ZAMBIA TRADE AND INVESTMENT ENHANCEMENT PROJECT (ZAMTIE)

Contract Number 690-C-00-00-00283-00

Supported By: United States Agency for International Development (USAID)

Implementing Contractor: Nathan Associates Inc
2101 Wilson Boulevard, Suite 1200
Arlington VA 22201

Sub-contractors: Independent Management Consulting Services Ltd
Aurora Associates International, Inc
Cargill Technical Services
JE Austin Associates, Inc

REVIEW OF FACTORS AFFECTING LEVELS OF INTEREST RATES IN ZAMBIA

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Revised November 2003

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INTRODUCTION

Background

This report sets out the findings of the review of factors affecting current levels of interest rates in Zambia. The study was sponsored by ZAMTIE[1], a USAID funded project supporting private sector trade and investment. This was in response to the concerns expressed by the Business Forum relating to the cost of borrowing and general lack of access to capital at affordable rates. More specifically, the Business Forum had expressed the following concerns with regard to the operations of financial and money markets:

I. Interest rates in Zambia have remained consistently high over a period of years. This has made the cost of borrowing prohibitively high thus, adversely affecting the development of existing and new businesses;

II. The gap that has developed between interest rates offered for Treasury Bills (TBs) and base rates applied by commercial banks (CBs) in their lending activities is inordinately wide. This has encouraged investment in TBs, especially by CBs instead of providing risk capital to business enterprises; and,

III. Consistently high margins demanded by CBs between their base rates and the actual charges for borrowed funds further increases the actual cost of servicing bank loans and overdrafts.

The Business Forum seeks to identify the causal factors to the above and, establish required policy interventions that can address this situation. More specifically, the Business Forum seeks to engage the government in policy dialogue that should ultimately result in the reduction of interest rates and as such, the cost of borrowing.

Scope of Work Undertaken

The study processes involved the analysis of the movement in borrowing and lending interest rates since 2000 based on the review of data supplied by BOZ and CBs. This was supplemented by the review of published economic reports and meetings with a selection of representatives from BOZ, CBs and the Zambia Revenue Authority (ZRA).

[1] Acronym stands for: Zambia Trade and Investment Enhancement (ZAMTIE)

Particular focus was given to determining the existence of a linkage between Government borrowing from CBs, regulatory ratios imposed by BOZ and changes in interest rates that the business sector is exposed to. This was on the basis that domestic borrowing by Government is largely by way of offering TBs and Bonds on the financial markets. In addition, BOZ is able to influence availability of funds that CBs can lend through statutory reserve and liquidity ratios that it imposes from time to time.

A draft report of findings was presented to a special workshop attended by members of the Business Forum, the Deputy Minister of Finance and Economic Planning and representatives from BOZ, ZRA and CBs on Wednesday, 19th July 2003, held at the Holiday Inn. This report has therefore incorporated the comments made at this workshop and additional data gathered after further meetings were held with the ZRA, BOZ and representatives of the CBs.

More recently (ie on 31st October 2003), BOZ announced the reduction of Statutory Reserve Ratios on both Kwacha and foreign denominated currency deposits from 17.5% to 14.0%, effective from 1st November 2003. To the extent possible, the effects of this reduction have been incorporated in this version of the report. Whilst every attempt was made to confirm the accuracy and reliability of the data used in the analytical processes of this study, it is however not possible to vouch for all such sources and anecdotal submissions that may have shaped some of the conclusions made. The authors however take full responsibility for the contents of this report.

The conclusions and recommendations of this report also reflect the considered views of the authors. They do not, therefore, necessarily reflect the official position of the Business Forum or indeed that of ZAMTIE, the sponsors of the study. On the other hand, issues that have been raised in this report are aimed at stimulating debate and consideration of required policy interventions that should improve access to affordable finance by the productive sectors of this fragile economy.

Summary of Findings

<u>Government Borrowing</u>

The study established that the current regimes of interest rates prevailing in the Zambian economy have been heavily induced by high Government borrowing. In particular:

i. By the end of 2002, total Government domestic debt had accumulated to K4,249 billion. On the other hand, domestic credit to the private sector had only accumulated to K885.4 billion;

ii. During 2002, Government accounted for about 82% of the total banking system credit (*Economic Report 2002*);

iii. Government has been mitigating its failure to mobilise external assistance to finance capital expenditure programmes by borrowing from the banking system. This has made the trade in government securities a favoured mode for CB operations and generation of profits. For example, the sale of TBs and Bonds between 2001 and 2002 increased by about 37%, ie from K1,079 billion to K1,478 billion.

   As a result, by end of 2002, government securities accounted for about 60% of total domestic credit supplied by CBs;

Due to high Government borrowing, CB holdings in TBs and Bonds have been increasing steadily, whilst the level of lending to the private sector has been declining. Another major area of concern has been the use of borrowed funds by Government. These have tended to be employed in the financing of consumptive expenditure and maintenance of a large bureaucracy. This approach to fiscal management fails to recognise that Zambia is one of the poorest countries in the world.

Relationship Between Inflation and Bank Lending rates

The study established that there was no clear relationship between inflation and movements in bank lending rates in the Zambian market. For example, the rate of inflation has been falling over the past 8 years, from about 62% in 1994 to 21% at the end of 2002. On the other hand, CB lending base rates have never dropped below 37% over the same period and where at about 43% at the end of 2002.

Apart from the above, it was noted that lending rates were in fact, increasing at a time when the inflation rate was dropping. For example, the inflation rate dropped from 28% at the end of 1999 to about 21% by the end of 2002. During the same period, lending rates increased from 42% to 43%. This largely confirmed that, conversely, an asymmetrical relationship existed between the two economic indicators of price movements over the period examined.

Linkage Between Government Security Offer rates and Bank Lending rates

The study established that movements in current CB lending rates have a symmetrical relationship with offer rates for TBs and Bonds. On the other hand, TBs and Bonds are offered at rates that are appreciably higher than bank saving rates and inflation patterns. It is difficult to understand why Government through BOZ is offering TBs and Bonds at rates that are higher than basic economic indicators. The net effect has been to divert loanable funds that can be accessed by the private sector, ie promoting the “crowding out effect”. This has led CBs to focus more on trading in government securities than commercial lending.

Effect of regulatory Ratios

Presently, BOZ enforces minimum: Liquidity Ratios at 35% of the total public liabilities or deposits that must be held in liquid form; and, Reserve Ratios at 14.0% of both the total Kwacha and foreign denominated public liabilities that must be kept in a sterile account with BOZ. The study established that CBs not only consistently met the Statutory Reserve ratios but, maintained their core liquid assets with BOZ at levels that were appreciably higher than the regulatory level of 35%. This was partly as a result of the attractiveness of the interest rates offered on government securities that are risk free and involve very little administrative costs as opposed to commercial lending.

In practice however, these regulatory ratios effectively lead to the “quarantine” of more than 42% of CB deposits that are placed in both sterile and interest earning accounts at BOZ. This leaves CBs with an insufficient amount of deposits that they can retain for lending to private borrowers.

The net effect has been to reduce accessible credit from the market for the private sector, whilst also forcing higher lending rates. An analysis of the factors influencing CB lending rates indicated that, under the current regime of regulatory ratios, despite BOZ having recently lowered the Statutory Reserve ratio from 17.5% to 14.0%, CBs are still only able to make a reasonable profit where their lending base rates are at least 38%.

This can partly explain why CBs appear less interested in lending to the private sector. They have limited resources that they can utilise as risk capital in the face of BOZ regulatory ratios and the attractions of higher returns on TBs and Bonds.

Treasury management Practices of Government

The study also established that, current treasury practices of Government do not engender fiscal discipline. Instead, they encourage wasteful use of resources and accumulation of debts to suppliers. Ultimately, the Government ends up borrowing its own money from the banking sector. In addition to the above, the Government has not been paying suppliers on time thus, creating cash flow lags amongst such suppliers that also fuel artificial demand for credit from the banking sector. Other key weaknesses in current treasury management practices include:

i. High consumptive expenditure that divert resources from productive sectors, largely due to the size and activities of Government that involve calls on financial resources;

ii. Government's inability to pay utility companies for services that it consumes. The utility companies cannot impose credit recovery conditions on Government that they apply to private consumers, such as withdrawal of services, etc. On the other hand, this forces them to pass on the cost to private consumers thus contributing to high factor costs in the economy;

iii. Government and public institutions, such as BOZ are maintaining parallel financing markets whereby, they offer interest free loans to Members of Parliament, civil servants and Bank staff that not only divert resources from priority areas but, result in the increase of money supply in the economy. In some cases, such beneficiaries are even allowed to import personal vehicles duty free. Most importantly, the policy makers are also the main beneficiaries of these facilities and as such, they are insulated from the effects of the real economy. The ultimate result is that the productive sector is subsidising such practices; and,

iv. Government ministries are offering CBs additional liquidity through the current system of managing expenditure commitments. Ministries start spending only after receiving funds from the Treasury. Such funds are held in CBs without earning interest but incur bank charges. On the other hand, CBs use these funds to buy TBs and Bonds in a cyclical (or perpetual) pattern that only serves to create an artificial deficit for Government.

The above are not exhaustive but illustrative of some of the direct effects of current Government treasury practices and level of fiscal discipline. They ultimately divert resources that should flow to the productive sectors apart from driving up interest rates in the market.

Overall Conclusions

It was difficult to obtain a rational explanation for the disparity between current offer rates on government securities and prevailing inflation and interest rates on savings. It would appear that offer rates for TBs and Bonds are deliberately pegged at levels aimed at attracting purchases by BOZ on behalf of Government, regardless of the distortionary effects on the financial market.

It is clear that high Government borrowing has largely had the effect of crowding out the productive sector from accessing both investment and working capital at affordable rates. This situation has been compounded by the less than favourable performance of the export sector. It has induced demand pressure on limited foreign exchange and domestic resources that can be accessed by the productive sector. Most importantly, recent measures introduced by BOZ to lower the Statutory Reserve ratio from 17.5% to 14.0% will have a very insignificant effect on CB lending base rates as these can not be expected to fall below 38% without such banks incurring opportunity costs that effectively translate into losses for their share holders. In particular, CBs have more profitable sources of high value and low risk investments that Government is offering through the floatation of TBs and Bonds and, placement of deposits that do not attract interest but give CBs excess liquidity.

The answer to this has to be seen from the perspective of excessive Government borrowing, use of CB banking services where no interest is paid whilst, the offer rates for TBs and Bonds place an artificial premium on funds that CBs can lend. Consequently, it will require both political will and tighter financial discipline by Government in order to re-align the operations of the financial markets and make them more responsive to the needs of the private sector.

Key recommendations

To redress the prevailing situation, conscious efforts are needed by the Government to contain its recourse to borrowing and, ensure that scarce resources are not applied to finance unnecessary consumptive expenditure. Strategies are therefore needed to encourage Government, at the political level, to introduce over-arching legislation that establishes some of the following:

i. Places limits on how much Government can borrow from both domestic and foreign capital markets. In particular, statutory limits should be placed on the total value of government instruments, especially TBs that can be availed on the market at any one time. Such a measure can involve setting a benchmark that is linked to GDP above which, Government would require special sanction of Parliament;

i. Remove the preferential treatment that Government receives from suppliers regarding the settlement of payments due on services and goods that it receives. Suppliers (especially utility companies) must be able to impose the same conditions on Government as they apply to defaulting private consumers without exception. Present practices encourage fiscal indiscipline and contributes to high factor costs in the economy. It is inexplicable that Government can be allowed to continue to consume services that it does not pay for thus compromising the position of other sectors;

ii. Revision of Government financial regulations to ensure that ministries can apply sound treasury management practices over subventions as these are received. Whatever measures are implemented, should aim to stem the process of Government borrowing its own money from CBs. An approach that could be considered is that of limiting the number of CBs that will provide banking services to government ministries who either receive a commission and act as “sub-chests” of BOZ, providing agency service;

iii. Revising procedures currently applied by ZRA in the management of tax collections and remittance of same to the control account at BOZ. For a start, CBs involved should be designated as sub-chests of BOZ who should ensure that such receipts are kept sterilised whilst in the hands of CBs. Such CBs engaged to handle such receipts can be paid a set commission.

iv. Another way would be to establish on-line communication systems between: ZRA, BOZ and MoFNP. Under such a system, ZRA would communicate (electronically) real-time positions of daily collections that then trigger BOZ and MoFNP assessing what has been received and using such information to commit expenditure releases based on credit notes. This can work if supported by the sterilisation of ZRA receipts at all points of the transaction chain until the funds are received in the BOZ control account.

Apart from securing fiscal restraint and improved treasury management practices by Government, other measures will be needed that specifically focus on the role of BOZ. In particular, the regulatory functions of BOZ need to focus on the stability of the financial market and promotion of growth of the production sectors. The recent downward revision of

Statutory Reserve ratios from 17.5% to 14.0% by BOZ is a step in the right direction. The measure is however insufficient as the reduction will neither, result in any significant release of funds for the CBs to lend to the private sector nor, influence the lowering of lending base rates below 3 percentage points.

In this regard, BOZ should consider further lowering of the current statutory liquidity and reserve ratios so as to enable the release of more funds that can be accessed from CBs by the productive sectors. Such a step should be accompanied by measures that ensure that Government does not become the beneficiary of increased CB liquidity. In addition, policy measures should be put in place that serve the following purposes:

- Adoption of best efforts to effect a moratorium on further issuance of new TBs and Bonds on the market except where these are to cover maturities that cannot be financed by other means. If supported by a limit on the value of government securities that can be allowed to circulate in the economy (based on a benchmark linked to GDP), this would help contain further Government borrowing from the banking system;
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- BOZ ceasing to encourage the operation of parallel financial markets associated with preferential loans that are provided to its staff and other public institutions. This will require that Government is also asked to support this measure so as to remove distortions and level the playing field.

Implementation of the proposed measures will require political will and placement of the national interest above those of inessential Government expenditure requirements. Most importantly, Government has to recognise its failings and commit to implementing difficult decisions that result in self-restraint whilst also placing priority on the measures that stimulate economic growth and competitiveness of productive sectors.

The above are intended to lessen but will not resolve the problem of availability of credit at affordable levels to the private sector. Another important factor should be strengthening of the legal process/framework regarding borrowing including defaulting and registering of assets offered as collateral to ensure that clients are made aware of the need to service their debts and the consequences of defaulting.

LIBERALISATION OF FINANCIAL MARKETS

Era of State Controls

Until the beginning of the 1990's, the Zambian banking sector operated under a Government controlled environment. During this period, the state regulated both interest and exchange rates that included regimes of price and import controls, and subsidies. The holding, purchasing and transacting in foreign currency was also subject to Government controls. Despite the regulated environment, setting up of private owned CBs was encouraged by the State as long as they maintained rural branches.

A key feature of this era was the existence of state sponsored (or supported) financial institutions that offered term lending facilities to productive sectors. These included the Development Bank of Zambia (DBZ), Export and Import Bank, Lima Bank, and the National Savings & Credit Bank. This was also during the period when State monopolies dominated the economy (ie about 85% of productive sector activities), accentuated by socialist policies that favoured subsidies to the wider population. State monopolies had preferential access to foreign exchange and credit supported by import and price controls, on the basis that they produced goods and services that benefited the wider population.

On the other hand, private sector enterprises subsisted in the economy by largely engaging in activities that did not directly compete with state monopolies - lest they got nationalised. Despite credit being more accessible to state owned enterprises, the environment promoted state intervention and patronage, a situation that was unsustainable and led to serious distortions in the economy. Some of the effects included:

i. Distorted pricing in the economy as prevailing interest rates discouraged lending and official dealings in tradable instruments;

ii. Inability to sustain supplies of foreign exchange with declining export receipts and increasing balance of payment deficits;

iii. Inability to service the mounting external debt burden was exacerbated by poor credit rating and inability to agree to a structural adjustment programme satisfactory to the multi-lateral lending institutions[2] to facilitate: balance of payments support, debt relief and re-scheduling of service payments.

[2] These include the World Bank, International Monetary Fund (IMF) and other multilateral support

The above factors inhibited growth of the economy leading to high inflation, shortages of foreign currency and tradable goods. In the case of the productive sectors, they could not easily access foreign exchange required to import raw materials and/or finance new investments in plant and machinery rehabilitation thus, leading to low capacity utilisation and production of sub-standard goods.

On the other hand, the Government increased its reliance on borrowing from the domestic markets to meet budget deficits, thus fuelling both money supply and inflation in the economy.

Implementation of Economic Reforms

The change of Government from November 1991 also marked the emergence of radical economic reforms. These reforms involved the introduction of market based policies by the Government whose main thrust was to:

i. Restore economic stability through fiscal and monetary policy reforms;

ii. Liberalize markets by removing price controls, trade and other restrictions. This included the removal of foreign exchange controls, liberalization of interest rates and the operations of money markets; and,

iii. Create an enabling environment for increased private sector participation through the implementation of an ambitious privatisation programme to shift ownership from public (Government) into private hands.

Other reforms that affected the financial services sector included the removal of the requirement for CBs to maintain rural branches. In turn, the Banking and Financial Services Act was introduced in 1994 that set out new regulations attuned to international practices of open economies. In addition, the Bank of Zambia Act was amended paving the way for CBs to maintain Government accounts. As part of this development, BOZ no longer plays the direct role of providing commercial banking services to Government ministries and agencies but focuses on the implementation of monetary policy and regulatory functions.

These developments encouraged the setting up of privately owned CBs[3] and other non-bank financial institutions, offering such services as: foreign exchange bureaux, merchant banking, leasing, pension fund management, insurance and venture capital.

The liberalisation of the foreign exchange market involved the implementation of a number of changes to the pre-existing systems of administrative controls in place and relaxation of retention rules. More specifically, in early 1992, BOZ relaxed rules allowing non-traditional exporters to retain 100% of foreign exchange earnings. This was followed later in the year by BOZ allowing licensed Bureaux de Change outlets to be established and operate on the market. By early 1993, administration of foreign exchange was also transferred from BOZ to CBs[4]. This was a major change as past controls had perpetuated a vibrant black (or informal) market for foreign exchange that invariably escaped the national accounting system[5].

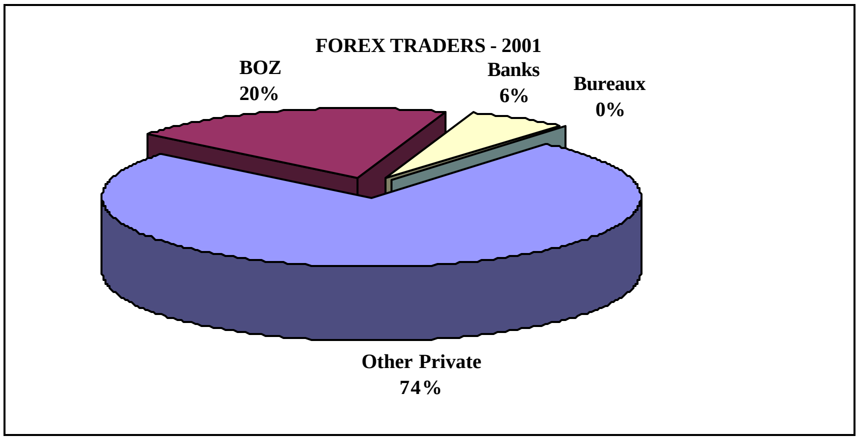
Under these arrangements, a dealing system was also introduced providing for CBs to buy and sell foreign exchange from the central bank (BOZ) by way of auctions. Under this system, the official exchange rate was determined by the dealing's weighted average rate determined from the bids received from CBs. Further reforms were introduced in 1994 making the Kwacha fully convertible and, by 1996, the ZCCM retention scheme was abolished with the mining company allowed to sell its foreign exchange earnings freely on the open market[6]. The make up of foreign exchange traders in the year 2001 is illustrated in the pie chart below.

[3] Privately owned CBs presently dominate the sector (i.e. of the total number at 14, only one bank, ZNCB, remains under complete Government ownership although it has been scheduled for privatisation).

[4] Prior to this a dual exchange system rate system comprising the official (or retail) and unofficial (applying to Ordinary General License holders) were in place. The allocation of foreign exchange was done through a Foreign Exchange Management Committee (FEMAC) under the auspices of BOZ.

[5] For a detailed analysis of Zambia's exchange rate policy and chronology of currency movements including administrative arrangements see: Chipili J Mpundu, A monetary Approach to Analysing the Floating Exchange rate Behaviour in Zambia - Sept 1998.

[6] Previously, ZCCM was required to sell part of its foreign exchange earnings to BOZ.



Source: Bank of Zambia

With these changes, the foreign exchange market became open to CBs, foreign Exchange Bureaux, exporters and any other organisations or persons that required to under-take transactions in foreign currencies. BOZ has been intervening through the dealing system to smoothen short-run exchange rate movements that are, supposedly seen as compromising monetary stability. Presently, Zambia's financial services sector market is one of the most liberalised in the region.

The Paradigm

The liberalisation of the financial services sector was expected to improve access to credit at low and competitive rates to the private sector. In reality, this objective was not achieved thus, frustrating growth of the productive sectors. Key factors accounting for this phenomenon have included the interplay of the following variables:

– The volatility of the exchange rate of the Kwacha against foreign currencies, particularly in the eight years up to end of 2002;

– Negative balance of payments position of the country resulting in perpetual current account deficits;

– High-levels of external debt calling on limited resources to finance service payments;

– High Government borrowing from both domestic (particularly) and foreign financial markets to finance unproductive consumption expenditure;

– Inability to contain excessive liquidity by BOZ thus allowing high levels of money supply to fuel inflation in the economy;

– Over dependence by the Government on donor funding to meet budget expenditure levels; and,

– Weak fiscal discipline and inadequacies in treasury management practices of the Government.

The interplay of the above factors has had a major influence on the stability of Zambia's financial markets and consequently, the level of interest rates obtaining. In the next section, the impact of the some of the above factors are analysed in more detail that can be directly associated with the concerns faced by the business sector.

COMPARATIVE VALUE OF THE KWACHA AGAINST FOREIGN CURRENCIES

Effects of the Foreign Exchange Liberalisation Measures

The liberalisation measures alluded to above have had major implications on the operations of the foreign exchange market. Firstly, they have led to the opening up of the market to various categories of players in the economy as foreign exchange is now freely traded. Secondly, the determination of the exchange rate prevailing is now influenced by the basic laws of supply and demand for foreign currency on the market.

This also means that, the instability of the market has played a significant role by influencing movements of the exchange rate, notwithstanding the actual availability of foreign currency. Coupled with this has been the reaction of the market to the liberalised environment. With the removal of import controls, the economy has experienced a rapid growth in foreign products on the domestic (consumer) market. Such investors have been encouraged by the liberalised foreign exchange regime and can therefore repatriate earnings freely.

On the other hand, most local transactions in foreign currency trading are based on earnings provided by exporters, especially mining companies. This means that the availability of foreign currency, which also influences the rate at which it is traded, is largely dependent on:

i. External trade balances, i.e. the relationship between the value of exports and imports;

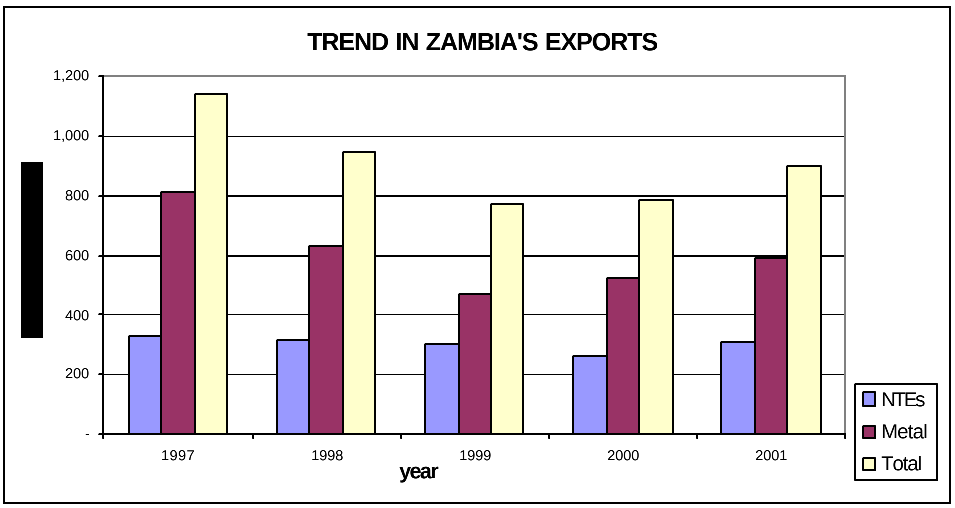
ii. Flow of direct balance of payments support provided to Zambia by the international donor community and multi-lateral institutions; and,

iii. Government expenditure and debt service obligations that involve calls on foreign currency.

The exchange rate of the Kwacha is now determined against the currencies of Zambia's main trading partners who comprise: the USA, UK, Japan, South Africa and Zimbabwe. This also means that Zambia needs to maintain positive trade balances with its main trading partners. This issue is discussed in more detail below to highlight the relationship between external trade performance and the movement in exchange rates.

External Trade Performance

Zambia has been perpetually operating under negative external trade balances. For example, in the past two year period, i.e. between 2001 and 2002, export earnings amounted to US$887 million and US$920 million, respectively, indicating an increase 4% within the period. An analysis of export earnings from the period 1997 through to end of 2001 indicated the trends shown in the table below. From the table, it is evident that the value of exports (in US$ terms) has been declining over the years.



Source: Export Board of Zambia

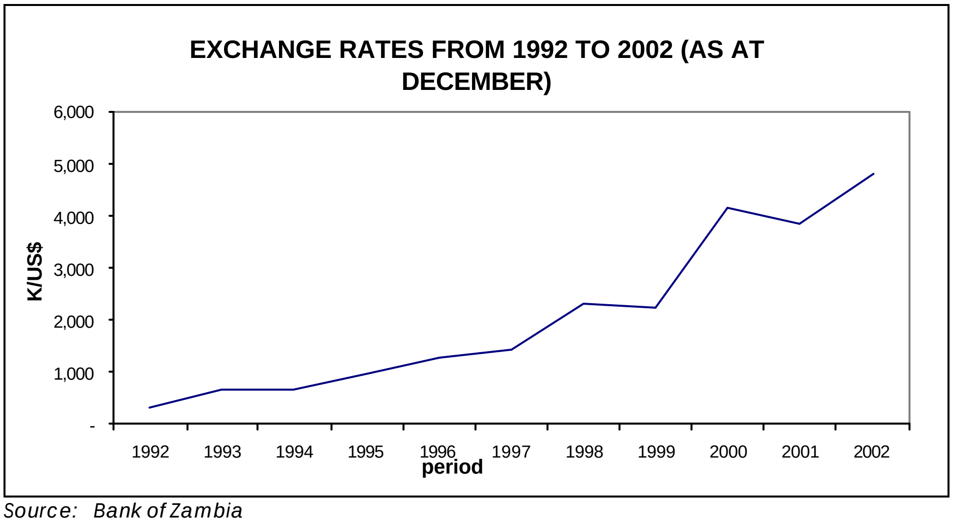
On the other hand, the value of imports for the same period was US$1,253 million in 2001 and US$1,157 million in 2002. Despite a reduction in the value of imports in the two-year period, the trade balance was negative by at least, 26%. The implication of this position is that Zambia has been purchasing goods and services without having the necessary internal resource generating capacities to meet the costs involved.

Balance of Payments support

The negative balance of payments position faced by the country has been exacerbated by Government expenditure resulting in increased foreign borrowing, and the accumulation of debt service commitments. By the end of 2002, Zambia's debt stock was of the order of US$6,488 million of which, US$5,856 million (or 90.3%) was owed directly by Government. Due to pressures to finance Government expenditure, debt service payments have also been less than projected. For example, in 2002, external service payments were projected at US$151 million but actual payments only amounted to US$137 million, further increasing the arrears schedule that have to be financed in the future.

The Government has also been overly dependent on external aid flows to meet balance of payment deficits. Aid flows have however been inconsistent. For example, w hilst US$687 million was pledged for the year 2002, only US$318.6 million was actually disbursed with some of the amount being in the form of commodity aid (i.e. to meet the cost of maize imports). As a result, Zambia has been in perpetual balance of payments deficits. For example, in the last four years, deficits have been at: US$334 million in 1999; US$416 million in 2000; US$399 million in 2001; and, US$403 million in 2002.

The above factors have clearly impacted the availability of domestically generated foreign exchange resources that can be allocated to the productive sectors. For example, in 2002, the total amount of foreign exchange sold through the BOZ dealing window was US$286.6 million as against a demand of US$558 million. This has also created scarcity of foreign currency thus, influencing the instability of the exchange rate on the market. For example, the Kwacha has been depreciating at a sharp rate, especially since 1992 from about K300 to about K4,840 to US$1.00 by end of 2002. An analysis of the movement of the Kwacha against the US Dollar since 1992 is shown below.



Source: Bank of Zambia

As can be noted from the table, movements in the exchange rate over the ten-year period analysed have shown an escalation with the local currency having deteriorated by a factor of more than 16 from the 1992 level. This has placed a premium on the cost of purchasing foreign exchange using Kwacha based funds thus, impacting on any settlement of foreign denominated payments. As indicated earlier, Zambia has been facing trade deficits thus putting pressure on the availability of foreign exchange, a factor exacerbated by inconsistent balance of payments support actually received from both bi-lateral and multi-lateral partners.

A major implication of the above can be illustrated by the effect on those business enterprises that responded to the market liberalisation policies of the early 1990s. Most such enterprises that invested in new and/or rehabilitation of production infrastructure using borrowed funds, especially foreign denominated loans have faced crippling debt service payments. For example, where an enterprise borrowed US$1 million in 1994 at an exchange rate of K300 to US$1.00, the Kwacha value of the principal was K300 million. By 1998 when the exchange rate was K2,298.92 to US$1.00, the principal had a nominal Kwacha value of K2.3 billion, ie increased by a factor of 7. This does not take into account the effects of compound interest payments due over the same period.

In such a case, the borrower would need to insulate earnings by way of exports or be able to adjust prices of their products in order to raise sufficient Kwacha resources that would compensate for the increasing cost of loan service obligations. In reality, business enterprises have had to compete for both the domestic and export markets with other producers from the region. As such, to remain competitive, they cannot afford to adjust prices to compensate for the deteriorating value of the Kwacha without loss of markets.

Government's Response to the Volatile Exchange Rate

Scarcity of foreign exchange, especially in the decade up to 2001, placed a premium on its price in the domestic market, thus partly accounting for the volatility noted in the movement of the exchange rate. Of particular importance, however, was Government's initial response to this situation.

Instead of addressing needs for tightening control over Government expenditure, policy measures have been imposed that directly affect the productive sectors. For example, in early 2001, in response to the sharp fall in the exchange rate between the Kwacha and foreign currencies (especially the US Dollar) the Government claimed that the following were precipitating factors:

- Business establishments were carrying out large cash transactions in foreign currency in order to externalise foreign exchange thus depleting resources;

- CBs were hoarding foreign exchange thus starving the local market unnecessarily;

- Far too many business transactions were being quoted in foreign currency; and,

- Major exporters were auctioning foreign currency instead of off-loading it through established channels.

In addressing this situation, the Government announced the introduction of new measures in January 2001 that included the following:

- All export receipts had to be receipted locally and at least, 75% of earnings had to be deposited with CBs within 180 days of the export transaction;

- All remittances, other than dividends, by business entities had to be made against invoices consistent with bills of entry collected by ZRA;

- All external payments above US$5,000 had to be channelled through CBs; and,

- All domestic transactions had to be charged and settled in Kwacha, except for licensed tourist enterprises authorised by BOZ.

Since then, the Government has relaxed some of the above measures but this is after supply response had worsened the situation that the measures were intended to address. For example, exporters do not necessarily have to ensure that 75% of their export earnings are deposited in CBs within 180 days of each transaction. What the Government failed to address was its own drawing of foreign exchange to meet expenditure that had a limited contribution to productive investments in the economy.

For example, between the end of 2000 and beginning of 2001, the Government made substantial calls on foreign exchange resources to meet the costs of hosting the Organisation of African Unit (OAU) conference. It involved purchases of luxury cars, construction of additional conference facilities and other materials that required the use of scarce foreign exchange resources to pay for importation.

This situation has continued, exemplified by the politically induced high Government expenditure during the 2001 General Elections. In addition, since early 2002, the Government has continued to allocate scarce foreign exchange resources to expenditure commitments that are politically induced. This has included the purchase of new fleet of high cost vehicles for Ministers and Members of Parliament that clearly remove scarce resources from productive sectors. The effects of such expenditure patterns are addressed in more detail below.

IMPACT OF HIGH GOVERNMENT BORROWING FROM DOMESTIC MARKETS

Underlying Philosophy

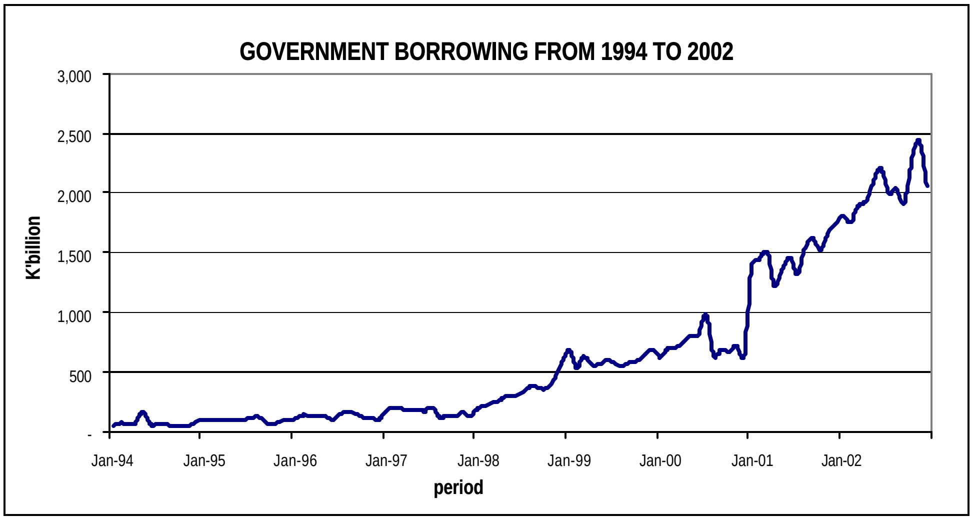
One of the underlying factors influencing high interest rates is Government's internal borrowing from the financial sector[7] through the use of instruments, such as: treasury bills (TBs) and government bonds. These funds are used to finance the national budget deficit and meet other Government expenditure programmes. The scale of Government borrowing has unfortunately resulted in the crowding out of the private sector and reduction of investment financing available to the productive sectors. More importantly, it has negated the creation of an enabling environment that can stimulate savings and investment as well as the competitiveness of the productive sectors.

It should be pointed out that when government borrows funds to finance an enlarged deficit (typically by issuing additional bonds and TBs), it is actively operating in the financial market for funds. In such circumstances, the total demand for loanable funds will increase as Government borrowing competes with the private sector for the available supply of funds. This in turn will increase the demand for loanable funds and thereby place upward pressure on interest rates. As such, consumers will reduce their purchase of interest sensitive goods and services. More importantly, high interest rates will also increase the opportunity cost of investment projects[8] that involve raising capital from financial markets.

Analysis of Government Borrowing from the Financial Markets

Government's borrowing from the domestic market (domestic credit[9]) has been rising sharply, especially from 1998. When a comparison is done covering the period 1994 through to 2002, this has increased by more than 2,000% (in nominal terms). The analysis of Government borrowing from the domestic financial sector from 1994 to 2002 is shown below.

[7] Bank of Zambia, Commercial Banks and other financial institutions
[8] This is also referred to as the "Crowding -out Effect".
[9] Domestic credit – This is also referred to as domestic debt and includes all amounts owed by the government to various institutions such as financial institutions and product/service providers.



Source: Bank of Zambia

A key feature noted from this analysis is that Government has been borrowing from the banking sector much more than the private sector. For example, by the end of 2002, Government borrowing from the banking system had accumulated to K4,015.7 billion whilst the private sector's total debt had only accumulated to K885.4 billion. Government's share of the total domestic debt was therefore about 82% of the total. This position means that investment resources from the banking sector are being consumed by Government, also the main contributor to the increase in money supply in the economy. Government's expenditure has largely being consumptive with capital investment programmes being tied to external donor support in the national budget.

The analysis also indicated that Government has been borrowing at a faster rate than the private sector, thus driving the rate of expansion in domestic credit. For example, between 2001 and 2002, Government's borrowing resulted in a 27.3% contribution to the expansion of domestic credit. On the other hand, banking system lending to the private sector contributed about 3% increase to the expansion of domestic credit.

The increase in the Government's domestic debt and its effect was however, acknowledged by the Minister of Finance and National Planning, during his presentation of the 2003 budget. The minister further explained that this increase was as a result of the need to finance the budget deficit and was mainly through issuance of government securities and direct borrowing from BOZ. A detailed analysis of Government's domestic debt for 2001 and 2002 is shown in the table below.

	2002	2001	% Change - 2001/02	2002 % Contribution	2001 % Contribution
TOTAL DOMESTIC DEBT	**4,249.1**	**4,139.3**	**2.7**	**100.0**	**100.0**
Govt Securities	**1,478.0**	**1,079.3**	**36.9**	**34.8**	**26.1**
Treasury Bills	817.6	676.7	20.8	19.2	16.3
GRZ Bonds	660.4	402.6	64.0	15.5	9.7
BOZ Loans & Advances	**1,789.5**	**1,787.9**	**0.1**	**42.1**	**43.2**
Kwacha Bridging Loan	467.8	383.3	22.0	11.0	9.3
Foreign Exchange Bridging Loar	1,321.7	1,404.6	(5.9)	31.1	33.9
Parastatal Liabilities	**255.6**	**725.8**	**(64.8)**	**6.0**	**17.5**
Other Liabilities	**726.0**	**546.3**	**32.9**	**17.1**	**13.2**
Domestic Arrears	420.0	346.2	21.3	9.9	8.4
Awards & Compensations	66.0	32.1	105.6	1.6	0.8
Unremitted GRZ Pension Funds	240.0	168.0	42.9	5.6	4.1

Source: Economic Report - 2002

As can be noted from above, public sector arrears at the end of 2002 was K420 billion and represented about 10% of the Government's accumulated debt. The Government arrears with the private sector contribute to the private sector's default rate with commercial banks and thus is another factor contributing to high interest rates.

In 2002 the Government had expected 43.3% of the national budget to be financed from external assistance with, 78% of the total capital expenditure budget being financed from the same support. The position during 2003 is also the same with external assistance expected to meet 44.6% of the total national budget and, cover 83% of the total budgeted capital expenditure programme.

In practice, the Government has not been able to mobilise projected external assistance resources each fiscal year. This has necessitated the increased reliance on domestic credit from BOZ, CBs and the private sector. For instance, in 2002, the Government recorded a budget deficit of K529.3 billion (excluding interest payments on external debt of K145 billion). This deficit was financed through borrowing from the banking sector[10], private sector[11] and external financing arrangements[12].

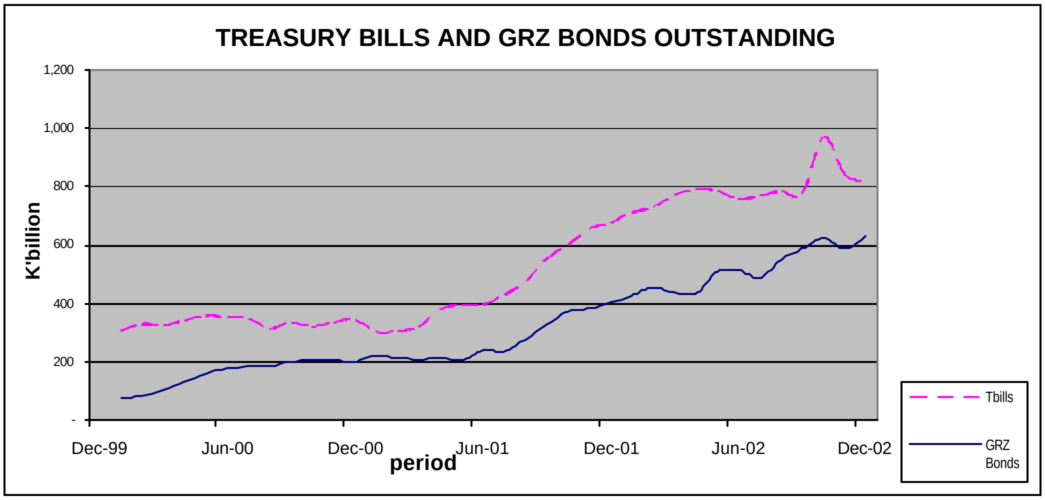
Thus, the sale of additional stock of TBs and Bonds between 2001 and 2002 led to the total stock of Government securities[13] increasing by 37% from K1,079.3 billion to K1,478.0 billion. An analysis of growth in the stock of Government securities from the last half of 2001 through December 2002 indicated a sharp acceleration in levels as can be noted from the chart shown below.

[10] K5.5 billion was from BOZ and CBs contributed K162 billion.

[11] K247 billion was financed from the private sector. This was largely through Government securities.

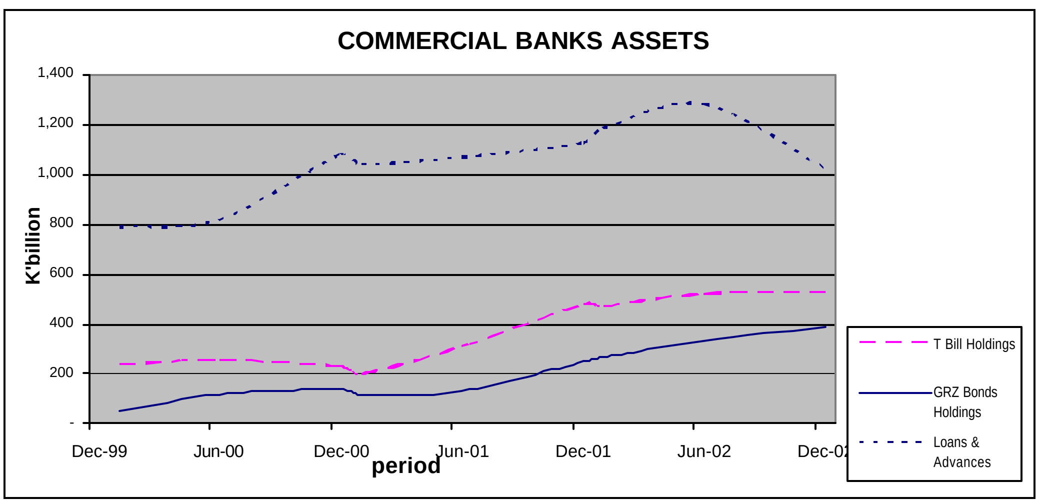
[12] External financing (from donor support) amounted to K114.7 billion.

[13] This excludes loans and advances.



Source: Extrapolated from BOZ data

This position has made CBs focus more on trading in Government securities than lending to the productive sectors. By the end of 2002, they accounted for about 60% of total (Government and private sector) domestic credit supplied by CBs, also indicating a reduction in loans and advances available to the private sector as can be noted from the chart shown below.

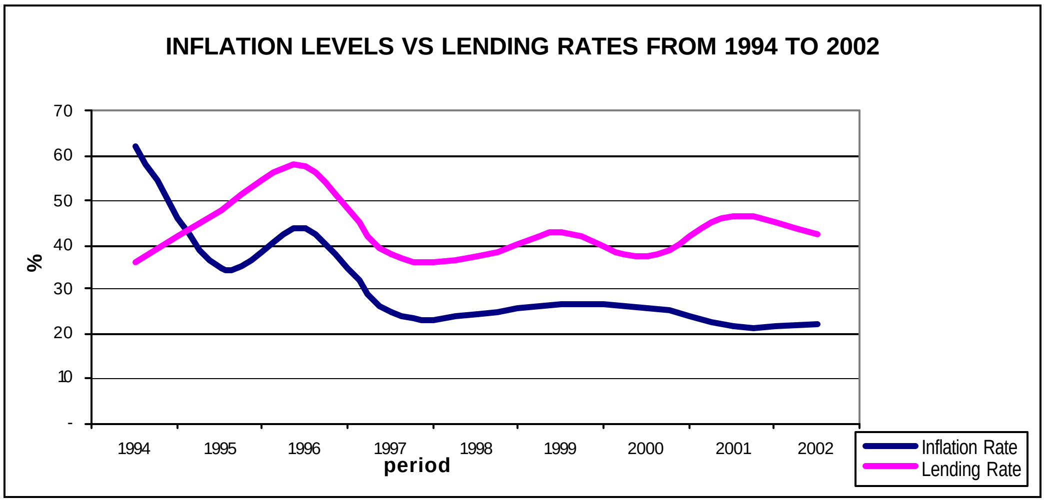


Source: Extrapolated from BOZ data.

CB holdings in TBs and Government Bonds have thus been increasing steadily over the period analysed (especially from mid 2001) whilst, lending to the private sector has been falling. Clearly, CBs are taking advantage of the low risks associated with investing in Government securities in comparison to other lending activities. In such a situation, activities in the financial markets are being driven by the Government's borrowing. This can also partially explain the peculiar relationship between inflation and lending rates, as illustrated below.

Inflation and Bank Lending Rates

Inflation is an indicator of the general movement of prices in an economy. Ordinarily, inflation should play a major influence in the movement of bank lending rates since a lending rate below the level of inflation results in a situation where the value of the funds repaid is lower than the value of funds lent. The difference between the rate of inflation and the lending rate is called the real interest rate, and reflects the real return on lending. In Zambia's case, the movement of these two variables is not only widely dispersed but barely show a causal relationship as can be noted from the chart shown below.

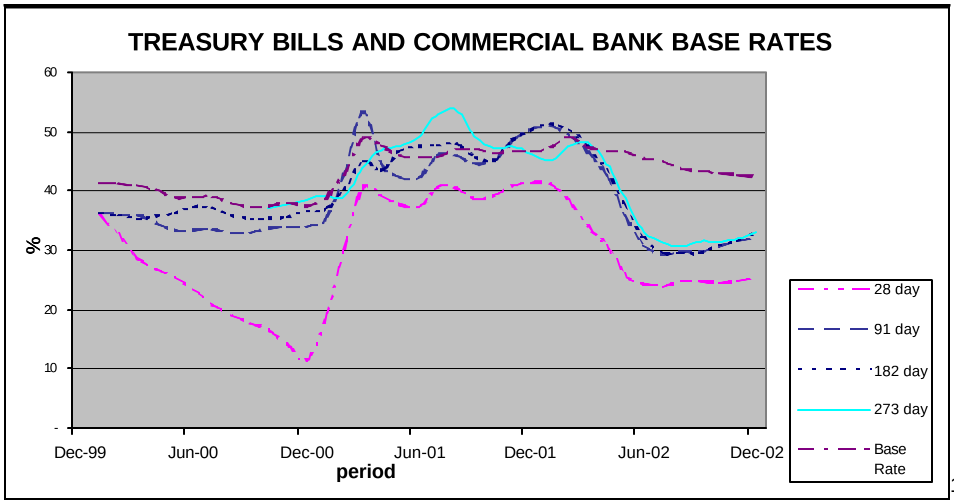


Source: Bank of Zambia Statistics

The rate of inflation has been on a downward trend over the past 8 years, i.e. dropping from a level of about 62% in 1994 to about 21% by the end of 2002. In the last 6 years, the average annual inflation rate has been oscillating at steady levels of between 28% and 22%. On the other hand, during 2002, CB lending base rates averaged about 43%. Over the period between 1994 and 2002 lending (base) rates never dropped below 37%.

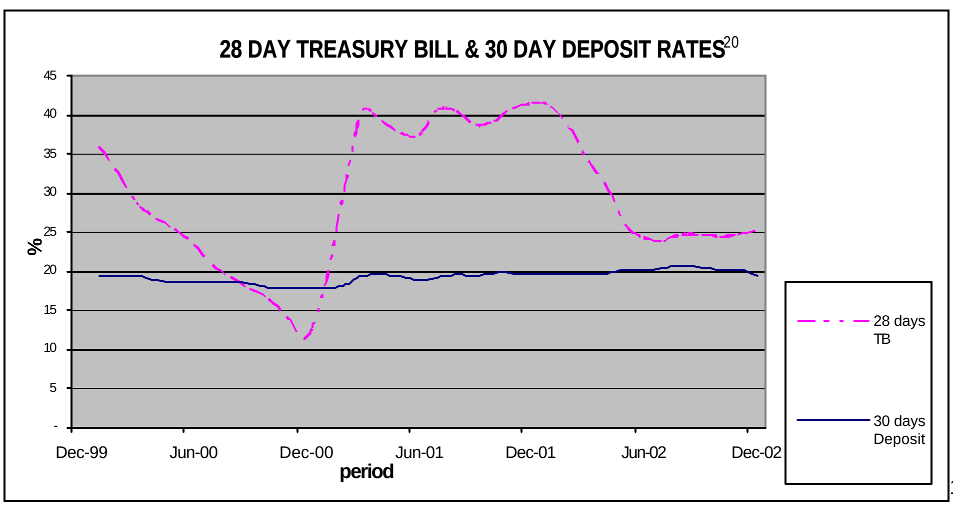
A noticeable feature has also been the comparatively low pace at which lending rates have been dropping in relation to inflation levels between similar periods. For example, the average inflation rate fell from about 28% 1999 to about 22% by the end of 2002. On the other hand, bank lending base rates did not register any fall but in fact increased from about 42% to 43% over the same period. It can therefore be deduced that the impact of inflation on the lending rates is of a low order, implying that there are other factors that have a stronger influence on the lending rates.

A more detailed analysis of this situation indicated that, CB lending rates have largely been influenced by the opportunity gains of investing in Government securities. As a result, lending rates appear to have a more discernible and closer relationship with movements in TB rates, as can be noted in the chart shown below.



[14]

The above further demonstrates the effect of excessive Government borrowing on the stability of the financial market and, ultimately, the perpetuation of high bank lending rates that the private sector is exposed to. On the other hand, saving rates offered by CBs to private depositors have been much lower than even those that apply for Government securities as is illustrated in the chart below.



[15]

[14] Base Rate applies to the minimum interest rate (lending rate) that a financial institution charges for loans.

[15] Deposit rate applies to interest rate on savings

As can be noted, the 30 days deposit rate offered to private depositors mostly oscillated at levels just below 20%. On the other hand, the 28 days TB[16] rate showed sharper fluctuations of between 12% and 42%.

In all cases, save for December 2000, the 28 days TB rate has been higher than the 30 days deposit rate offered to private savers. This margin however narrowed to a difference of about, 5 percentage points by the end the close of 2002.

As long as the Government fails to contain its need to continue borrowing from CBs, it is difficult to envisage a tangible drop in lending rates that are offered commercially. An important point arising fom the above is to also the need to establish the actual source of CB liquidity that is used to invest in Government securities in an economy of low private savings. This issue is considered below in some detail together with its impact.

FACTORS AFFECTING THE STRUCTURE OF CB LENDING BASE RATES

In depth discussions with representatives of CBs indicated that there are a number of factors presently influencing their preference to investing in government securities rather than private lending. The three most important contributory factors are: low private savings; lending risk; and, structure of regulatory ratios that are enforced by BOZ and must be adhered to. Each of these are analysed in some detail below.

Low Levels of Domestic Savings

This is associated with the prevailing macroeconomic environment and pace at which the business sector is responding to liberalised markets. More specifically, industrial productivity has slumped over the years with a number of formal sector business closures thus, increasing unemployment levels in the country. This has also led to the increase in poverty levels (estimated at 80% of the total population). The overall effect of these factors has been to reduce domestic savings potential. Given the economic situation, especially high inflation and volatile exchange rate of the Kwacha against international currencies, few savers are willing to place their funds in long-term deposit instruments.

This therefore means that the commercial banks cannot mobilise sufficient levels of retail savings to support needs of commercial borrowers. On the other hand, CBs are competing for limited private savings that are placed with them on short-term basis. It also means that they have to place such

[16] The minimum amount for which one purchase Treasury Bills is K30 million and in multiples of K5 million. However, it is possible to invest in these instruments through commercial banks at amounts as low as K5 million.

funds in secure lending activities whilst, minimising risk. This has invariably created a mismatch between demand for credit and availability of funds that CBs are willing to lend that carry commercial risks.

CBs operate under increasing pressures to realise maximum returns on any such deposits that they can mobilise. This can also partially explain why CBs are reluctant to lend long-term. The inevitable outcome has been to place a price premium on the available funds that CBs can lend to support commercial and therefore risky ventures. This has also contributed to the cautious approach of CBs in assessing lending risk and loading of actual interest rates charged above what they publish as base rates.

Lending Risk

Partly due to the factors indicated above, assessment of lending risk has become a critical part of CBs' management of credit. This emphasis has been instigated by a number of factors associated with the business environment. Firstly, business enterprises are operating under unstable parameters making it difficult for them to plan cash flows and meet debt service obligations when these fall due. Volatility in the movement of the exchange rate has been one of the major sources of this problem.

Another source of the problem has been the knock on effects of slow supplier payments, especially where the Government is involved at some stage in the cycle. For example, a supplier of goods to Government may have obtained inputs from a manufacturer who also borrowed from a CB to cover production costs. Where the supplier is unable to collect dues from Government on time, thus making them default in meeting the credit terms agreed with the manufacturer. In turn, the manufacturer will not have received the sales proceeds to enable them meet service payments to the CB. This cycle of slow creditor payments is most prominent where the government is involved as a consumer of goods and/or services. Its track record of timely creditor payments is virtually non-existent. On the other hand it is the biggest consumer (both directly and indirectly) of goods and services in the economy.

Secondly, the quality of borrowers in recent years has been dropping with the liberalisation of markets and poor entrepreneurial discipline. In the past, borrowers operated in an environment of fixed interest rates, supported by price and import controls. The environment was largely one where sellers dominated terms due to the inward nature of the economy. The culture of defaulting on debt service payments was also prevalent largely due to political interference and static markets.

Adjustment to the more liberalised market environment has therefore, been slow for a number of borrowers who also have to compete for the limited credit available from CBs. This factor has also meant that CBs have to make large provisions for loan losses thus making credit more expensive and subject of stringent collateral requirements.

Regulatory Ratios

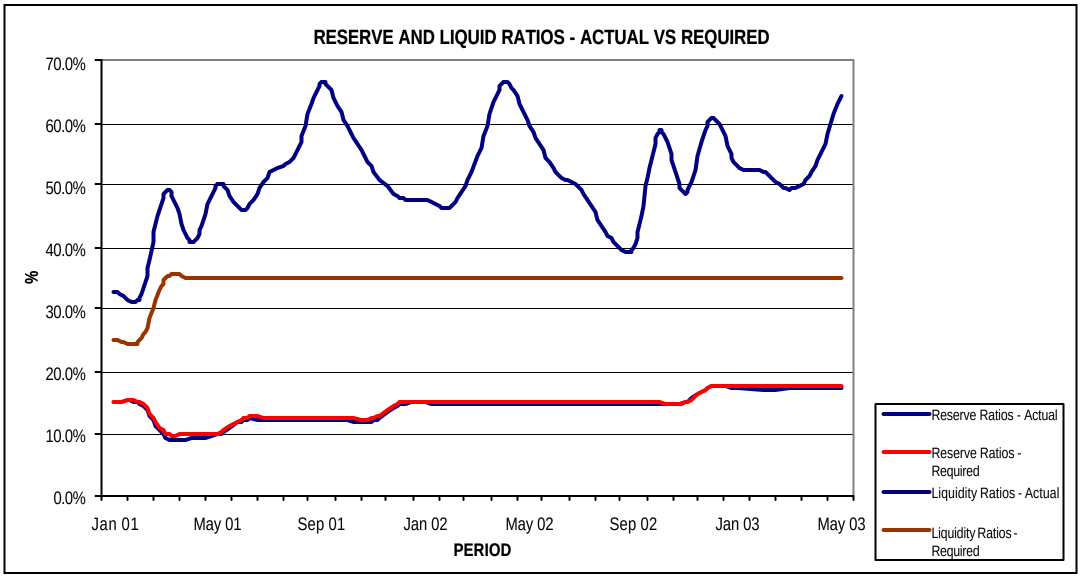
BOZ in its quest to regulate the financial markets has instituted monetary policy measures aimed at supporting stability in the exchange rate and striving for the principal goal of achieving low inflation. As part of the measures that it employs is the enforcement of minimum (or regulatory) liquidity and reserve ratios that CBs must adhere to. At present, two sets of regulatory ratios are enforced at the following levels:

– **Liquidity Ratio**. This ratio measures the value of liquid assets[17] that a CB has as a percentage of liabilities to the public. The requirement by BOZ is that 35% of a CB's public liabilities should be in liquid form and available on demand. This means that CBs must always ensure that, at least 35% of their total balance sheet assets are maintained as liquid funds or, near cash assets (equivalent assets); and,

– **Reserve Ratio**. Apart from the Liquidity ratio, CBs are also presently required to maintain 14.0% (reduced from 17.5% effective 1st November 2003) of both the Kwacha and foreign denominated public liabilities in a sterile[18] statutory reserve account with BOZ. This means that CBs must maintain with BOZ, cash reserves of not less than 14.0% of their total public liabilities.

CBs are amenable to severe penalty interest charges by BOZ where they fail to adhere to the regulatory ratios at any one time. This has meant that CBs must always ensure that they retain sufficient liquidity to stay within the limits of the BOZ regulations. The trend in both reserve and liquid ratios, in terms of the BOZ requirements and CB holdings of same is shown below, covering the period: January 2001 through to May 2003.

[17] Liquid assets include cash, TBs, Bonds and current account balances with BOZ
[18] Non-interest earning account



As can be noted from the chart, CBs have over the period analysed been maintaining statutory reserves in accordance with regulatory ratios as enforced by BOZ. In the case of liquidity funds, CBs have tended to hold levels that are higher than regulatory requirements. They are not bound to maintain present levels of liquid funds with BOZ that are higher than regulatory requirements. They hoverver appear to do so due to the attractive rates offered for Government instruments that they can invest in that are risk free as opposed to returns that can be made from commercial lending.

On the other hand, Statutory Reserve ratios of 14% are maintained by CBs at levels that are in line with regulatory requirements since these are held in sterile accounts, ie do not attract interest. When looked at together, regulatory ratios do impose limitations on the application of deposits that CBs mobilise for on lending.

Given that government instruments are virtually risk free and attract higher returns even when matched against movements in the inflation rate, they offer a safe and secure source of CB profitability. For the productive sectors seeking to borrow from CBs, they have to compete with, not only government instruments being traded on the financial markets but suffer the residual effects of regulatory ratios. More importantly, the levels at which the two ratios have been set ultimately contribute to the high cost of lending rates[19].

[19] Commercial banks have also mentioned the fact that the Central Bank imposes stiff penalties for non-compliance of liquidity levels. As such, CBs ensure that liquidity levels at all times are above the requirements.

Factors Influencing Commercial Bank Lending Base rates

One of the concerns raised by the business sector has been the lack of transparency in how the CBs determine prevailing lending base rates. This concern has also been accentuated by the CBs' preference for placing their loanable funds in government instruments. In response, CBs have argued that, lending base rates are largely influenced by the interplay of factors prevailing that are outside their control together with the need to remain profitable. Drawing on the arguments of CBs, the make up of factors influencing lending base rates were analysed in detail based on three scenarios[20] as set out below.

Assumptions based on average holdings of CBs

Application of Regulatory Ratios:

1. Core liquid asset ratio		35%
Portion[21] in: Notes & coins	*3%*	
Current accounts	*4.4%*	
Term deposits	*1%*	
TBs	*26.6%*	
2. Statutory reserve ratio		14.0%

Typical rates of interest applying and provisioning:

Average interest rate on the deposit		23%
Average base lending rate		41%
TB average interest rate yield		32%
Government Bonds average yield rate		42%
Weighted average of government borrowing:	36%	
Loan loss provision on commercial lending		8%

<u>Worked example on deposit received by a CB:</u>

Deposit obtained from public		1,000,000.00
Less: Statutory Reserve Ratio Requirement @ 14.0%	(140,000.00)	
Liquid Ratio Requirement @ 35%	(350,000.00)	
Amount Available for Lending		**510,000.00**

[20] Note that these scenarios were presented by Barclays Bank at a 19 July 2003 meeting with the Business Forum. However, certain parameters have been modified from the original presentation.

[21] These portions are based on average holdings of commercial banks in core liquid assets. The average numbers are based on the period from Jan 01 – Apr 03.

Portion set aside for Investment in TBs	266,000.00

Using the above assumptions, three scenarios were analysed against different rates of interest income that could accrue to the CB as follows: Scenario 1: based on current base rate; Scenario 2: based on weighted average of government borrowing; and, Scenario 3: based on the TB average yield rate. The results of this analysis are shown below.

Amount Available for Lending	510,000.00		
Investment in TBs	266,000.00		
	Scenario 1	**Scenario 2**	**Scenario 3**
Rate of interest for income	*41%*	*36%*	*32%*
Interest Income on Available Amount	209,100.00	183,600.00	163,200.00
Interest cost on deposit @ 23%	(230,000.00)	(230,000.00)	(230,000.00)
Interest on portion of liquid assets (TBs)	95,760.00	95,760.00	95,760.00
Loan loss @ 8% of amount lent	(40,800.00)	(40,800.00)	(40,800.00)
Net interest income	**34,060.00**	**8,560.00**	**(11,840.00)**

The above analysis indicates that interest rates below 36% yield negative returns to the CB. At base rates of 36%, the net interest accruing to the CBs would be insufficient to cover their administrative overheads and earn a reasonable return for their shareholders. As such, it can be deduced that base rates would still be in the range of at least 38% after the reduction of the Statutory Reserve ratio from 17.5% to 14.0%. Clearly, the BOZ measure is insufficient to achieve the desired effect.

A further analysis was carried out in order to make a clearer comparison of how much returns would be obtained from investing in Government instruments. In this case, it is assumed that the same amount available for lending (K510,000) is invested in Government instruments. Illustrated below are the computations on net interest income that would be obtained from such a transaction.

Assumptions

Issue Date	01-Jan-2003
First Instalment	30-Jun-2003
Settlement Date	31-Dec-2003
Rate	36%
Frequency of interest payments	2 times

	Amount (Kw)
Interest earned from investment	183,600.00
Less: Withholding Tax @ 15%	(27,540.00)
Net interest income	156,060

From the above computations, it is evident that Liquidity and Statutory Reserve ratios diminish the loanable funds that are available to CBs for on lending. Where deposits of CBs are placed in government instruments, the returns are not only higher but, there is less risk involved and transaction costs are virtually non-existent.

It has thus been shown that when determining the cost of lending, commercial banks consider factors such as regulatory ratios, deposit rates and mismatch risk. It is therefore necessary to address these issues before the high cost of borrowing in the country can be brought under manageable levels.

EFFECTS OF WEAK FISCAL DISCIPLINE

The above analysis clearly demonstrated that the major causes of distortions in the financial markets are linked to Government borrowing and the level of regulatory ratios imposed on CBs by BOZ. The specific effects of the interplay of the above two factors have been analysed in some detail in previous section of this report.

BOZ has been focusing on containing the flow of excess liquidity on the market by using interventionist instruments such as regulatory ratios whilst, Government has been perpetually borrowing from the same market. The build up of Government borrowing also forces BOZ to offer new instruments in order to meet maturities of previous issues. This has also created a vicious cycle where, government instruments have to be continuously placed on the market to cover past and new borrowing requirements of the Government.

Thus, the BOZ has focused on palliative measures that address likely increases in money supply on the market through the control of CB liquidity by applying tight monetary policies that have included the current levels of regulatory ratios. This in turn, has led to the reduction of loanable funds that the productive sectors can access from CBs. Key questions that arise can include:

- Why is the Government continuing to borrow to cover past deficits and new expenditure requirements when it is fully aware of the negative effects on the whole economy?

- If the Government has to borrow, why is it encouraging TB and Bond issue rates of interest that are appreciably higher than inflation rates and completely out of line with CB interest rates for deposits placed with them by private savers?

- Why is BOZ maintaining regulatory ratios at such high levels when the effect is to limit loanable funds available to private borrowers?

The above questions are pertinent given the causal factors alluded to in earlier sections of this report. They also illustrate the nature of the paradigm in the operations of the financial markets and constraints faced by the private sector to access affordable credit. Some of the answers to the above questions are proposed below that are based on the broader analysis of issues associated with fiscal indiscipline.

Consumptive Expenditure by Government

The Government's calls on scarce local and foreign currency resources should also be seen from the perspective of what could be termed as, "the cost of policy". This is related to development choices and priorities that a government selects in the allocation of resources in an economy. Like all other things, it involves trade offs, or the cost of financing a set of interventions logically results in a reduction of what can be allocated in other areas, as the resource envelope is limited.

In Zambia's case, the Government has found it expedient to maintain its size and role in the economy supported by expenditure that can only be met by starving other more socially acceptable causes and needs for stimulating economic growth. In all this, the Government appears oblivious to the fact that Zambia is one of the poorest countries in the world. If the areas meriting the Government's attention were linked to national (and popular) priority objectives, as espoused in policy pronouncements, the effect would be less negative.

More specifically, an economy under severe stress as in Zambia's case requires highest levels of fiscal prudence. In practice however, politically induced calls on expenditure have tended to influence priority setting and allocation of resources. Examples include:

<u>Operation of a Parallel Financial Market</u>

Government has the deliberate policy of allocating interest free loans to the order of US $45,000 to each Member of Parliament used to purchase personal vehicles that are also imported duty free. It also offers car and house loans to civil servants (virtually interest free) that are funded directly by the treasury. This practice has been extended to BOZ and other public sector institutions that also offer high value interest free house and car loans to their employees. The effects of these practices are several but notably, result in the following:

- They divert financial resources from priority areas apart from reducing available foreign exchange and domestic resources on the market; and,

- They also create a parallel financial market for policy makers, senior civil servants, employees of statutory institutions (such as BOZ) and Members of Parliament who are insulated from the effects of commercial borrowing.

As a logical outcome, scarce national resources are being applied to finance expenditure that benefits a few privileged individuals whilst also contributing to increasing the overall Government deficit. Under such circumstances, key policy makers who are not exposed to the effects of the real economy cannot be expected to place priority to removing distortionary practices, as they would also be affected.

Government's Accumulation of Supplier Debts

An aspect often ignored that has a major effect on the economy has been the failure by Government to settle supplier payments as these fall due. Government is presently ascribed the notorious image of being poor at settling debts to suppliers of goods and services. For example, Government owes utility companies (i.e. electricity, water and telecommunication service company) colossal amounts of money in unsettled bills. Due to political pressure, such companies cannot withhold services or impose penalties on Government. The net effect however, includes the following:

- Such utility companies face high unit costs of delivering services due to one major consumer not paying for what it consumes. As a result, tariffs are kept high to enable these companies to absorb the cost of extending unofficial credit to Government. They are therefore, forced to pass on this cost to private consumers. This increases factor costs of the productive sectors thus compromising their profitability; and,

- Suppliers to the utility companies face delays in payments due to the liquidity pressure induced by Government's failure to settle its own debts. As a result, a vicious cycle of debt service failures occur in the economy that have a knock on effect through to the financial markets – as delinquency is perpetuated in all transactions that have a link to Government default.

A basic principle that ought to be promoted is to remove the preferential status that Government enjoys in matters of settling supplier debts. This would not only encourage fiscal discipline but, would also stabilise the economy and reduce transaction costs.

Rates offered on TBs and Bonds

A rational explanation could not be obtained regarding the current rates of interest offered on TBs and Bonds that are issued by BOZ on behalf of Government. Presently, these are appreciably higher than the prevailing inflation and saving rates. In such circumstances, they offer a more profitable alternative for CBs who are in turn, induced to invest available funds in government securities rather than lend to commercial borrowers.

According to BOZ, they participate in the market by these issues in order to: mobilise resources for Government to cover expenditure deficits; meet maturities of old issues; and, to mob up excess liquidity. On the other hand, excess liquidity is fuelled through Government borrowing and the allocation of such resources towards consumptive expenditure.

It is therefore apparent that Government is oblivious to the distortions that it is creating in the operations of the financial market. This is also not helped by the inability of BOZ to ease pressure on CBs through regulatory ratios. Ultimately, further consideration has to be given to the contributory factors influencing Government's recourse to borrowing. Some of the causes relate to current financial and treasury practices of Government as discussed below.

Treasury Management Practices of Government

Current treasury management practices applied by the Government offer CBs windfall gains that effectively contribute to increases in the fiscal deficit. This also forces the Government to increase its dependence on borrowing even when this can be avoided. Two principal causes of this situation are noted as follows:

i. Firstly, the Government has maintained the same financial regulations that suited the time when BOZ provided commercial banking services to it's ministries and agencies. In particular, Government ministries are only allowed to maintain subventions in operating or current accounts held with CBs. This means that they cannot invest these funds pending actual expenditure. On the other hand, with the implementation of the "cash budget", ministries are only permitted to commit expenditure after receiving actual releases from the Ministry of Finance and National Planning.

   This means that ministries will receive funds that are then deposited in current accounts of CBs that are both non-interest bearing and, also attract bank charges. During the time that ministries are awarding supply contracts, the CBs have unimpeded use of these funds that often end up being lent back to Government by way of investments in securities. These funds are also used for short-term and inter-bank lending, especially that the ministries invariably require time to expend the money received. Since this is regular occurrence, it provides CBs excess liquidity that form part of their balance sheet.

ii. Revenues collected by the ZRA previously took about 14 days from the time of receipt from taxpayers to the time that they were remitted to the control account of Gov ernment at BOZ even though an ordinary local cheque takes three working days to clear through the clearing system[22]. This situation has since improved with funds being remitted to the BOZ account the following day after collecting, especially for VAT and Direct Taxes divisions in Lusaka, Kitwe and Ndola. For other towns, transfers are usually made within 3-4 working days. However, about 60% of collections (amounting to approximately K500 billion) under Trade Taxes pass through the transit accounts held with commercial banks where these funds sit

[22] The Zambian Electronic Clearing House (ECH) was set up to streamline processing and clearing of cheques on the financial market to ensure accuracy and data integrity, timely *availability of cleared funds, reliability and availability of data in the system, cost effectiveness, introduction of new paym ent instruments, enhanced security and a decreased use of cash. The Physical Interbank Clearing (PIC) stream processes the Magnetic Ink Character Recognition (MICR) cheques or vouchers. Banks are also required to electronically transmit the Match Files or electronic record of all physical items they processed. Under the Direct Debits and Credits Clearing (DDACC) stream, electronic media (diskettes) are delivered to the ECH for processing. This is a non-paper clearing of payment instructions. The information is based on the codeline details on the physical items with additional referencing information. This facility also allows bank customers to send payment instructions electronically to their banks. Banks in turn effect these payments to other banks through the ECH. There is a minimum of four DDACC daily clearing and settlement sessions in order to provide same day value to the customers. To provide for these multiple settlements of DDACC clearing, the Bank of Zambia has made intra-day credit lines available to participating banks.*

for an average of 4 days[23] before being transmitted to BOZ (worst case scenario of 7 days has been recorded, although amounts involved were insignificant).

A detailed schedule of ZRA collections for 2001 and 2002 is illustrated below:-

	2002	2001	% Change - 2001/02	2002 % Contribution	2001 % Contribution
TAX REVENUE	**2,848.8**	**2,448.6**	**16.3**	**100.0**	**100.0**
Income Tax	**1,246.5**	**945.2**	**31.9**	**43.8**	**38.6**
Company Income Tax	279.4	195.5	43.0	9.8	8.0
Personal Income Tax	964.6	743.2	29.8	33.9	30.4
Pay As You Earn	*828.6*	*649.7*	*27.5*	*29.1*	*26.5*
Withholding Tax	*136.0*	*93.5*	*45.5*	*4.8*	*3.8*
Mineral Royalty Tax	2.5	6.6	(62.1)	0.1	0.3
Domestic Goods and Services	**773.0**	**676.7**	**14.2**	**27.1**	**27.6**
Excise Tax	427.3	384.7	11.1	15.0	15.7
Domestic VAT	345.7	292.0	18.4	12.1	11.9
Trade Taxes	**829.2**	**826.6**	**0.3**	**29.1**	**33.8**
VAT on Imports	470.9	488.6	(3.6)	16.5	20.0
Import Tariffs	358.3	338.0	6.0	12.6	13.8

Source: ZRA

During this time that the funds are held, CBs are able to use them for investment purposes. This situation is compounded by the practice whereby CBs that operate taxpayer-receiving accounts on behalf of ZRA have unimpeded access to revenue receipts that start circulating in the economy prior to being received by the BOZ control accounts. This arises due to the clearing process of ZRA cheques collected on behalf of the Government and time taken for the consolidated cheque payment to reach BOZ. During this period, CBs are provided excess liquidity.

Presently, CBs do not charge ZRA for such services but hold ZRA funds in their accounts in between the time that same are moved to BOZ. This can be mitigated if, at least, BOZ became the primary receiving and operating account for all ZRA cheques associated with revenue collections. Under such an arrangement, BOZ could appoint CBs as agents who can operate as sub-chests for locations where logistics would not enable BOZ to be direct recipients. Such a change of procedure would help reduce incidences where the unofficial increase in money supply is brought about through unrecorded circulation of deposits held by CBs.

[23] Commercial banks are charged interest on ZRA collections that are not remitted to BOZ within 4 days. Interest is calculated on a daily basis and is based on the 30-day Treasury Bill Rate.

The above treasury management practices require to be analysed quantitatively so as to determine the extent to which CB profitability is being artificially aided and impact on money supply in the economy. In addition, the extent to which Government could reduce domestic borrowing if it received full value on these national resources requires detailed analysis.

Another important effect of the above situation is that CBs do not need to place reliance on the mobilisation of private savings to stay in business. A contrast can be made of the time when BOZ acted as commercial banker to Government ministries and the importance that CBs attached to the mobilisation of private savings. In those days, CBs invested in the provision of support to the productive sectors, as they were the principal source of both deposits and profitability. It is instructive to note that most CBs have streamlined credit management supervisory units (especially for agricultural enterprises), and instead, have strengthened lending risk appraisal.

Under the present arrangements, Government has not only become a critical source of deposits for CBs but is also their principal borrower thus, partially explaining why the private sector cannot access domestic credit readily or, when it is available, interest rates remain high and mostly prohibitive. Added to this are the other factors alluded to above that perpetuate instability in the financial market and they distortion of interest regimes.

OVERALL CONCLUSIONS

The study established that the current regimes of interest rates prevailing in the Zambian economy have been induced by high Government borrowing and level of regulatory ratios imposed on CBs by BOZ. It was difficult to obtain a rational explanation for the disparity between current offer rates on government securities and prevailing inflation and interest rates on savings. It would appear that offer rates for TBs and Bonds are deliberately pegged at levels to attract purchases for Government by BOZ, regardless of the distortionary effects on the financial market.

It is clear that high Government borrowing has largely had the effect of crowding out the productive sector from accessing both investment and working capital at affordable rates. This situation has been compounded by the less than favourable performance of the export sector. It has induced demand pressure on limited foreign exchange and domestic resources that can be accessed by the productive sector.

RECOMMENDATIONS

To redress the prevailing situation, conscious efforts are needed by the Government to contain its recourse to borrowing and, ensure that scarce resources are not applied to finance unnecessary consumptive expenditure. Strategies are therefore needed to encourage Government, at the political level, to introduce over-arching legislation that establishes some of the following:

i. Places limits on how much Government can borrow from both domestic and foreign capital markets. In particular, statutory limits should be placed on the total value of government instruments, especially TBs that can be availed on the market at any one time. Such a measure can involve setting a benchmark that is linked to GDP above which, Government would require special sanction of Parliament;

ii. Remove the preferential treatment that Government receives from suppliers regarding the settlement of payments due on services and goods that it receives. Suppliers (especially utility companies) must be able to impose the same conditions on Government as they apply to defaulting private consumers without exception. Present practices encourage fiscal indiscipline and contributes to high factor costs in the economy. It is inexplicable that Government can be allowed to continue to consume services that it does not pay for thus compromising the position of other sectors;

iii. Revision of Government financial regulations to ensure that ministries can apply sound treasury management practices over subventions as these are received. Whatever measures are implemented, should aim to stem the process of Government borrowing its own money from CBs. Approaches that could be considered are that of either:

- limiting the number of CBs that will provide banking services to government ministries who either receive a commission and provide an "off balance sheet" agency service; or

- increasing the statutory reserve ratios of those banks holding government deposits so that such funds are kept out of circulation until actual transactions are carried out based on special ledgers monitored by BOZ.

iv. Revising procedures currently applied by ZRA in the management of tax collections and remittance of same to the control account at BOZ. For a start, CBs involved should be designated as sub-chests of BOZ who should ensure that such receipts are kept sterilised whilst in the hands of CBs. In addition, CBs engaged to handle such receipts can instead be paid a set commission; and,

v. Another way would be to establish on-line communication systems between: ZRA, BOZ and MoFNP. Under such a system, ZRA would communicate (electronically) real-time positions of daily collections that then trigger BOZ and MoFNP assessing what has been received and using such information to commit expenditure releases based on credit notes. This can work if supported by the sterilisation of ZRA receipts at all points of the transaction chain until the funds are received in the BOZ control account.

Apart from securing fiscal restraint and improved treasury management practices by Government, other measures will be needed that specifically focus on the role of BOZ. In particular, the regulatory functions of BOZ need to focus on the stability of the financial market and promotion of growth of the production sectors. The recent downward revision of Statutory Reserve ratios from 17.5% to 14.0% by BOZ is a step in the right direction. The measure is however insufficient as the reduction will neither, result in any significant release of funds for the CBs to lend to the private sector nor, influence the lowering of lending base rates below 3 percentage points.

In this regard, BOZ should consider further lowering of the current regulatory ratios so as to enable the release of more funds that can be accessed from CBs by the productive sectors. Such a step should be accompanied by measures that ensure that Government does not become the beneficiary of increased CB liquidity. In addition, policy measures should be put in place that serve the following purposes:

- Adoption of best efforts to effect a moratorium on further issuance of new TBs and Bonds on the market except where these are to cover maturities that cannot be financed by other means. If supported by a limit on the value of government securities that can be allowed to circulate in the economy (based on a benchmark linked to GDP), this would help contain further Government borrowing from the banking system;

- BOZ ceasing to encourage the operation of parallel financial markets associated with preferential loans that are provided to its staff and other public institutions. Such a measure will involve the introduction of a policy that requires that all public resources where lent to political and public officers must be at rates of interest matching CB average lending base rates without exception. This will require that Government commits itself to support this measure so as to remov e distortions and level the playing field.

Implementation of the proposed measures will require political will and placement of the national interest above those of spurious Government expenditure requirements. Most importantly, Government has to recognise its failings and commit to implementing difficult decisions that result in self-restraint whilst also placing priority on the measures that stimulate economic growth and competitiveness of productive sectors.

The above are intended to lessen but will not resolve the problem of availability of credit at affordable levels to the private sector. Another important factor should be strengthening of the legal process/framework regarding borrowing including defaulting and registering of assets offered as collateral[24] to ensure that clients are made aware of the need to service their debts and the consequences of defaulting.

[24] This factor was suggested by commercial banks