by the BoZ and meets the required minimums to render banking services under the law. |
| 2. | A bank has Board approved risk management procedures | A bank is primarily a corporation under the Companies' Act with control being exercised by its Board. As such, the Board must sanction the business the bank enters into and take ultimate responsibility for managing risks arising from the business. |
| 3. | A bank meets minimum prescribed capital requirement (in accordance with the Banking and Financial Services Act) | Capital in a bank is essentially meant to absorb losses arising from the use of depositor funds to undertake business. In essence, the bank must have 'skin-in-the-game' for all its activities. |
| 4. | A bank has tailor-made market making information page on an information system authorised by the Bank of Zambia | A screen that displays FX and money market pricing for other players to see where a particular bank is pricing. It's a transparency requirement. |
| 5. | A bank has a Dealing system and any other relevant trading and information systems authorised by the Bank of Zambia from time to time | Communication between banks on bids (buying price) and offers (selling price) is via a closed and secure system with audit trail capability. Speed is of essence as continuous market presence is expected. |
| 6. | A bank has in place a Secure Dealing Room and Back Office with restricted access and recorded direct telephone/fax lines | The size of transactions executed in Dealing Rooms and confirmed in their Back Offices run into millions of dollars. Only appropriately trained and authorised persons should have access to these facilities. |
| 7. | A bank has installed fixed and secure recording facilities for all telephone lines for foreign exchange Front and Back Office operations | In case of disputes with bank or non-bank players over a transaction, Dealing systems have an audit trail and phone conversations are recorded. |
| 8. | A bank has Board approved policy guidelines for the Dealers | The Board is ultimately in control and oversight has to be exercised over dealing conduct. 'Rogue' traders have led to bank closures such as Barings in 1995. |
| 9. | A bank has provided the dealers with Dealing Authorization and has prescribed limits | A bank's management must authorize a Dealer to deal on its behalf by way of a Dealing Authorization. Based on skill and experience of a Dealer, a bank must indicate how much risk the Dealer can expose the bank. Limits are generally personal, expire (usually annually) and can be withdrawn at any time. |
| 10. | A bank has in place, complete segregation of duties between the Front, Middle and Back Office activities | It is not recommended practice to deal and settle your own transaction as this is a recipe for erroneous transactions, Dealers concealing losses and other unwanted behaviours. Checks and balances are supported by segregation of reporting lines. |
| 11. | A bank has capacity to provide two-way firm pricing at all times | Two-way pricing means that both buying and selling price is quoted simultaneously. The Authorized Dealer is a market maker whose benefit is the spread. Critical for liquidity and price discovery. |
| 12. | A bank is able to trade with fellow Authorised Dealers at the agreed marketable threshold determined by the Bank of Zambia from time to time | This ensures continuity of the interbank market. The market amount is the counterpart to two-way price. i.e. the amount of US dollars for which a player stands good on his two way price. |
| 13. | A bank has at least two (2) ACI qualified Dealers and two (2) ACI Operations Certified Back Office personnel | It is important to have qualified personnel and these are minimum standards. Additionally, all ACI qualified staff abide by a Code of Conduct. |

**Source:** Interbank Foreign Exchange Market Framework, Bank of Zambia 2013.
The author draws on his understanding as a certified ACI Dealer and draws from the ACI – The Financial Markets Association Model Code.

**11.2Weekly Foreign Exchange Auctions 1985 - 87**

| Week | Date | Bid Amount (US $ mil) | Allocated Amount (US $ mil) | Excess Demand (US $ mil) | Exchange Rate (K/$) | Depreciation (%) |
|---|---|---|---|---|---|---|
| 1 | 11/10/85 | 16.90 | 4.80 | 12.10 | 2.20 | 127.7 |
| 2 | 18/10/85 | 12.50 | 5.00 | 7.50 | 5.01 | 21.8 |
| 3 | 25/10/85 | 10.30 | 5.20 | 5.10 | 6.10 | 14.8 |
| 4 | 31/10/85 | 10.20 | 7.50 | 2.70 | 7.00 | (8.0) |
| 5 | 08/11/85 | 8.10 | 6.20 | 1.90 | 6.44 | (3.0) |
| 6 | 15/11/85 | 4.80 | 4.10 | 0.70 | 6.25 | (3.5) |
| 7 | 23/11/85 | 5.00 | 3.90 | 1.10 | 6.03 | (3.8) |
| 8 | 30/11/85 | 4.90 | 4.20 | 0.70 | 5.80 | (0.9) |
| 9 | 07/12/85 | 4.60 | 4.20 | 0.40 | 5.75 | (0.2) |
| 10 | 14/12/85 | 5.20 | 4.50 | 0.70 | 5.74 | 0.2 |
| 11 | 21/12/85 | 4.60 | 4.30 | 0.30 | 5.75 | 0.3 |
| 12 | 28/12/85 | 3.50 | 3.50 | 0.00 | 5.77 | (1.2) |
| 13 | 04/01/86 | 5.00 | 4.60 | 0.40 | 5.70 | 1.1 |
| 14 | 11/01/86 | 5.40 | 4.10 | 1.30 | 5.76 | (6.9) |
| 15 | 18/01/86 | 6.70 | 3.30 | 3.40 | 5.36 | 12.1 |
| 16 | 25/01/86 | 10.20 | 4.70 | 5.50 | 6.01 | 6.5 |
| 17 | 01/02/86 | 6.50 | 6.10 | 0.40 | 6.40 | (0.6) |
| 18 | 08/02/86 | 7.20 | 3.90 | 3.30 | 6.36 | 2.4 |
| 19 | 15/02/86 | 6.70 | 5.20 | 1.50 | 6.51 | 2.6 |
| 20 | 22/02/86 | 11.90 | 7.70 | 4.20 | 6.68 | 1.5 |
| 21 | 01/03/86 | 10.20 | 5.40 | 4.80 | 6.78 | 3.4 |
| 22 | 08/03/86 | 7.70 | 5.90 | 1.80 | 7.01 | (1.6) |
| 23 | 15/03/86 | 7.40 | 5.60 | 1.80 | 6.90 | (2.2) |
| 24 | 22/03/86 | 10.80 | 8.80 | 2.00 | 6.75 | 2.4 |
| 25 | 29/03/86 | 8.30 | 7.40 | 0.90 | 6.91 | (0.9) |
| 26 | 05/04/86 | 8.30 | 7.20 | 1.10 | 6.85 | 0.3 |
| 27 | 12/04/86 | 9.30 | 3.70 | 5.60 | 6.87 | 1.6 |
| 28 | 19/04/86 | 11.40 | 8.60 | 2.80 | 6.98 | 1.1 |
| 29 | 26/04/86 | 8.80 | 6.80 | 2.00 | 7.06 | (1.1) |
| 30 | 03/05/86 | 7.20 | 6.30 | 0.90 | 6.98 | 0.3 |
| 31 | 10/05/86 | 8.90 | 7.60 | 1.30 | 7.00 | 0.4 |
| 32 | 17/05/86 | 10.60 | 3.70 | 6.90 | 7.03 | 1.1 |
| 33 | 24/05/86 | 7.80 | 4.00 | 3.80 | 7.11 | 1.7 |
| 34 | 31/05/86 | 10.10 | 7.30 | 2.80 | 7.23 | 1.1 |
| 35 | 07/06/86 | 7.30 | 4.00 | 3.30 | 7.31 | (0.7) |
| 36 | 14/06/86 | 11.10 | 7.00 | 4.10 | 7.26 | 0.8 |
| 37 | 21/06/86 | 12.20 | 8.00 | 4.20 | 7.32 | 1.0 |
| 38 | 28/06/86 | 12.30 | 7.00 | 5.30 | 7.39 | 1.6 |
| 39 | 05/07/86 | 15.20 | 7.60 | 7.60 | 7.51 | 2.7 |
| 40 | 12/07/86 | 13.90 | 7.30 | 6.60 | 7.71 | 4.7 |
| 41 | 19/07/86 | 15.20 | 4.40 | 10.80 | 8.07 | (37.7) |
| 42 | 26/07/86 | 23.50 | 7.50 | 16.00 | 5.03 | 20.9 |
| 43 | 02/08/86 | 24.00 | 20.80 | 3.20 | 6.08 | (17.6) |
| 44 | 09/08/86 | 17.50 | 10.30 | 7.20 | 5.01 | 6.8 |
| 45 | 16/08/86 | 15.40 | 6.00 | 9.40 | 5.35 | 7.7 |
| 46 | 23/08/86 | 18.20 | 3.80 | 14.40 | 5.76 | 8.7 |
| 47 | 30/08/86 | 20.40 | 9.90 | 10.50 | 6.26 | 9.7 |
| 48 | 06/09/86 | 22.80 | 13.60 | 9.20 | 6.87 | 1.9 |
| 49 | 13/09/86 | 12.90 | 11.70 | 1.20 | 7.00 | (19.4) |
| 50 | 20/09/86 | 14.80 | 3.10 | 11.70 | 5.64 | 12.9 |
| 51 | 27/09/86 | 20.10 | 6.00 | 14.10 | 6.37 | 11.3 |
| 52 | 04/10/86 | 22.30 | 5.60 | 16.70 | 7.09 | 7.8 |
| 53 | 11/10/86 | 22.80 | 5.00 | 17.80 | 7.64 | 8.6 |
| 54 | 18/10/86 | 22.60 | 2.60 | 20.00 | 8.30 | 12.7 |

### 11.2: *Continued:* Weekly Foreign Exchange Auctions 1985 - 87

| Week | Date | Bid Amount (US $ mil) | Allocated Amount (US $ mil) | Excess Demand (US $ mil) | Exchange Rate (K/$) | Depreciation (%) |
|---|---|---|---|---|---|---|
| 55 | 25/10/86 | 17.30 | 4.10 | 13.20 | 10.32 | 10.4 |
| 56 | 01/11/86 | 13.80 | 4.00 | 9.80 | 11.51 | 11.5 |
| 57 | 08/11/86 | 12.20 | 4.20 | 8.00 | 12.30 | 6.9 |
| 58 | 15/11/86 | 11.30 | 4.20 | 7.10 | 13.48 | 9.6 |
| 59 | 22/11/86 | 8.40 | 4.10 | 4.30 | 14.68 | 8.9 |
| 60 | 29/11/86 | 7.20 | 4.10 | 3.10 | 15.25 | 3.9 |
| 61 | 06/12/86 | 5.60 | 4.10 | 1.50 | 12.10 | (20.7) |
| 62 | 13/12/86 | 12.40 | 4.00 | 8.40 | 11.90 | (1.7) |
| 63 | 20/12/86 | 8.40 | 4.00 | 4.40 | 12.50 | 5.0 |
| 64 | 27/12/86 | 6.60 | 4.10 | 2.50 | 12.71 | 1.7 |
| 65 | 03/01/87 | 5.70 | 4.10 | 1.60 | 12.97 | 2.0 |
| 66 | 10/01/87 | 9.90 | 4.10 | 5.80 | 13.51 | 4.2 |
| 67 | 17/01/87 | 8.90 | 4.00 | 4.90 | 14.12 | 4.5 |
| 68 | 24/01/87 | 8.90 | 4.80 | 4.10 | 14.92 | 5.7 |
| **Auction suspended for 8 weeks** | | | | | | |
| | 28/03/87 | | | | | 15.00 |
| | 04/04/87 | | | | | 16.99 |
| | 11/04/87 | | | | | 18.75 |
| | 16/04/87 | | | | | 19.95 |
| | 26/04/87 | | | | | 21.01 |
| | 02/05/87 | | | | | 15.00 |

**Source:** Aron and Elbadawi (1992)

### Box 11.1: Selected Operational Guidelines of Foreign Exchange Auction

- A foreign exchange management committee (FEMAC), chaired by the General Manager (BoZ), administered the auction in line with an approved foreign exchange budget. The Committee conducted fortnightly/weekly foreign exchange auctions as well as make allocations outside the auction system.
- Only users not directly allocated foreign exchange from the budget were allowed access to the auction.
- Participation to the auction was restricted to commercial banks acting on behalf of their customers. Foreign exchange bids from commercial banks were required to indicate the precise amount of Kwacha a client was willing to pay per US dollar and the purpose for which the foreign exchange was required.
- At the time of placing bids, customers were required to pay to the commercial banks the full value of their foreign exchange application.
- Each commercial bank was required to consolidate its customers' foreign exchange requests and tender bids on its customers' behalf. The banks were further required to provide customer identifying information, bid prices, and value and type of transactions involved. Commercial banks were required to ensure that their customers' bids were supported by documentary evidence such as proforma invoices, import licenses, and/or Exchange Control approval by the BoZ.
- Bids were lodged by the commercial banks with the FEMAC Secretariat on a prescribed form not later than 09:00hrs on Thursday.
- Commercial banks were required to hold the consolidated amounts of total bids for an auction in designated accounts with the BoZ.
- The FEMAC secretariat sorted, classified and consolidated all the received bids from commercial banks.
- They met at 15:00 hrs on Friday to price the available foreign exchange.
- The price of foreign exchange at each auction was determined by the marginal bid which was the bid that fully exhausted the available foreign exchange. The marginal bid was the ruling foreign exchange rate until the next auction.
- Applicants whose bids exceeded the marginal bid were allocated the amount of foreign exchange requested at the price struck at the auction.
- The foreign exchange provided by the BoZ would be held by commercial banks against the successful bidder's external payments obligations in earmarked accounts with all interest earned being surrendered to the BoZ.
- Commercial banks sold foreign exchange to successful bidders at the BoZ approved spread.
- The BoZ reserved the right to reject any bid without assigning reasons.

# 3.9 Financial Inclusion and Financial Literacy in Zambia: Some Critical Lessons from the Global Trends

**Sumbye Kapena***

**Abstract**

Since the dawn of modern economic development thought in the 1940s, interest in understanding the nature and usefulness of financial inclusion for important economic outcomes has been growing. This paper reviews the key theoretical, empirical and policy developments that have taken place from that time to date on this subject with the purpose of drawing useful lessons for Zambia, in particular, and other developing countries in general.

**Key words: Financial inclusion, financial literacy, financial education.**

## 1. Introduction

From time immemorial, human society has been concerned with finding the best ways of bringing about desired economic outcomes. Once such ways are identified, attention is turned to finding the key factors that influence those ways, and consequently how to encourage those with positive influence and how to deal appropriately with those that have negative influence.

One of the important ways of bringing about desired economic outcomes discovered long ago is financial inclusion. Broadly defined, financial inclusion is the situation where everyone in society has access to and enjoys the benefits of a well-functioning financial system. This definition presupposes that there is a possibility of some people in society being excluded from the best financial system. Thus, financial inclusion also implies finding ways of ensuring that no one is excluded and those who might be currently excluded get included.

There is no single definition of financial inclusion. However, each of the definitions carries the same underlying meaning mentioned above, thus differing only in the breadth and depth in which certain aspects of the dimensions of financial inclusion are covered. The following frequently used definitions of financial exclusion and financial inclusion might illustrate the point just described. McKillop and Wilson (McKillop and Wilson, 2007, p. 9) define financial exclusion as 'the inability, difficulty or reluctance of particular groups to access mainstream financial services'. Leyshon and Thrift (1995) define financial exclusion as referring to those processes that serve to prevent certain social groups and individuals from gaining access to the formal financial system.

Claessens ( 2006, p. 210), defines financial inclusion as 'availability of a supply of reasonable quality financial services at reasonable costs, where reasonable quality and cost have to be defined relative to some objective standard, with costs reflecting all pecuniary and Non-pecuniary costs'. Lastly, Demirguc-Kunt and Levine (Demirguc-Kunt and Levine, 2008) define financial inclusion as the absence of price and non-price barriers.

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Because of overwhelming empirical evidence, financial inclusion has come to be accepted as one of the factors that exert positive influence on key economic outcomes. For instance, financial inclusion has been found to enable poor people manage their irregular incomes, resulting from such shocks as droughts and illnesses. This leads to the poor managing to maintain consumption at healthy levels. Financial inclusion also enables the poor to protect themselves against potential crises from the shocks they face, or at least mitigate the effects of the crises that befall them. Financial inclusion also enables the poor build assets and consequently increase their income and afford to pay for things that promote wellbeing, including shelter, water, food, health services, clothing, and education (Imboden, 2005).

Following such overwhelming evidence of the importance of financial inclusion for desirable economic outcomes, attention has generally turned to identifying and understanding the nature of the factors that constrain or boost the effectiveness of financial inclusion respectively.

This paper discusses the current scholarly and policy debate on financial inclusion in the context of the field of economic development, using the strand that has come to be known as modern economic development. The field of economic development is concerned with determining why poor countries are poor and what can be done to help them get out of poverty, with special attention made on categories of poor people within respective developing countries. The paper traces the debate on financial inclusion, during the modern economic development era, from the time that one factor (saving) was prescribed as the factor to focus on if desired levels of financial inclusion were to be attained, to the period when multiple financial factors (rather than only saving) were prescribed to be taken into account if desired levels of financial inclusion were to be attained, through to the current period when once again one factor (this time, financial literacy) is being recommended, by a group of renowned policy makers, to receive special attention as the factor that ,possibly, exerts the greatest positive influence on financial inclusion.

The paper cautions that the return to focusing on one determinant (financial literacy) of financial inclusion, that came about following the 2007-2009 global financial crisis, could be a negative disruption of the progress that had been made on how multiple factors interact to promote financial inclusion that , in turn, influences economic development. Among the approaches that had benefitted from the multifactor analysis of financial inclusion was the Millennium Development Goals (MDGs) paradigm.

The paper observes, further, that the current global policy response that has been recommended by the leading international organisations and countries is only a work in progress to which the participants have been requested to make empirical based proposals for further improvements. To this effect, the paper cautions participating countries not to neglect the other policies that have already been known to contribute positively to financial inclusion, both in the case where these countries are spending their own funds and the case where external funding is being provided to support the current policy. Zambia has been particularly cautioned because it is among the few countries that have made tremendous progress in the new policy direction, posing the potential danger of overspending its meagre resources on this policy, to the relative neglect of already proven poverty reducing policies

This paper is first and foremost addressed to the Bank of Zambia, being the organization that has been given the task of coordinating the new financial inclusion policy process. Secondly, the paper is addressed to other policy making bodies that are part of the leadership of the new financial inclusion policy in Zambia, such as the various Government Ministries involved. Finally, the paper is addressed to all the institutions and individuals that have stake and/or interest in the new policy process of financial inclusion in Zambia or other developing countries and emerging market countries.

The rest of the paper is structured as follows. Section two presents a review of literature on the theoretical, empirical and policy developments on the subject of financial inclusion covering the period from the beginning of modern economic development, in the early- to-mid-1940s, to the period of the Millennium Development Goals in the early- to- mid-2000s.This is the period when economic policy prescription moved from focusing on one determinant of financial inclusion, namely saving, to giving consideration to all determinants of financial inclusion.

Section three gives evidence that financial literacy had never been treated as a special factor in influencing financial inclusion before the 2007-2009 global financial crisis. After presenting empirical evidence, the section discusses the key variables that most respondents in empirical studies reported to be important in influencing financial inclusion.

Section four reviews the literature regarding the ongoing global policy response to financial exclusion since its inception in the 2007-2009 global financial crisis period. This period has seen a return to focusing on one determinant of financial inclusion, in this case, financial literacy. During this period, there has been a call for global economies to take a coordinated policy response to the problem of financial exclusion, initiated by international organizations and spearheaded alongside the G20 countries, that takes financial literacy as the key determinant of financial inclusion. The section starts by describing the new policy guidelines and analytical frameworks. It then gives critiques on a number of aspects of the new policy response. The section ends by making a recommendation in the light of the findings presented in it.

Section five reviews Zambia's on-going financial inclusion and financial literacy policy process being done along the guidelines provided by the new global policy response to financial inclusion principles and frameworks. After the review, the section commends the great achievements made by the Country in the short period that it has implemented the policy prescriptions. The section then goes on to caution the Country regarding the possibility of diverting larger amounts of resources, than would be necessary, to the new policy and risk neglecting the existing policies whose effectiveness in stimulating economic development is well established. This caution is in view of a number of weaknesses of the new policy, discussed in various sections of the paper, and the fact that Zambia is among the few countries in the world that are highly committed to implementing the prescriptions of the policy. For instance, Zambia was among the first 25 countries that had their National Strategies on Financial Education ready by February 2012 (a number that rose only to 45 in 2013 (OECD, 2013) out of about 108 countries that were willing to avail themselves for empirical studies related to the new global policy process (AFI, 2013). Section six gives the conclusion and recommendation.

## 2. Review of Literature on the Theoretical, Empirical and Policy Developments on the Subject of Financial Inclusion, from the 1940s to the 2000s

The current scholarly debate on financial inclusion, generally defined as bringing into the financial market people who had hitherto been excluded, may trace its origin to the dawn of modern economic development thinking. Modern economic development thinking is normally traced to the early-to-mid 1940s when attention was turned to improving economic conditions in the colonies of Western countries to avoid decent and possible adoption of development ideas of communist countries by these colonies (Lewis, 1954).

The reparation of Eastern Europe following the devastation of the Second World War that ended in 1945 was another motivation for the commencement of modern economic development era. The World Bank and the International Monetary Fund were consequently established in 1945 and 1946, respectively, by the world community, under the auspices of the United Nations, as organizations to spearhead and implement the development agenda (Arndt, 1989). The rest of this section reviews the key developments concerning financial inclusion that took place under the various economic development paradigms that existed from mid 1940s to late 2000s.

### 2.1 Developments under Keynesianism

The paradigm that gave birth to modern economic development thinking was Keynesianism. Keynesianism arose following the failure of the Western economies to recover from a prolonged depression through the automatic operation of the market forces of supply and demand as predicted by the previous paradigm, the classical economics. The prolonged depression ran from the 1920s to the early 1930s and was dubbed the Great Depression (Blaug, 1986).

The dominance of Keynesianism lasted from1950 to1973, a period dubbed the "Golden years of capitalism". Unlike classical economists who proposed that the economy was capable of correcting itself without government intervention through the operation of the market forces of supply and demand, John Maynard Keynes recommended that the government should get involved in economic activities by injecting into it an additional investment component to supplement that of private investors. This would boost aggregate demand and finally move the economy out of depression (Samuelson, 1946).

Keynesianism, being a product of prolonged economic depression took the economy as being characterised by such high levels of labour unemployment that there was believed to be excess (or surplus) labour in the economy. Since the most important factors of production were labour and capital, under this condition of economic depression all a country needed to be concerned with was capital. Since capital is created through investment, having adequate levels of investment is what every country was to concern itself with. In turn, since saving is the main source of investment, promotion of saving was to be an important policy. The Keynesian-based Harrod-Domar model, provided policy guidance during the period of Keynesianism. According to Harrod-Domar model, all a country was supposed to do was determine the rate of saving and its corresponding capital output ratio, which when presented as a ratio (the saving rate, capital output ratio) would constitute the optimum or equilibrium growth rate for the country involved.(Keynes, 1936; Harrod, 1939; Domar, 1946).

When Keynesian thinking was extended to the colonies or developing countries, the idea of focusing on boosting capital, given excess labour, was maintained, and promotion of saving was an important policy. In addition, governments were advised to plan their economies in such a way that they would maintain the right ratio between the saving rate and the capital output ratio so that equilibrium economic growth rate would be maintained. The industrial sector was supposed to be promoted, among other processes, through drawing labour from the agricultural sector that was believed to have excess labour and was backward (Lewis, 1954; Rostow, 1960).

Under Keynesianism a country was expected to attain a high level of economic growth. The high national income attained through economic growth would then be redistributed to every member of the country through a trickledown effect, operating mainly through employment and the corresponding multiplier effect of expenditure by the income earners.

However by the end of the 1960s a lot of doubt was cast on Keynesianism. In the area of general economics, it was proposed to discard Keynesianism because it was prone to instability. This characteristic was based on its reliance on one factor, capital (both the saving ratio and the capital output ratio in the Harrod-Domar model related to capital). Thus, if there was a problem with capital, labour would not come in to substitute for it. This implied that the national income had a very narrow and unstable path of growth to follow. Such a narrow path was a problem and was dubbed "the knife-edge " (or even razor edge) path (Mankiw, Romer and.Weil,1992).

In the field of economic development, Keynesianism was discarded because, although policies recommended by it helped countries attain high levels of growth, this growth did not trickle down to benefit the majority of the people. Instead poverty became even more widespread (Hunt, 1989; Meier, 1984).

### 2.2 The Basic Needs Approach

The basic needs approach to development was the paradigm of economic development that arose following the failure of the benefits of economic growth, from Keynesian-based policies, to trickle down and help reduce poverty. The basic needs approach aimed to distribute the benefits of economic growth to the majority of the people in the countries concerned. In other words, unlike Keynesianism, basic needs approach has more micro-level focus than macro. The basic needs approach was dominant throughout the 1970s, starting around 1974.[1]

With a strong origin at the Sussex University's Institute of Development Studies (IDS) and with strong support from the International Labour Organisation (ILO) and the World Bank (Seers, 1969; Morse, 1971; ILO, 1972, 1976; UlHaq, 1971; McNamara, 1972, 1973), the basic needs approach was guided by the following tenets, among others:

- Basic needs were broadly defined to include what are considered traditional needs (such as, water, food and nutrition, shelter, clothing, primary health care), basic education, basic services to the poor (e.g. agricultural extension), road infrastructure in poor areas, employment, and income equality.
- Redistribution of benefits of growth to the poor was to be achieved through creation of employment suitable to them. This was to most informal employment. Thus, informal employment was no longer looked down upon.
- Very high economic growth rate was no longer the focus. Rather, modest economic rates of economic growth of around 6 per cent were considered to be adequate.

Of special importance for financial inclusion was the policy of cheap credit for the poorer segments of society. The idea of vicious circle (or vicious cycle) of poverty was behind this policy. The vicious circle of poverty thesis maintained that the poorest segments of society were trapped in the vicious circle of poverty because they were too poor to save. It was explained that the vicious circle persisted because it was self-reinforcing as follows: because someone has little income (that is, is poor), they cannot save; because they cannot save, they cannot invest; because they are not investing, they are not creating capital; because they are not creating capital, they cannot increase their income; therefore, they remain poor.(Nurkse,1953). Besides the governments, international donor institutions also gave cheap credit to the poor, especially for agricultural purposes. Microcredit institutions became prominent during this time, one of them being the Grameen Bank in Bangladesh started by Muhammad Yunus, a Nobel Prize Winner for starting and running this bank

[1]A paper making a general discussion of evolution of economic development models would have said something about the non-capitalist contexts chosen by a number of developing countries in the 1970s after experiencing disappointment with Keynesianism, such as neo-Marxism and Dependencia.

(Yunus, 2003; Latifee, 2003).

The cheap credit policy finally failed, for a number of reasons. One of the reasons was that governments enacted the policy that ordered formal lenders to lower interest rates to levels that would not cover their costs (the repression policy). Another reason for the failure of cheap credit was that governments could no longer afford to subsidise it when global economic problems of the 1970s, such as the rise in the price petroleum products on the world market, led to sharp increase in production costs in the domestic economies. As a matter of fact, governments had resorted to borrowing for the purpose of subsidising the credit for the poor but their debt finally reached unsustainable levels. Further, the cheap credit policy failed because the poor borrowers had no investment opportunities, as the concept of microenterprise was not yet well developed. Therefore, much of the credit money was spent on consumption. Also, in some cases, those who were given cheap credit treated it as a gift, rather than something to repay with interest on top. (Bouman and Hospes, 1994; Seibel, 1994; Adams and Von Pischke,1994, Bouman, 1990).

### 2.3 Neoclassical Counter-revolution

Neoclassical counter revolution was basically a reaction to the weakness of Keynesianism that itself was developed as a revolution against the ideas that had been forwarded by classical economists. However, neoclassical counter revolution also critiqued aspects of the basic needs approach, as explained below. The dominance of neoclassical revolution lasted through the 1980s.

At the general economics level, neoclassical counter revolution was an effort to correct the instability of the Keynesian model caused by focusing on capital alone (described above). The correction came through justifying the substitutability between labour and capital using Solow's (1956) growth model as a starting point (Solow, 1956; Mankiw, Romer and Weil,1992; Lucas, 1988). The model also sought to correct the problem of state intervention that was practiced in both Keynesian and basic needs approach. Neoclassical counterrevolution now placed more responsibility on individuals for many functions that government had been doing for them under Keynesianism or under the basic needs approach paradigm.

Neoclassical counter revolution also brought a strong macro-level focus with micro-foundations, unlike the basic needs approach that was basically of micro focus. The reforms that neoclassical counter-revolution brought about was later (1989) dubbed the Washington Consensus by British Economist (Williamson, 1989). The same reforms are also referred to as Structural Adjustment Programme (SAP). The basic nature of the reforms was bringing back the market forces to guide the economy rather than leaving this function in the hands of the government. Thus, the key components of the reform included privatisation, freeing prices of goods and services, and deregulation.

Of special importance to financial inclusion under this paradigm were the following points:

- Turning the focus back to saving from the failed cheap credit policy. Empirical research proved wrong the vicious circle adage that the poor people were too poor to save. Instead it was discovered that the poor habitually saved except that they used informal methods that were normally group based. With this knowledge, attention was turned to finding ways of helping the poor access formal banks (Deaton, 1992; Rutherford, 1999 ).
- Encouragement of microenterprise after it was realised that one reason cheap credit policy had failed was that the poor people who received credit had no investment ventures (Schmidt, and Kropp, 1987; Hannig, A., 1998).
- Client-centred financial business models were developed. Microcredit institutions had

learnt lessons from the problems of extending cheap credit to financial product consumers. Now they knew that client-centred business approach was the best way to go. Client-based business approach or model is whereby the business people start by finding out what products the consumers would want and of what nature and from there design products that would be suitable to the consumers. (Barnes, 2001; Chen and Snodgrass 2001).

### 2.4 The Millennium Development Goals

The Millennium Development Goals (MDGs) are a paradigm of economic development that was first implemented in 2000, with the aim of achieving the goals by the year 2015. The MDGs comprise eight goals namely: (i). To eradicate extreme poverty and hunger, (ii). To achieve universal primary education, (iii). To promote gender equality and empower women, (iv). To reduce child mortality, (v). To improve maternal health, (vi). To combat HIV/AIDS, (vii). To Ensure environmental sustainability, (viii). To develop a global partnership for development (United Nations, 2000; Fukuda-Parr and Hulme, 2011; Hulme and Scott, 2011).

The MDGs were born from the realisation that neoclassical counter revolution (SAP/Washington consensus) prescriptions, like Keynesianism helped countries attain high levels of economic growth but that the benefits of such growth did not trickle down to the majority of the people, leading to widespread poverty levels. The MDGs paradigm, in many ways, is a rebirth of basic needs approach but without government interventions. Its basic premise is that poverty is a multidimensional problem that ,therefore, needs a multipronged approach to attack it. Among the many potential causes of poverty included are those related to the basic needs as defined by the basic needs approach.

It has been observed by many researchers that the basic concept of basic needs crept back into the global policy process in 1990 in the form of Human Development Reports that have since been presented annually by the UNDP (UNDP, 1990). It is also observed that in a sense the Human Development Report is a more sophisticated way of presenting the basic needs. The indices reported in the Human Development Reports have also been getting more and more sophisticated since the first Human Development Index of 1990 (Stanton, 2007; Sen, 2000; Anand and Sen, 1994). Among the means of combating poverty recommended in the MDGs paradigm is for the poor to have access to a wide range of assets, including financial assets (Bonfiglioli, 2003). Put differently, financial inclusion has been taken to be an effective tool for achieving the Millennium Development Goals (Claessens and Feijen, 2007).

According to empirical studies conducted in the late 1990s and early 2000s, poor people actually had access to and used a wide range (of up to thirty) of informal financial products and that when a narrower range of formal financial products were introduced, they made up for the gap in the range by sticking to some informal products (Rutherford 2002, Dunn and Arbuckle, 2001). The challenge for policy makers, who aimed to help the poor escape the weaknesses of informal financial products, was to be creative enough to introduce an adequate number of financial products to at least equal the range of informal products in use. Another important point to mention is that client-centred financial product business models continued to be encouraged under the MDGs paradigm in order to continue supporting micro, small and medium enterprises (MSMEs) (Conroy, 2008; Littlefield, Murduch and Hashemi, 2003; United Nations, 2006; Ramji, 2007).

## 3. Evidence that Financial Literacy had Never been Treated as a Special Factor in Influencing Financial Inclusion before the 2007-2009 Global Financial Crisis

In this section we give some pieces of evidence that show that while studies on financial inclusion was widespread during the period before the 2007-2009 global financial crisis, financial literacy was not treated as its special determinant in any way. This contrasts with the way financial literacy has being treated in the new global policy response to financial exclusion led by, among others, the G20 member countries after the 2007-2009 global financial crisis. At the same time, the evidence on the period before the 2007-2009 global financial crisis shows that financial inclusion in developed countries (where financial literacy was found to be insignificant) was quite high (later found to be on average 89 per cent -Demirguc-Kunt and Klapper, 2012), suggesting that other factors might have been more significant in explaining changes in financial inclusion than financial literacy or that, at best, financial literacy might only have been as good at as the other factors in explaining the changes in financial inclusion, but not better than them.

### 3.1 Empirical Evidence

There appears to be strong empirical evidence that financial literacy was not treated as a special determinant of financial inclusion during the period before the 2007-2009 global financial crisis. A few examples given below support this observation. In their review of empirical work on financial inclusion, Deb and Kubzansky (2012) discovered that, throughout the world, there was very little that had been done regarding financial education during the period before the 2007-2009 global financial crisis and that the little financial education that was provided was not effective in imparting financial literacy.

Likewise, Bernheim and Garrett (2003) established, after their review, that most consumer financial literacy programs, that were implemented almost exclusively in developed countries, started only in the late 1990s or early 2000s while the record of studies and policy on financial inclusion was much older. The OECD (2009), for its part, made the observation that financial literacy and consumer protection were aspects of the 2007-2009 global financial crisis that had been overlooked by researchers and policy makers.

### 3.2 Variables typically reported to be important in influencing Financial Inclusion

The variables typically reported by respondents in empirical studies on financial inclusion during the period before the 2007-2009 global financial crisis also give a clue on how financial literacy was treated during that period. Our literature review on this score has revealed that financial literacy was found to be just one of the many variables that respondents reported to be determinants of financial inclusion, and not more important than others factors.

Below, we present a list of variables that were often reported by respondents as being determinnats of financial inclusion, according to a large number of researchers, including Kempson and Whyley (1999a, 1999b); Schoombe, A. (2000); Carbo et al. (2007) and Sarma, M. (2008).

Typical supply side determinants and corresponding forms of exclusion of financial exclusion of the poor often reported were:

- ***Geographical exclusion***: e.g. resulting from branch closures;
- ***Condition exclusion***: e.g. failure to qualify regarding minimum deposit required, poor credit history, or unclear identity;
- ***Price exclusion***: e.g. the relative cost of financial products and services such as
- ***Marketing exclusion***: i.e. some less profitable groups of customers are not targeted by financial product providers and so the customers are not aware of the financial products and services available;
- Self-exclusion: i.e. cultural and psychological barriers. Some people, without even trying, rule themselves out regarding some financial services. Such behaviour could be a result of how they were mistreated in the past or how people of the same status as they were mistreated.

Typical costs that financial suppliers feared to incur if they served the most disadvantaged poor (which actually prompted them to erect the exclusion barriers described above) were found to be:

- ***High risk***: Serving the poor customer carry potential high risk. The reasons include lack of records about the customers' behaviour;
- ***Lack of collateral*** : The poor normally do not have sufficient forms of conventional title to submit as collateral;
- ***Sustainability***: The means of repaying loans that poor customers have, such as small businesses, normally create very little income, that is at the same time uncertain;
- ***High operating costs***: This includes those relating to the transaction costs resulting from too many transactions as the poor customers bring the small amounts of money from their many ventures that generate very little income each.

Typical demand-side barriers, that is those for which the suppliers have no hand in creating, have been found to be:

- ***Cultural*** : e.g. gender financial role where, for instance, only husbands are expected to open an account;
- ***Low and irregular incomes***: implying frequent small transactions with the banks;
- ***Low awareness of the existence of financial products***: The implication here is that those who need particular services (the customers) are the ones to bother to find out where those services are (just as it is the duty of the sick person to seek and find the doctor).
- ***Low financial literacy; and***.
- ***Consumer mistrust of financial institutions***. For instance, that banks are not stable in many ways.

## 4. Review of the Literature on the Ongoing Global Policy Response to Financial Exclusion Since its Origin in the 2007-2009 Global Financial Crisis Period

In this section, we give a brief review of the literature the ongoing global policy response to financial exclusion since its origin in the 2007-2009 global financial crisis period. This policy response was initiated by some renowned international organizations and spearheaded alongside the G20 member countries. This policy is a return to focusing on one determinant of financial inclusion, in this case, financial literacy, reminiscent of the hey days of Keynesianism when saving was prescribed as the most important factor in influencing financial inclusion. This is a departure from the practice during the time of the Basic Needs Approach Paradigm and even from the multipronged attack on causes of poverty prescription of the ongoing Millennium Development Goals paradigm.

This section aims to show the reader the three main achievements of the current global policy response to financial inclusion, namely:

i. To describe the dimensions of financial inclusion (as the dependent variable) that researchers might focus on in any given study);

ii. To give a broad framework that can be used to design a process (financial education) that can lead to the type of financial literacy (the output) that would be effective in influencing financial inclusion.

It is important for the reader to know that the designers of the frameworks for both financial inclusion dimensions and financial education have made it clear that the underlying model that is guiding the new global policy process is not yet complete but rather is in the process of evolving. To this effect, there has been a clear call to every country that is trying to implement the policy to contribute to the ongoing studies aimed at making required contributions for the improvement to the evolving model.

### 4.1 Financial Inclusion: General principles and frameworks

Work on the general principles and frameworks on the dimensions of financial inclusion started in earnest in 2009 when G20 Leaders established the Financial Inclusion Experts Group (FIEG) as the main mechanism for implementing the *Financial Inclusion Action Plan*. In 2010, the G20 leaders endorsed The Principles for Innovative Financial Inclusion. The same year, the G20 leaders endorsed the first *Financial Inclusion Action Plan.*

Later in the same year, FIEG was replaced by the Global Partnership for Financial Inclusion (GPFI) as the main mechanism for implementing the *Financial Inclusion Action Plan*. The GPFI was expected to function as an inclusive platform for G20 countries, non-G20 countries, and relevant stakeholders for peer learning, knowledge sharing, policy advocacy and coordination. Since then, the *Financial Inclusion Action Plan* has been used as a guide when setting priorities. The priorities, thus set, in turn lead to the formulation of a GPFI Working Plan for the subsequent calendar year.

The G20 Principles of Innovative Inclusion comprise nine subjects namely, leadership, diversity, innovation, protection, empowerment, cooperation, knowledge, proportionality, and framework. The G20 Principles for Innovative Inclusion seek to provide guidance to nations and cooperating institutions globally on putting into action the commitments and strategies for promoting financial inclusion, particularly in developing countries and emerging market economies. The important components of the financial inclusion principles and frameworks are described below.

### 4.1.2 The global partnership for financial inclusion (GPFI)

The GPFI implementing partners are Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), the International Finance Corporation (IFC), the Organisation for Economic Cooperation and Development (OECD) and the World Bank.

In order to streamline its work, the GPFI has established four sub-groups, namely Sub-group on the G20 Principles and Standard Setting Bodies (SSBs), Sub-group on SME Finance, Sub-group on Financial Inclusion Data and Measurement, and Sub-group on Financial Literacy and Financial Consumer Protection. The last sub-group is the most recent having been formed in March 2013.

The Sub-group on the G20 Principles and Standard Setting Bodies (SSBs) is charged with the task of ensuring that the Principles for Innovative Financial Inclusion are put into practice. The Sub-group on SME Finance is given the task of innovative development of SMEs which involves, among other things, improving SME access to finance in the poorest countries, improving access to finance for agricultural SMEs, and promoting access to finance for women entrepreneurs.

The sub-group on Financial Inclusion Data and Measurement is given the task of supervising the process of improving the quality of data and other measurement issues. This process includes getting a consensus of definitions and methodologies to use while allowing for flexibility within the broad parameters of agreements. An important output of this sub-group is the set of financial inclusion indicators that was first published under the name G20 Basic Set of Financial Inclusion Indicators (also just called the Basic set), endorsed and put on trial in 2011 but only officially launched in June 2012. Over the years, improvements have been made to the indicators in the Basic Set both in terms of quality and number to reflect most recent understanding. The subsequent groups of indicators are therefore no longer referred to as basic, but rather carry other names such as G20 Financial Inclusion Indicators, endorsed in June 2012 and currently on trial.

It is important to mention here that member organizations have a lot of independence in this area resulting in the fact that there several parallel sets. For instance, the G20 Basic Set of Financial Inclusion Indicators has had parallels such as the AFI's Core Set suggested by AFI's Financial Inclusion Data Working Group (FIDWG), and the World Bank Financial Inclusion Index, respectively.

The newly formed (March, 2013) Sub-group on Financial Literacy and Financial Consumer Protection has been given the task of designing measures to capture the demand side of financial inclusion that so far has lagged behind compared to the supply side.

### 4.1.3 The Maya Declaration

Internationally, the Alliance for Financial Inclusion (AFI) has been the largest network of developing countries, emerging market economies and international organizations involved in the debate and implementation of financial inclusion related policies.

The AFI was founded in 2008 as a Bill & Melinda Gates Foundation-funded project, with support from Australian Aid (AusAid). Members of the AFI meet annually at the Global Policy Forum (GPF) to deliberate on important issues. An important output of the IFI was the Maya Declaration, that was adopted at the GPF meeting of 2011 in Riviera Maya in Mexico.[2]

Countries that sign the Maya Declaration agree to make measurable commitments in four

[2]Although the practice has been to name subsequent Declarations after the cities hosting the meetings where the Declarations are made, e.g. Cape Town Declaration, and Bali Declaration, it has been a tradition to generally refer to all these Declarations as Maya Declaration.

broad areas, aligned with the G20 Principles for Innovative Financial Inclusion, and are important for financial inclusion. These are:

- To create an enabling environment to harness new technology that increases access and lowers costs of financial services;
- To implement a proportional framework that advances synergies in financial inclusion, integrity, and stability;
- Integrate consumer protection and empowerment as a key pillar of financial inclusion; and
- To utilize data for informed policymaking and tracking results.

Countries that sign the Maya Declaration also agree to be guided by three core values, namely:

- Self-determination;
- Peer-to-peer knowledge exchange; and
- New forms of international cooperation.

### 4.1.4 Strategies for national financial education: Principles and frameworks

The subject of national financial education strategies is about financial literacy. Financial education and financial literacy are closely related in that financial education is the process while financial literacy is the expected output of that process. Thus, the definition of financial education developed by the OECD (2005) and endorsed by G20 leaders in 2012 for use by all countries following current global financial inclusion guidelines is that it is:

"*the process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being.*"

Similarly, OECD (2005), defines financial literacy as *"the combination of consumers'/investors' understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being"*.

### 4.1.4 OECD/INFE HIGH-level Principles on National Strategies for Financial Education

All members of the world community that have united in dealing with financial inclusion issues in a coordinated manner under the new global policy response are expected to design respective national strategies for financial education based on common broad principles. The OECD/High-level Principles on National Strategies for Financial Education (hereafter to be also referred to only as OECD/High-level Principles) have been endorsed as such common guidelines to use.

The OECD/INFE High-level Principles were developed by the OECD International Network on Financial Education (OECD/INFE) and endorsed in 2012. The OECD/INFE comprises all the G20 members and other countries (all together 100) as well as various international institutions.

The OECD/INFE High-level Principles was a culmination of a series of other OECD/INFE guidelines and are expected to be implemented in conjunction with these guidelines. Among such guidelines are those found in the following publications:

- OECD (2005) Recommendation of the Council on Principles and Good Practices on Financial Education and Awareness;
- OECD (2008) Recommendation of the Council on Good Practices for Financial Education relating to Private Pensions;
- OECD (2008) Recommendation of the Council on Good Practices for Enhanced Risk Awareness and Education on Insurance issues;
- OECD (2009) Recommendation of the Council on Good Practices on Financial Education and Awareness relating to Credit;
- OECD/INFE (2011) High-level Principles on the Evaluation of Financial Education Programmes and dedicated Guides on Evaluation; and
- OECD/INFE (2012) Guidelines for Financial Education in Schools.

The OECD/INFE High-Level Principles on National Strategies for Financial Education instruction manual were published in 2012. The main components of the guidelines are as follows:

**I. Definition, scope and purpose**

A national strategy for financial education is defined as “a nationally co-ordinated approach to financial education that consists of an adapted framework or programme, which:

- Recognises the importance of financial education
- Involves the cooperation of different stakeholders as well as the identification of a national leader or co-ordinating body/council
- Establishes a roadmap to achieve specific and predetermined objectives within a set period of time ,
- Provides guidance to be applied by individual programmes in order to efficiently and appropriately contribute to the NS.

II. Preparation of national strategy: defining its scope through assessment and consultancy.

This part comprises: (a). Mapping and evaluation of existing initiatives; (b). Assessments of the needs of the population and main policy issues; (c ).-Consultation ; and (d). National awareness and communication

III. Government mechanisms and role of main stakeholders in the national strategy

This part comprises: (a). Leadership and governing structure; and (b). Co-ordination and the roles and responsibilities of various stakeholders.

IV. Road map of national strategy: Key priorities, target audience, impact assessment and resources

This part comprises: (a). Common defined objectives and policy priorities; (b). Target audiences; (c ). Overall Impact Assessment; and (d). Resources.

V. Implementation of national strategy: Delivery mechanisms and evaluation of programmes

This part comprises:

**(a). Delivery methods, training and tools; and (b). Impact and process evaluation of programmes.**

### 4.2 Some Critical Observations on The Financial Inclusion And Financial Literacy Principles And Frameworks Of The Global Policy Response To Financial Exclusion

In this section we present a number of observations, regarding the financial inclusion and financial literacy principles and frameworks of the global policy response to financial exclusion that deserve some attention. Some of these observations relate to enduring challenges that the new policy process has been meeting since its inception. These persistent challenges might require radical changes in the way things have been done so far.

#### 4.2.1 Regarding Financial Inclusion Principles and Frameworks

All the critical issues presented in this sub-section have been distilled from the Report of the 2012 AFI Global Policy Forum (GFI) meeting that was held from 26 to 28 September in Cape Town, South Africa (AFI, 2012). An important nature of this report is that it covers the entire period of existence of the new global policy response from its inception around 2009 up to the time of the meeting in September 2012. The issues selected for this section are among the key challenges that the new policy process has been meeting since its inception. These persistent challenges have been identified by a variety of stakeholders within the new policy system. At this meeting, the categories of stakeholders, that included associates, were contributors. Some of the main issues during the 2012 meeting include:

**(i). Advice against the tendency by regulators to push for interoperationability in mobile phone services (P7 of the Report)**

The Report observed that there has been a tendency by financial regulators to push for interoperationability in mobile services right from the beginning instead of designing a framework for a smooth transition to interoperationability. Mobile operators have insisted that introducing interoperationability right from the beginning would not be financially viable.

**(ii). Advice against the tendency to focus on consumer responsibility, neglecting consumer rights (P8 of the Report)**

It was observed that there was a tendency both by design and by implementation to neglect consumer protection. Central banks were advised to take a central role in ensuring that there was a healthy balance between consumer responsibility and consumer rights.

**(iii). Advice against bias towards supply side in data collection (P8 of the Report)**

It was reported that there was a tendency to focus more on collecting data on the supply side and that of the three dimensions of financial inclusion, access, usage and quality; quality was the most neglected. It was hoped that the framework for collecting demand side data that is being developed by the newly introduced Consumer Protection and Financial Literacy Sub-Group would go a long way in providing balance on this subject.

**(iv). A call to put in place ways of inspiring consumer trust in formal financial institutions (P9 of the Report)**

It was reported that low income people have valid reasons for not trusting formal financial institutions, especially banks. These reasons include past mistreatment of the poor customers and potential customers, unauthorised disclosure of customer personal statistics, past bank "bank failures" such as real interest that are too low to inspire saving, and sudden bank closures that result in failure by customers to access their finances.

**(v). Call for innovation (P16 of the Report)**

It was reported that financial institutions focused on up-scaling traditional products that were not suitable to poor consumers, through such methods as branch expansion. It was advised that there was need to complement such traditional expansionary activities with designing products that were suitable for the poor customers in both urban and rural areas.

**(vi). Choice of justifiable policy towards Micro, Small and Medium Enterprises (MSMEs) (P14 of the Report)**

It was reported that there was a tendency for many countries to vacillate between different types of MSME policy instead of having a framework to guide them. Examples of policies to choose from were given including countries that had opted for which, based on their circumstances. Some of these were: traditional policy e.g. monetary policy as indirect measures of treating MSMEs (e.g. Uganda), guarantee in a counter cyclical fashion (e.g. Chile), provision of a percentage of guarantee funds according to regions (e.g. Russia).

**(vii). Introducing and expanding micro-insurance (P14 of the Report)**

It was reported that micro- insurance was a neglected area. To this effect, countries were advised to introduce and expand it. Such product should be innovative so that it could be suitable for the poor. Particularly, it was advised that "micro" should not necessarily mean small amounts and/or subsidised interest rates. Of particular emphasis was also micro-insurance for small scale agriculture where such innovative methods as relating insurance to actualised weather pattern to deal with problems of information asymmetry, that have been used in a few countries.

**(viii). Incorporation of financial inclusion in national statistics (P20 of the Report)**

Since it has been generally agreed that financial inclusion is one of the determinants of important economic outcomes it would be advisable for countries to find ways of reporting how financial inclusion influence such economic out comes on annual basis just as it is done for such determinants as gross domestic product (GDP) and human development index (HDI).

**(ix). Advice against being overambitious about the new global financial inclusion policy (P21 to P23 of the Report)**

It was reported that the impact of financial inclusion resulting from the implementation of the new global financial inclusion policy is not yet conclusive. Countries were also reminded that the new global policy was still work in progress to whose development every country had been asked to contribute, especially through scientific surveys. According to David Porteous, Associate of AFI present at the meeting in Cape Town, the new global financial inclusion policy is only at hypothesis stage (P21 in the Report). To this effect, countries were advised not to ignore existing policies whose contribution to economic development was already established.

A related point mentioned on this subject is for the Central Banks to withstand pressure from donor community to give undue focus to the new policy and risk moving away from their core functions.

**(x). Need for activity prioritising and sequencing (P20 to P23 of the Report)**

It was advised that there were certain aspects of financial inclusion processes that dictated that activity prioritising and sequencing should be exercised, some of these are:

- Level of economic development at which a country is;
- Level in the new global policy process at which a country is;
- Certain things are better attended to in the mid-term or in the long term either because they are only available then or because attending to them earlier than that would not be effective.

**(xi). Key preliminary aspects of Strategies for National Financial Education are yet to be established (P22 of the Report)**

In the words of Kimanthi Mutua, Associate of AFI present at the meeting in Cape Town, "Consumer education remains a challenge both in terms of implementation and the identification of a good model. Questions of who or what institutions should take up this intervention remains unanswered------------Reliable data and performance measurements for effective consumer education also have yet to be established, making it difficult for members to monitor and report on the impact of policy interventions (P22 of the Report).

This observation is critical because the current global financial inclusion policy takes financial literacy (an output of financial education) as the most important determinant of financial inclusion. If this factor cannot be well determined, then the whole financial inclusion policy is in serious doubt.

### 4.2.2 Regarding financial literacy principles and frameworks

We can start by reproducing Mutua's general critique of financial education presented in the foregoing section. In the words of Kimanthi Mutua, Associate of AFI present at the meeting in Cape Town, "Consumer education remains a challenge both in terms of implementation and the identification of a good model. Questions of who or what institutions should take up this intervention remains unanswered. Reliable data and performance measurements for effective consumer education also have yet to be established, making it difficult for members to monitor and report on the impact of policy interventions (AFI, 2012: P22 of the Report).

Observations like the one above, made by Mutua, say a lot about how little we know about the nature and importance of financial literacy with respect to financial inclusion. However, such observations are not a call to discard financial literacy as a potentially important determinant of financial inclusion but rather are a challenge to researchers to find ways of learning more about financial literacy as it relates to financial inclusion.

From the material presented in earlier sections in this paper, we can now put in clear terms some critiques that were then only alluded to regarding financial literacy and frameworks.

**(i). The first global data set did not show that literacy was the most important determinant of financial inclusion**

It is difficult to understand why financial literacy was picked by the new global policy response to be the key determinant of financial inclusion when the first global data set, the GlobalFindex data set (Demirguc-Kunt and Klapper, 2012), on which, apparently, the policy was initially based does not seem to indicate so. In the first GlobalFindex data, financial literacy was not cited to be among the barriers reported by most respondents. For instance, in the case of formal banks the two barriers reported by most people were affordability (implying both low income and high cost of financial products), and physical distance from the banks. Likewise, a study by Mandell (2008) did not find financial, literacy to be the most important determinant of financial inclusion.

**(ii). Underlying causes of the global financial crisis were ignored**

If one takes the example of the USA in respect of the global financial crisis of 2007-2009, one begins to notice more fundamental issues about the global financial crisis than financial illiteracy. Among such fundamental issues are the flow of cheap funding into the USA from abroad, and the depressed prices of the houses in Detroit. As a matter of fact researchers continue to argue on what the main causes of the 2007-2009 might have been. Even very sophisticated PhD theses, arguing for different causes, have been written since.

**(iii). Relating the poor in developing countries to the global financial crisis overshadowed the crises relevant to them**

Following the logic of Cohen and Sebstad (2003), one sees that the financial illiteracy that might have had a connection with the 2007-2009 global financial inclusion was far removed from the financial illiteracy of the poor residing in developing countries. They observe that the illiteracy that could be logically connected to the global financial crisis referred to such to financial products of no relevance to the poor people in developing countries. These products included stocks, bonds, housing mortgages, using credit cards, choosing what insurance to buy, devising tax strategies. By contrast, the poor people in developing countries were concerned with crises related to living at a subsistence level, such as droughts, floods, chronic diseases, lack of clean drinking water. Overall such crises translate into very low and uncertain incomes for these people.

**(iv). The financial education recommended was unbalanced**

It has been argued that the people, in the developed countries concerned, whose financial illiteracy could have contributed to the global financial crisis, were also victims of the "small print" that the financial institutions were aware of. In this sense, the financially illiterate were also victims of the financial institutions' greed for profit (or being too busy to explain to the financially illiterate). This being the case, there should be financial literacy lessons for both consumers and suppliers, respectively.

**(v). Recommended financial education is institution-centred**

The trend, so far, indicate that the emphasis of the proposed financial education is to teach the poor about the existing products and their fast- multiplying related sub-products so that the poor are not left behind in this financially fast paced money economy. Very little emphasis is put on encouraging financial product suppliers to engage in innovative business that would follow the principle of consumer sovereignty.

## 5. Some Critical Observations on Zambia's Ongoing Financial Inclusion and Financial Literacy Policy Process Under The Guidance of the New Global Policy Response Principles and Frameworks

This section gives a brief description of Zambia's National Strategy on Financial Education, being the context in which the country's financial inclusion and financial literacy have been planned to be achieved. This description is followed by a critical discussion of some aspects of the country's strategy.

### 5.1 Description of Zambia's policy design, implementation and achievements

Zambia's current financial inclusion and financial literacy policy follows the broad prescriptions recommended by the global policy response to financial inclusion principles and frameworks. Zambia's financial inclusion and financial literacy policy is embedded in its National Strategy on Financial Education in which it is one of the programmes. Below we present, in summary form, the structure of Zambia's National Strategy on Financial education.

### 5.2 General aspects of Zambia's National Strategy on Financial Education

The following are the key general aspects of Zambia's National Strategy on Financial Education

#### 5.2.1 Global priorities that had/has a bearing on the study. These were the MDG No.2; attaining Universal primary access by 2015; and the World Bank's 2013 declaration of universal primary education for all by 2020

#### 5.2.2 National priorities with close connection

The national priorities with close connection to the Strategy were Vision 2030 that has the general objective of turning Zambia into a prosperous middle income country by 2030; the 6$^{th}$ National Development Plan that runs from 2011 to 2015 and has, as its theme, sustaining economic growth and poverty reduction; and the Financial Sector Development Plan that has, as its theme, supporting efficient mobilization and allocation of resources for diversification, and sustaining economic growth and poverty reduction.

#### 5.2.3 Other general aspects of the Strategy

The initial work on the strategy commenced in mid-2010 and had included findings by the 2009 field research by FinScope). Represented by the Governor of the Bank of Zambia, Zambia made a formal commitment to following the principles of the new global financial inclusion policy response by signing the Maya Declaration in September 2011. In February 2012, Zambia launched its National Strategy on Financial Education with the stated vision being: A financially educated Zambian by 2030. Zambia adopted the broad definition of financial inclusion used by the OECD (presented earlier in this paper). The first phase of the Strategy would run from 2012-2017. The country promised to keep the Strategy under review and to be revised if need arose. The final review for the first phase would be done before the expiry of phase one in 2017. Zambia also pledged to remain committed to research-based financial education strategy process maintaining that "*If you can't measure it you can't plan it, and if you can't plan it you can't fix it*" (slightly rephrased, and italics supplied by author).

The Bank of Zambia was given the task of coordinating the Strategy process while general leadership task was assigned to the Bank, the Zambia Securities and Exchange Commission, and the Pensions and Insurance Authority. Several Government Ministries, including the Ministry of Education, were also identified to be among institutions that would be closely involved in the policy process.

### 5.3 Concrete Targets

**Zambia has pledge to meet the following targets.**

- Increase financial inclusion from 37.3% (based on the 2009 FinScope survey) to at least 50% within the next five years;
- Provide affordable and appropriate banking and financial services to all 74 districts of the country by the end of 2012; from the existing situation, in 2011, where 6 of the 74 districts did not have such services;
- Develop a national financial literacy strategy under the Financial Sector Development Plan;
- Implement a national financial education strategy that encompasses various stakeholders, including the Ministry of Education, through integration in the schoo curriculum by 2012;
- Undertake market research in order to measure and improve the levels of access to financial services.

### 5.4 Achievements

According to Alliance for Financial Inclusion (AFI, 2013), by September 2013, Zambia had reached almost all its targets and was set to surpass them by the end of the midterm (2015) of the strategy. The Report notes the following achievements, in particular:

- The country is already close to achieving the 50% target and might have to update commitment based on the results of upcoming FinScope Survey
- By March 2013, in a situation where more districts had been created, the number of districts provided banking and financial services increased to 86, indicating surpassing the target 0f 6 by 100 percent.
- The number of bank branches and agencies increased from 277 in September 2011 to 322 as of March 2013.
- The country developed an index to measure the depth and breadth of financial inclusion. The index was presented to the SPC Technical Committee on March 2013.
- Finalized the draft framework on branchless banking
- Draft bill for the Unified Collateral Registry was prepared in March 2013 for consideration and review by key stakeholders.
- The revised Banking and Financial Services Bill has been reviewed by stakeholders and is being harmonized with other key financial sector laws
- In July 2012, launched the financial education strategy with four priority target groups: children, youth, adults and cross-cutting programs
- Held Financial Literacy Week in March 2013, resulting in a total outreach of 4,600 young people across 22 locations in Zambia.

### 5.5 Critical observations on some aspects of Zambia's financial inclusion and financial literacy policy process

In this section, we make some critical observations of some aspects of Zambia's on-going financial inclusion and financial literacy policy process that might require attending to at one point in time.

#### 5.5.1 Relating to beings among the fast implementers

Zambia was among the first 25 countries to launch a National Strategy on Financial Education by 2012 under the guidance of the new global policy response to financial education (OECD, 2013). It is interesting to note that to date; only about 45 countries have launched National Strategies on Financial Education under this system, out of about 108 countries that have made a commitment to participate in the global coordinated approach to financial inclusion (AFI, 2013).

A disadvantage of being such a fast implementer is that Zambia did not have the opportunity to incorporate in its Strategy, the empirical findings that have been endorsed by the system for use in improving the design of the Strategies. This implies that some resources could have been used for some aspects of the Strategy that were not necessary. It could also imply that, so much had been left out that the Strategy in its current form is not detailed enough.

#### 5.5.2 Zambia has prioritized financial literacy

Zambia's recorded policy commitments are improving financial literacy, and improving measurement. Now, prioritising financial literacy in dealing with financial inclusion is in line with the thinking of the new global financial inclusion policy school of thought. The problem with this prioritising, though, is the potential of achieving very little in the area of financial inclusion if financial literacy finally turns out not to be an important factor for financial inclusion. The point to consider now then is that since there was the prioritising of financial literacy, it means that there were other factors (determinants of financial inclusion) that were not taken to be among the priorities. It might have been safer to add one or a couple of these to the priority list so that not only financial literacy would appear as the priority independent variable.

#### 5.5.3 Zambia has taken an institution-centred approach to financial learning

This can be seen from its first contact with financial product consumers, namely to sensitise them about the existence of financial products and why they (consumers) should learn about them, as opposed to client-centred approach where the first exercise would have been to learn about what the consumers would have wanted to be modified in the existing traditional financial products.

#### 5.5.4 Zambia has planned to commit a huge amount of resources.

Going by the broad focus that Zambia has taken, namely to cover all school going children, youths and adults; at their learning places and outside their learning places, in the case of the first two categories; and at their work places and outside their work places, in the case of adults; a lot of resources would be required. The question is whether the country would be able to mobilise enough resources to cater for this kind of focus and deliver the required quality of financial literacy.

## 6. CONCLUSION AND RECOMMENDATION

This paper has reviewed the literature on financial inclusion as one of the determinants of required economic outcomes that contribute to economic development. The period covered was from the dawn of modern economic development thinking in the 1940s to date.

The review has revealed that financial inclusion has been upheld throughout the modern economic development period to be one of the important determinants of economic development. However, the review has not found any evidence to show how much financial inclusion contributes to influencing economic development when it is taken together with other known determinants of economic development. The review has also revealed that financial literacy has been upheld during this period as one of the important determinants of financial inclusion. However, the review has not found any empirical evidence to support the assertion that financial literacy is more important than other factors that influence financial inclusion. In particular, the review has not found any empirical evidence that the level of influence of financial literacy, on financial inclusion, relative to the other determinants has improved since the new global policy on financial inclusion brought an increased focus on financial literacy since the 2007-2009 global financial crisis.

The paper appreciates the fact that the increased focus on financial inclusion and financial literacy that has been around since the 2007-2009 global financial crisis has made researchers and policy makers know more about these factors than ever before. However, in view of the above mentioned findings, the paper cautions against transferring resources to the implementation of the new financial inclusion policy in amounts that could result in relative neglect of the existing policies that have already been proved to be useful in advancing economic development. This caution is apt even in cases where financial resources are externally provided specifically for the new policy, since even in this case more amounts of nonfinancial own resources than are necessary would still be drawn away from the other useful related policies.

In the case of Zambia, in particular, the review has found that the country has done very well, so far, in the policy process as guided by the new global policy response to financial inclusion, surpassing a good number of targets before their deadlines. However, the same caution given for every country applies to Zambia too, especially that being a developing country, Zambia has to guard its meagre resources carefully.

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