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Financial Sector Reforms and Savings Mobilization in Zambia

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Abstract

The paper explores the relationship between financial sector reforms and savings mobilization in Zambia. Although there exists an extensive literature on financial sector development and savings levels in developing countries, there does not seem to exist satisfactory work on the above nexus for sub-Saharan African countries, particularly Zambia. Along these lines, the paper examines the linkages between the financial reforms of the early 1990s and savings mobilization. It considers the characteristics of banks and non-bank financial institutions, especially micro finance institutions, and savings levels and identifies problems associated with the relatively poor performance of savings in recent years and concludes with a set of policy guidelines for strengthening savings mobilization, highlighting the expected effect on poverty-reducing growth.

Keywords: financial sector reforms, saving mobilization, Zambia

JEL classification: E21, E44

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1 Introduction

Many sub-Saharan African countries introduced financial sector reforms to improve the performance of the financial sector in general, and financial savings levels in particular, in the 1980s and 1990s. Yet, despite these reforms, for many countries, the expected increase in financial savings levels was short lived. Compared to East Asian economies, sub-Saharan African countries like Zambia continue to register very low levels of savings mobilization, which is of great concern for policy makers working on the country's poverty reduction strategy. Along these lines, the paper examines the linkages between the financial reforms of the early 1990s and savings mobilization efforts in Zambia. It considers the characteristics of banks and non-bank financial institutions (NBFIs), especially micro finance institutions (MFIs), and identifies problems associated with the relatively poor performance of savings in recent years.

The low savings phenomenon is multidimensional and has a complex causality structure. Understanding the nature and causes of this phenomenon is therefore multifaceted and methodologically diverse but inclusive of both qualitative and quantitative measures. The absence of consistent and reliable data complicates the study of Zambia's low savings rates, resulting in a dearth of literature on the subject. Nevertheless, the present paper identifies a number of key factors affecting savings mobilization in Zambia which include the poor state of the economy, the 1995 and 1997/8 bank closures, increased investment in property for private and commercial purposes, foreign exchange liberalization, the absence of rural financial savings institutions, the parastatal sector reforms, and the HIV/AIDS epidemic.

The rest of the paper is organized as follows. In Section 2 we briefly discuss the theoretical linkages in the financial sector development – savings mobilization relationship. Section 3 discusses the nature of financial savings institutions before the early 1990s financial sector reforms. It traces how financial repression during the 1970s and early 1980s resulted in the absence of an appropriate environment for financial sector development in general, and savings mobilization in particular. Then, it identifies the nature of the financial sector reforms, before examining their consequences on financial savings institutions and savings mobilization rates. In section 4 we present some of the key factors contributing to Zambia low savings performance. Section 5 concludes the paper with a set of policy guidelines for strengthening the rate of savings mobilization in the country.

2 Financial sector development and savings mobilization: theoretical linkages

Low-income countries often lack an appropriate financial sector, which provides incentives for individuals to save, and acts as an efficient intermediary to convert these savings into credit for borrowers. In what follows we briefly discuss theoretical linkages between financial sector development and savings mobilization.[1]

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[1] Clearly, there are causality issues related to the direction of causation between growth and savings – see Mavrotas and Kelly (2001a) for recent evidence on this within the context of a new econometric approach which departs substantially from traditional Granger-causality tests.

2.1 Traditional theoretical linkages and the life-cycle model of saving

Traditionally, the models that look at the interface between saving and development are based around the life-cycle or permanent income theory of consumption, and it will be useful to briefly review these hypotheses, and then discuss the relevance of financial sector development to these models. The model described below draws on Gersovitz (1988), but is typical of the style used by most authors.[2]

We consider an individual who lives for T periods and receives income payments of y_i and consumes c_i. She neither receives nor leaves bequests. The only constraint on the individual's consumption is that the present value of lifetime consumption (C) cannot exceed the present value of lifetime income (Y):

$$C \equiv \sum_{i=0}^{T-1} \left[\frac{c_i}{(1+r)^i} \right] \leq \sum_{i=0}^{T-1} \left[\frac{y_i}{(1+r)^i} \right] \equiv Y \qquad (2.1)$$

However, she is able to borrow or lend at interest rate r in period i if her objective, namely maximizing her discounted lifetime utility, V, does not require that $y_i = c_i$. V is defined as follows:

$$V \equiv \sum_{i=0}^{T-1} \delta^i U[c_i] \qquad (2.2)$$

The decision maker's problem is solved for the two-period model by the first-order condition:

$$U'[c_0] = (1+r)\delta U'[c_1] \qquad (2.3)$$

which, along with condition (2.1) holding as an equality, yields optimal values of consumption, $c_0{*}$ and $c_1{*}$. Current savings are then treated as a residual, which is why most models examining saving are formulated in terms of consumption rather than saving.

Bayoumi (1993), using an overlapping-generations model describes the effects of financial deregulation on household saving in the life-cycle model. It is assumed that consumers live for a fixed number of periods and wish to smooth their consumption path. It is also assumed that the endowments available to individuals when they are young are small, so they would like to borrow when young in order to smooth consumption over their life-cycle. Prior to financial liberalization, consumers have limited access to financial intermediation; they are unable to finance their desired level of consumption when young, as they have no financial assets and are unable to go into debt, so they are in a corner solution.

After the initial period, consumers are able to use capital markets to smooth consumption over middle to old age. Because consumption was lower than desired when young, consumption is higher in middle and old age than it would have been, had they been able to follow the optimal consumption path over their entire lifetime. Financial liberalization increases competition between providers of financial

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2 See Mavrotas and Kelly (2001b) for a detailed discussion of the above theoretical linkages.

intermediation, thereby eliminating the constraint on going into debt. This means the young can now borrow in order to attain their optimal lifetime consumption path.

This results in two effects:

- Initially, there is a temporary effect. In the short term, there will be an increase in aggregate consumption, which will wane over time. The immediate increase reflects that the consumption of the young increases as soon as financial deregulation occurs. There is no immediate effect on the borrowing of older consumers, as they are still affected by their inability to borrow while young. The effect dwindles as previously credit constrained consumers drop out of the economy and overall consumption tends back to its original level.
- There is also a permanent effect. As young consumers are no longer credit constrained, they smooth their consumption. As a result, young consumers' saving becomes sensitive to wealth, real income, demographics and interest rates. This means that aggregate saving in the economy becomes more sensitive to these factors. Thus, during youth and old age an individual will dissave, and saving will occur while an individual is productive.

Obviously, such a model relies on a number of strong assumptions. There must be a system of financial intermediation that permits saving and dissaving to a degree it is hard to envisage the saving taking place in a non-monetary form. Therefore, a major element of the process of financial liberalization is the reform of the financial sector, in order to generate institutions that provide more efficient financial intermediation. The intertemporal elasticity of substitution in consumption determines the extent to which individuals are prepared to defer consumption into the future, and therefore their propensity to save. This in turn will depend on the real rate of interest, which will both determine the preparedness of individuals to save in the financial sector, and influence their consumption decision depending on whether it is above or below the individuals' subjective discount rate (Mavrotas and Kelly 2001b).

2.2 Theoretical linkages derived from models of financial sector development and endogenous growth

Apart from models of saving behaviour rooted in the popular life-cycle hypothesis, there exists a quite interesting strand of theoretical literature which focuses on the role of savings in the context of models of endogenous growth and financial sector development.[3] Most of these models seem to emphasize the relationship between the banking system and economic growth. The spirit of these models can be represented by the model of Pagano (1993). Pagano (1993) considers the simplest endogenous growth model (known as the AK model) where the aggregate output is a linear function of the aggregate capital stock, to capture the potential effects of the financial development on growth.

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[3] See Levine (1997) for a comprehensive review of the theoretical literature, Arestis and Demetriades (1997) for a critical discussion of the empirical literature and Mavrotas and Santillana (1999) for a brief discussion.

The steady growth rate in Pagano's model can be written as:[4]

$$g = A(I / Y) - \delta = A\phi s - \delta \qquad (2.4)$$

where

g is the growth rate
A is the social marginal productivity of capital
I is investment
Y is income
ϕ is the proportion of saving channeled to investment
s is the private saving rate
δ is the depreciation rate.

Along these lines, financial sector development can affect growth by:

- raising ϕ, i.e. under the assumption that financial sector development reduces the leakage of resources (the X-inefficiency of the intermediaries and their market power) this will raise ϕ and therefore raise the growth rate, g in the above model.
- increasing A, i.e. allocate funds to those projects with the highest marginal product; the productivity of capital will be improved by collecting information to evaluate alternative investment projects and by inducing individuals to invest in riskier but more productive technologies by providing risk management.
- affecting the private saving rate s, Bencivenga and Smith (1991, 1993) show that the emergence of banks may reduce the saving rate but also identify conditions under which the growth enhancing effect of financial intermediation (higher A) outweighs the lower saving rate (lower s) – situations of credit rationing. Capital markets also channel funds from households that save, to households that dissave, in the form of consumption credit and mortgage loans. Clearly, the possible shortage of loan supply can raise the issue of liquidity constraints on households.[5]

Finally, another strand of literature (not directly related to savings mobilization) stresses the importance of stock market development for economic growth by acquiring information on investment opportunities, facilitating risk amelioration, monitoring managers and exerting corporate control.[6]

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[4] It is notable that the production function on which this model is based has been influenced by theoretical developments on the endogenous-growth theory as presented in Romer (1989) and Lucas (1988) among others.

[5] Liquidity constraints issues are considered in depth in Jappelli and Pagano (1994) – financial deregulation on national savings rates will reduce savings and growth rates in countries where households currently have limited access to credit; along these lines, the increase in financial savings does not necessarily yield an increase in effective post-savings, but rather helps finance consumer credit, commercial construction and housing.

[6] See Demirgüç-Kunt and Levine (1996) as well as Levine and Zervos (1996) for an excellent discussion.

3 Savings institutions and savings mobilization activities

3.1 Financial savings institutions before financial sector reforms

Before the 1990s financial reforms, the banking sector in Zambia consisted of four distinct groups – pre-independence foreign banks, Government banks, post-independence foreign banks, and local banks. The Government perceived the pre-independence foreign banks, namely, Barclays Bank (1918), Standard Chartered Bank (1906) and Grindlays Bank (1956) as not serving the interests of the local population in need of small and medium scale financial services and created a number of banks, principally, the Zambia National Commercial Bank (ZNCB), 1969, and the National Savings and Credit Bank (NSCB), 1972. During the 1980s the Government also established Lima Bank (1987) and the Cooperative Bank (1989) (Brownbridge 1996, 7; Musokotwane 1997, 1; Muke 1998a, 2; Simatele and Ndulo 1998, 6; Maimbo 2000b, 290).

The Government also established a number of monopoly NBFIs, notably, the Zambia National Building Society (ZNBS) and the Zambia National Provident Fund (ZNPF). Because ZNBS restricted its loan portfolio to the total amount of its deposits and shares, it actively engaged in savings mobilization to sustain its operations. Despite its deposit rates being below market rates, it offered easy account opening procedures; it was accessible with several branches nationwide and, therefore, managed to attract public deposits through the 1970s and 1980s. ZNPF on the other hand, attracted compulsory contributions, which never resulted into meaningful benefits to its contributors since the Government used the funds as a cheap source of financing for its activities.

Until the 1990s, the Government also took the lead in providing micro, small and medium scale financial services. In the early 1980s, for example, the Bank of Zambia (BoZ) set up the Credit Guarantee Scheme as a means of encouraging banks to extend credit to small-scale industries. Other important organizations included the Small Industries Development Organization, Village Industries Service, and the Small Enterprise Promotion Unit. Policymakers thought that banks did not extend credit to this group of entrepreneurs because of their inability to raise adequate collateral. These schemes, like many others before them, relied on government and donor funds for their operations, which precluded the need to raise funds directly from the public.

Overall, government involvement in the financial sector resulted in an inefficient and non-competitive market, which inhibited the development of the private sector financial institutions and discourage private savings. Interest rates controls, which, together with, high reserve requirements, deteriorating macroeconomic conditions, political interference, negative interest rate policies, and directed credit policies, depressed profit margins for banks (Brownbridge 1996, 3-4), and reduced returns on financial assets for savers. Furthermore, an inefficient payments system, an inadequate legal framework, and weak accounting standards reduced the banking systems efficiency, especially its ability to perform its financial intermediation function (Mbalashi 1999, 1; Muke 1998a, 3). Because of the above reasons, few private banks entered the sector between 1970 and 1990. However, when the financial liberalization programme started in the late 1980s, the prospects for profitability improved, and the banking sector attracted more bank license applications. Further, the low capital requirements required by the bank of Zambia, permitted easy access for the new banks and by 1990 there were 12 banks compared to 5 in 1980.

3.2 Financial sector reforms

The BoZ started implementing the financial liberalization programme as part of the World Bank/IMF economic reforms. The reforms started with the partial liberalization of interest rates and the removal of sectoral credit ceilings in the late 1980s. However, the most significant reforms took place during 1992/93 with the restructuring of government banks, prudential supervision reforms, and, foreign exchange and interest rates liberalization.

3.2.1 Restructuring of government owned banks

By the late 1980s, the ZNBS, ZNPF, NSCB, Lima Bank and Cooperative Bank were either financial distressed, illiquid or insolvent. Though initially successful in providing savings facilities, they all faced severe financial problems due to high transaction costs, mismanagement, political interference and the withdrawal of Government subsidies that had previously sustained their high overheads.

By 1992/93, the NSCB was insolvent and only saved from collapse by government reorganization. As part of a K400 million (US$ 100,000) investment programme, the government separated it from the national post office and restructured it to manage external financing intended for micro and small enterprises. Lima Bank and Cooperative Bank, however, failed to attract government resources and went into liquidation. Lima Bank, which handled agricultural loan disbursements, had incurred long running financial losses, a negative capital position, and a large non-performing loan portfolio. Mismanagement, severe drought, low loan recovery rates and erratic government funding accelerated its closure. Cooperative Bank too, failed primarily due to mismanagement and weaknesses in the agriculture based cooperative movement.

3.2.2 Reforms to the prudential system

Prudential reforms involved a revision of the 1972 Banking Act and the enactment of the 1994 Banking and Financial Services Act (BFSA 1994), the introduction of new reporting and accounting procedures, and the strengthening of BoZ supervisory capacity. The BFSA, 1994, granted BoZ new legal powers to licence, regulate and supervise banks. All decisions concerning licensing and other banking activities became subject to BoZ approval (Muke 1996, 1). Banks were required to submit additional, and more frequent, financial reports. Further, statutory instruments were issued for capital adequacy, insider loans, large loans, fixed assets, interest disclosure, classification and provisioning of loans (Mwape 1997a, 6-10; Mwape 1997b, 4-8). The reforms were part of the BoZ's overall capacity building programme, which involved the recruitment of professionally qualified persons, and provision of specialized training (Kani 1996, 21). The number of off-site Bank Inspectors also increased from four in 1994 to thirteen in 1995 (Maimbo 2000a).

3.2.3 Liberalization of foreign exchange and interest rates

In 1992, BoZ ceased the direct determination of interest rates and introduced weekly auctions of treasury bills. It progressively reduced the commercial bank statutory and core liquid assets ratios and commenced open market operations through the sale of deposits of banks and repurchase agreements. By 1993, BoZ had removed all restrictions on commercial bank lending and deposit rates (Kani 1996, 21).

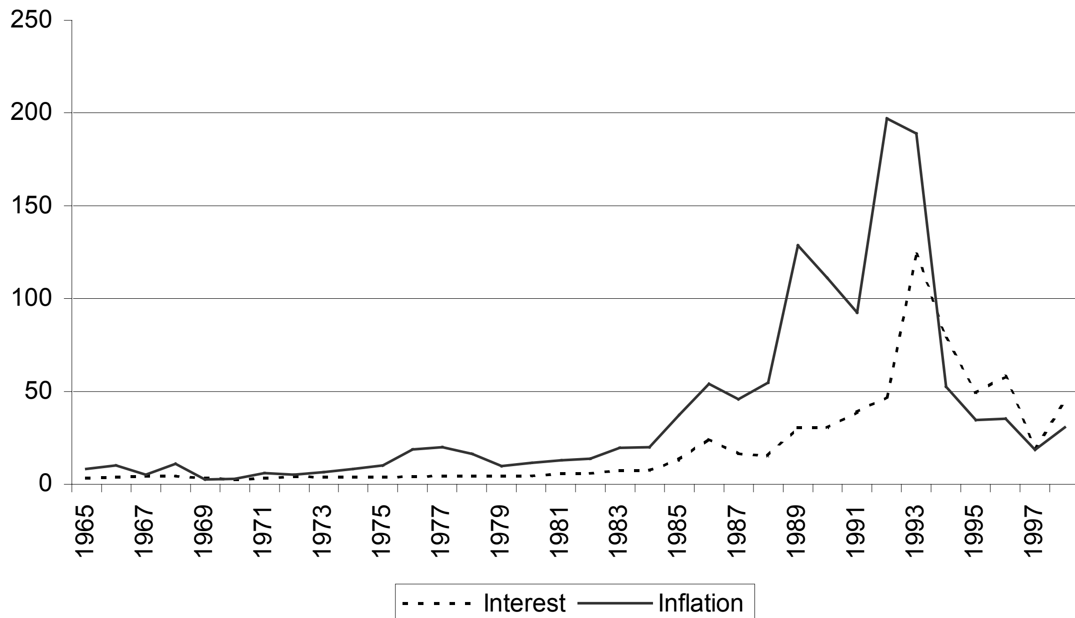
It also started adjusting the foreign exchange rate in order to reflect the true value of the local currency, the Kwacha. Weekly auctions of foreign exchange commenced in 1993 (Muke 1996, 2; Muke 1998b, 3). By January 1994, the government controlled official exchange rate and the market rate had merged, and all remaining foreign exchange regulations were suspended. Also suspended were the need to obtain import and export licenses and the need for exporters, including ZCCM, to surrender a portion of their foreign exchange earnings to the central bank (Kani 1996, 21).

3.3 Financial savings mobilization performance

Foreign exchange and interest rate liberalization had a profound effect on banking sector profitability. The interest rate rise from 40 per cent (1992) to 192 per cent (June 1993), shown in Figure 1 above, led to a sharp rise in interest rates on loans and government securities (Muke 1996, 2). Because deposit interest rates did not increase proportionately, the interest rate spread resulted in higher nominal banking profits. By December 1994, there were 25 registered banks, 19 of which were operational with 188 branches (Muke 1996, 2).

There was also a rise in the number of NBFIs. By 1996 there were over twenty six NBFIs registered with the BoZ, namely, leasing companies, building societies, deposit taking NBFIs, and development finance institutions. Compared to banks, their relative size remained small. Deposits, and deposit like instruments, amounted to K28.5 billion in 1996, almost half of which was accounted for by the ZNBS, which represented 4.5 per cent of the total deposits of banks.

Figure 1: Interest and inflation rates (1965–1998)



Source: Bank of Zambia.

There was also a marked increase in the number of MFIs since liberalization of the financial services industry in 1992/93. By September 1999, there were about thirty organizations engaged in MFI activities (Maimbo 2000c, 10; Maimbo 2001). Two organizations now exist that foster the interests of MFIs – the Micro Banks Trust (MBT) and the Association of Micro-finance Institutions in Zambia (AMIZ). The MBT, established in 1996 at the initiative of the government and the European Union, provides wholesale funds, as well as limited training to micro-financing institutions. The AMIZ, established by micro finance practitioners, has taken a leading role in advocating for new legislation, setting of standards, and training of staff of new institutions (BoZ 1999, 6). Table 1 shows that, with a few exceptions, the majority of MFIs emerged between 1996 and 1998.

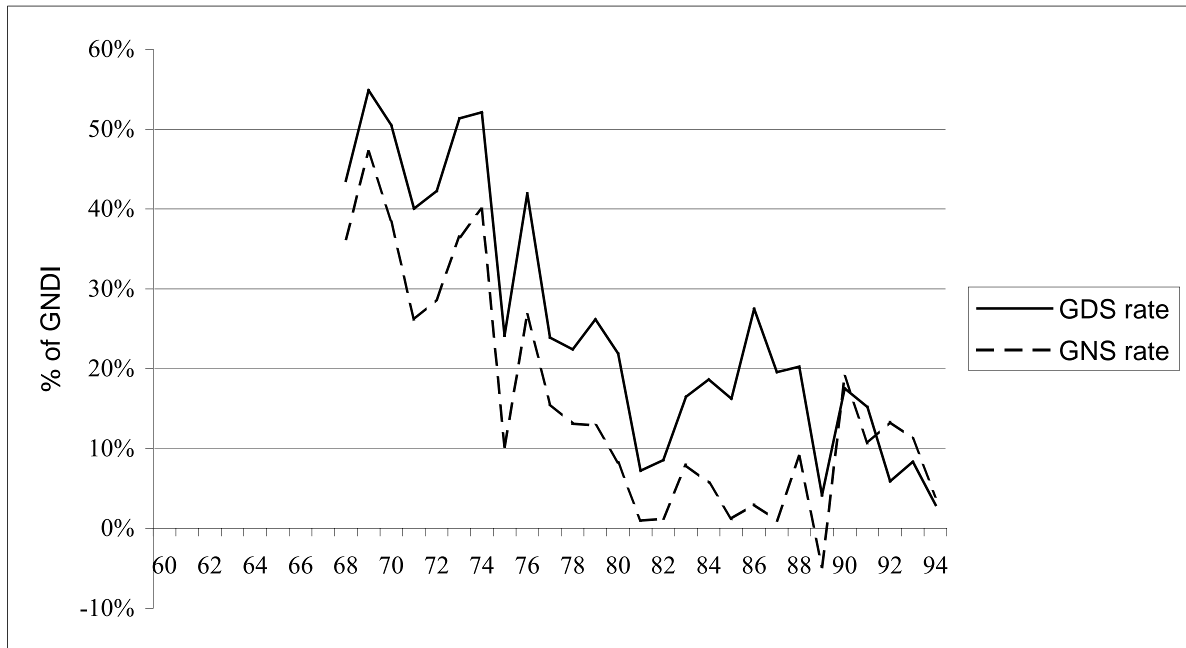
Table 1: The growth of MFIs in Zambia

Institution	Year	Legal status	Target group
Care-Pulse	1994	NGO	Entrepreneurs in peri-urban Lusaka
CMS	1992	Company	Small and medium scale enterprises
Country Services	1997	Company	Small scale farmers and business
C.P.G Castor Oils	1996	Company	Peasants
ECLF	1993	NGO	Women youth and church groups
Irish Aid	1996	NGO	Small scale entrepreneurs
ISBDA	1997	NGO	Marketers, vendors, small business
Keepers Foundation	1997	NGO	Enterprises in livestock development
MBT	1996	Trust	MFIs
Mukungwila Village Bank	1998	NGO	Rural poor people
PPF	1996	Company	The rural disadvantaged
Pride (Zambia)	1999	NGO	Small scale manufacturers
Progress Financing Ltd.	1988	Company	Women and youth
Women Finance Cooperative	1995	Co-operative	Low income women entrepreneurs
ZFAWIB	1998	NGO	Farm workers

Source: Maimbo (2000c).

Although the financial reforms resulted in the emergence of new forms and types of financial institutions, they did not boost savings mobilization. The relatively stationary level of GDS in absolute terms means that Zambia has suffered a declining rate of GDS as depicted in Figure 2. The impact of the collapse of the copper prices is clear; after a high rate of GDS in the early 1970s, there is a structural break in the series in around 1974, and a decline set in which has continued, with the rate reaching around 4 per cent by 1994. Figure 2 documents the trends in GNS and GDS over the period 1968-94. It is clear that the GNS rate is lower than the GDS rate and that both rates follow a downward trend over the same period. The GNS rate was around 15 per cent lower than GDS until 1988, at which time the two series converged somewhat, reflecting the fact that Zambia had negative net transfers from abroad during the period to 1988. IMF measures imposed in 1988, and a devaluation of the currency helped correct the problems to a degree; since 1988 the two series have been at a similar level.

Figure 2: Gross domestic savings and gross national savings



Source: World Bank savings database (1998).

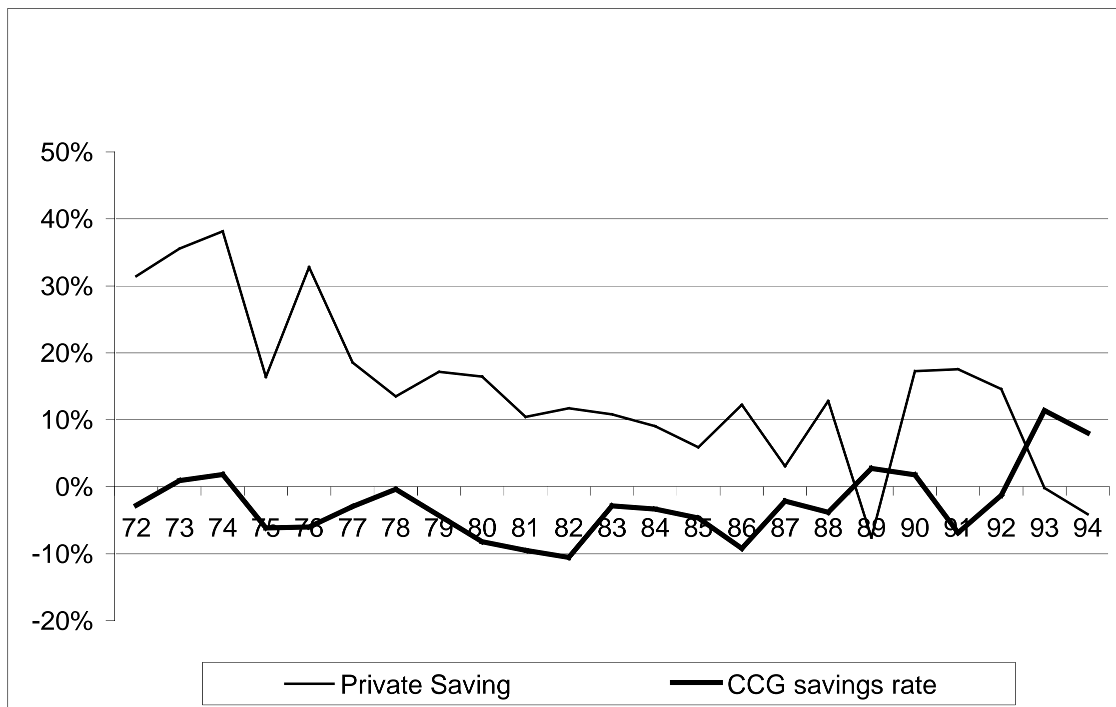
Notes: GNDI = gross national disposable income; GDS = gross domestic savings; GNS = gross national savings.

4 Explaining Zambia's poor savings mobilization performance

Data is not available on private enterprises, so aggregate savings can only be disaggregated into private and government saving. However, it is immediately clear that the driving force behind the decline in the aggregate savings figure over the period is private savings, which have decreased from a peak of almost 40 per cent in 1975 to dissaving of around 3 per cent in 1994 (Figure 3). It is interesting to note that private savings showed a recovery to around 16 per cent following the implementation of financial liberalization measures in 1991. However, this recovery was short lived, lasting until the onset of the financial crisis in 1995. At the same time, for most of the period the government has been dissaving, partly as a result of the country's crippling external debt, although matters seem to have improved somewhat in the 1990s.

The low savings phenomenon is multidimensional and has a complex causality structure. In what follows we discuss a number of factors which appear to have influenced the level and rate of private savings in Zambia. They include the poor state of the economy, increased levels of poverty and unemployment, the 1995 and 1997/8 bank closures, increased investment in property for private and commercial purposes, foreign exchange liberalization, the absence of rural financial savings institutions, the parastatal sector reforms, and the HIV/AIDS epidemic.

Figure 3: Private and government savings



Source: Loayza *et al*. (1998).

4.1 The state of the economy

Following independence in 1964, mining revenues provided Zambia with steady economic growth and one of the highest levels of per capita income in sub-Saharan Africa. However, subsequent to the 1973 copper prices collapse, Zambia faced what has become a permanent adverse shift in its terms of trade. The over dependence on copper revenues, and weaknesses in other areas of the economy, such as the high degree of protection afforded to the manufacturing sector, which made exports non-competitive, meant that the economy has deteriorated significantly. Zambia faced problems of a kind typical in an inflexible, poorly diversified economy: rapid money supply growth, skyrocketing inflation, large and unsustainable fiscal and balance of payments deficits, low real incomes and declining private investment (BoZ 1999). Zambia's problems were compounded by the world interest rate and oil shocks of the 1970s and 1980s; the high level of external debt in relation to exports and GDP meant that by 1987 the per capita debt burden was the highest in the developing world (Jones 1994). To date, despite a number of IMF and World Bank adjustment programmes undertaken in the 1980s and 1990s, Zambia has not succeeded in reversing the declining investment and per capita income trends, nor has it been able to bring about fiscal and monetary stability. From being one of the strongest economies in sub-Saharan Africa at independence, Zambia is now one of the world's poorest countries, with a per capita income of about US$ 300 (1964; US$ 1,200). Zambia's impoverishment resulting from the above problems has had an adverse effect on savings.

In 1991, 67.7 per cent of Zambia's population, nearly 8 million people were poor, with 58.2 per cent in the extremely poor category; by 1998, 73 per cent of the population were considered poor (GRZ 2001, 4). Despite economic reforms between 1991 and 1998, Zambia, with an annual average real GDP growth rate of only 0.2 per cent, double-digit inflation and continuous nominal exchange rate depreciation and high indebtedness, has not experienced real growth. Instead there has been an increased level and incidence of poverty. Using the 1991, 1993, 1996 and 1998 Central Statistical Office Household Surveys, McCulloch *et al.* (2000) discussed the evolution of poverty and inequality using poverty line lower than the international standard of US$ 1 per day (McCulloch *et al.* 2000, 15-16). Their study found that there was a dramatic increase in the level of poverty in both urban and rural areas between 1991 and 1996 induced in part by the economic reforms implemented recently (McCulloch *et al.* 2000, 27).

The urban and peri-urban areas witnessed an increase in poverty levels particularly in the high-density areas. These areas are characterized by high population densities, high formal unemployment and general underemployment of labour. In addition, the removal of food subsidies, the privatization of overstaffed government institutions, and trade liberalization also contributed to the higher levels of poverty. The formal sector only employed 17 per cent of the labour force in 1991. Despite a 46 per cent increase in the labour force, formal sector employment has declined by 15 per cent and now constitutes less than 10 per cent of total employment. The declining performance of the mining and manufacturing sectors are primarily responsible for the decline in employment demand. Mining and quarrying, which employed 64,800 workers in 1991, only employed 34,434 workers by 1998. Formal manufacturing sector employment declined from 75,400 in 1991 to 43,320 in 1998 (McCulloch *et al*. 2000, 6) Information on informal sector employment is largely unavailable but was estimated at 2.3 million in 1993 and has subsequently increased by at least 35 per cent in the agricultural sector and 15 per cent in non-agricultural activities between 1995 and 1998 (McCulloch *et al*. 2000, 7). In the rural areas, drought devastated rural livelihoods over the same period. The economic reforms, such as the maize marketing reforms, mainly benefited those near major urban centres, but hurt more remote rural farmers. Poor rural infrastructure and thin non-existent markets for key agricultural inputs and services, notably fertilizer, credit and transport reduced the ability of rural farmers to benefit from the reforms and exploit their agricultural potential (McCulloch *et al.* 2000, 27). Finally, lack of food, safety nets and poor access to social services accelerated the rate and growth of poverty (GRZ 2001, 4).

4.2 The 1995 and 1997/8 bank closures

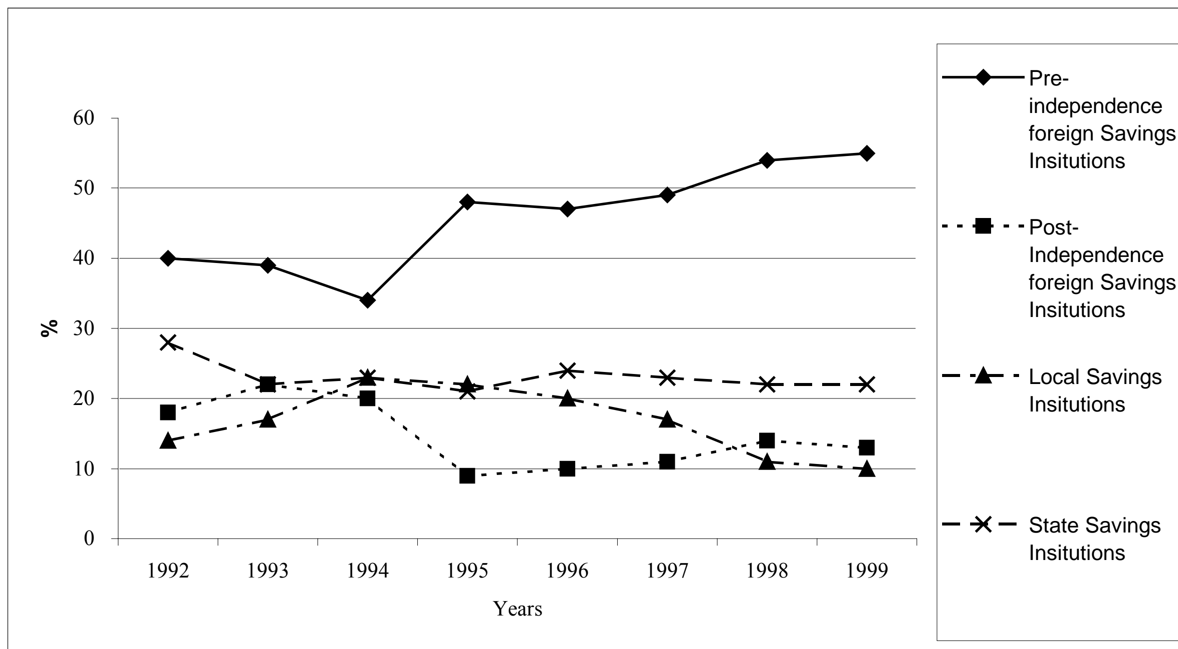
As inflation and the exchange rate began to stabilize, in the last quarter of 1993 and early 1994, it became more difficult to maintain earlier levels of profitability. Instead of curtailing activities in line with the declining profit margins, some banks took on greater risks to match previous results (Mwape 1997b, 3; Mbalashi 1999, 7). In the third quarter of 1994, and early 1995, adverse developments were taking place. Reckless lending left banks with unrecoverable loans and, in the quest to attract and retain customers; banks were disregarding prudent loan procedures and security arrangements. This was compounded by a rise in the cost of funds, the erosion of earnings from treasury bills and foreign exchange operations, and shortages of capital and liquidity (Brownbridge 1996, 11; Muke 1996, 2). These developments culminated in the closure of three banks in 1995. Meridien BIAO Bank, then the fourth largest bank, with 25 per cent of the total

industry deposits, collapsed on 19 May, African Commercial Bank on 17 November and Commerce Bank later within the same month (Maimbo 2000a, 2).

The crisis affected the remaining banks in different ways. There was a general loss of confidence in the banking system, which favoured the foreign banks at the expense of local banks. The latter experienced unprecedented deposit withdrawals and, consequently, some faced severe liquidity problems. There was a general 'flight to quality' as customers moved accounts to foreign banks, which they perceived as being more stable and better managed. The declining financial performance of the local banks was made worse by the managerial deficiencies exhibited over the following two years. Despite the efforts of the BoZ to redress the situation, the last quarter of 1997 saw yet another crisis emerge. Prudence Bank collapsed on 17 October, followed by Credit Africa Bank on 2 December, Manifold Investment Bank on 5 December and First Merchant Bank on 2 February 1998.

After the 1995 bank failures, the pre-independence foreign banks continued to dominate the banking sector with respect to deposit size. Figure 4 shows that in the period 1994 to 1999, the total deposits market share of pre independence foreign banks grew from 35 per cent to well over 50 per cent. Local banks, on the other hand, have lost the largest proportion for the market with a decline from 25 per cent of total deposit market share in December 1994 to just under 10 per cent in December 1999.

Figure 4: Total deposit trends (1992–1999)



Source: Bank of Zambia.

The 1995 and 1997/98 bank failures dissipated public confidence in the banking system. Although there was a general 'flight to quality' from local banks to foreign banks, there was also a 'flight to non-financial assets'. Firstly, the foreign banks required higher minimum bank balances and therefore excluded a large proportion of private savings. Secondly, they offered very lower interest rates on deposits, which discouraged savers. Thirdly, they were generally reluctant to open accounts for individuals who were not in formal employment and therefore a proportion of the informal sector labour force must

have been dissuaded from applying for savings accounts. Lastly, and perhaps most importantly, the fear of losing ones deposits was probably highest amongst those who had recently been retrenched or declared redundant and had just received lump sum separation financial packages. In the absence of a deposit insurance scheme and a working social security system, people were understandably weary of the risk of losing their money in failing banks. In the event of a bank failure, the Banking and Financial Services Act only provided for a fixed compensation amount of K500,000 (US$ 150). As a result, would be financial savers turned to investments into non-financial assets, especially real estate, to secure their personal livelihoods.

4.3 Investment into real estate for private and commercial purposes

There has been a substantial increase in the level of investment into real estate for both private and commercial purposes in the last five years. In a recent study of the property market, Chikolwa (1996) found that the rise primarily been funded by private savings, retirement benefits and for a very small proportion of the formal sector, through employers such that offer mortgages with low interest loans of less than 5 per cent to their employees. The mortgage market is still in its infancy with only three building societies in existence. The funds at these building societies are expensive as the interest rates are high (currently on average between 35 – 40 per cent) and the conditions are generally not flexible. Funds from commercial banks are not any better as they cost more than building societies loans. Chikolwa (1996, 3) further noted that, although the 1996 National Housing Policy and the 1999 Budget Speech, allocated 15 per cent of the Gross National Product (GNP) for housing development (GRZ 2001, 15), the public pronouncements have not been implemented. Public investment in housing development dropped from 3 per cent of GNP in 1969 to less than 0.5 per cent by 1992; way below the World Bank recommended minimum of 5 per cent (GRZ 2001, 6), consequently, the use of personal savings to build or acquire land and housing, continues to grow at the expense of investment in financial assets.

The growth in private property investment has further been encouraged by the recent privatization of State enterprises and the central and local government divestment from public provision of housing for employees and residents. Of the approximately 15,000 central government housing units in 1996, about 14,000 have been offered to sitting tenants and nearly 2000 people have paid a total of nearly K15 billion (US$ 3 million). The entire local government housing stock of 25,000 local units has also been offered to sitting tenants and nearly 65 per cent people have paid in full. The housing stock of privatized firms has also been made available for private purchase. Due to the rising interest in property as an alternate form of investment, property prices in Lusaka have been rising at an annual rate of approximately 30 per cent. The value of vacant urban land for development, already in short supply, has also been rising at a very higher rate of approximately 70 per cent per annum in the last three years (Chikolwa 1996, 5).

4.4 Foreign exchange liberalization

One of the reasons why the financial reforms failed to encourage domestic financial savings is that foreign exchange liberalization, which allowed individuals and companies to legally hold foreign currency denominated financial assets, coincided with the negative real interest rates period. Individuals and corporate entities transformed

(and continue to do so) their savings into foreign currency. Zambia has now been listed as one of the countries whose citizens are making huge anonymous deposits in secret Swiss accounts. According to a recent study by an organization called Swissmoney Research, Zambia was among the six 'least affluent' countries that were identified as having the 'largest percentage growth' of deposits last year. Other countries in this group of 'least affluent' countries include Vietnam, Eritrea, Albania, Sierra Leone, and Benin. Using publicly available data, the report traced the flow of funds from more than 180 countries and territories to Switzerland between 1990 and 1999, examined where the money was reinvested and showed which banks were most active in gathering these funds. The study examined so-called fiduciary transactions, which mainly consist of large, short-term cash deposits placed with Swiss banks by foreigners. Unlike conventional deposits, they are then transferred to banks outside Switzerland in order to avoid the 35 per cent Swiss withholding tax on interest. Moreover, by placing the funds abroad in the name of the Swiss bank, clients are able to maintain anonymity (*Financial Times*, 4 January 2000).

4.5 Absence of informal and rural financial savings institutions

However, for the majority of Zambians, especially the peri-urban and rural poor, who cannot afford to externalize their savings, let alone, meet the minimum savings balance required by banks there are few informal and rural financial savings institutions that offer viable alternatives. Rural areas are characterized by poverty, isolation and marginalization from the mainstream economy and women, who play the leading role in economic activity, are involved in small economic activities, which typically yield insignificant (for financial institutions) marginal returns.

Initial expectations that the new NBFIs would foster financial deepening and encourage financial savings mobilization were short lived. Firstly, the new NBFIs did not target the general population as a primary source of their funds. Leasing companies generally focused on loans from their parent banks, other NBFIs and foreign parent organizations. Secondly, although, it would have been less expensive to mobilize deposits from the general public, the low level of customer confidence following the 1995 banking failures made it difficult for new institutions to solicit public deposits.

Thirdly, the financial condition of the NBFIs did not inspire confidence. A study commissioned by the BoZ in 1996 revealed that at least half of the NBFIs were in a weak or financially distressed condition. Most of the Government institutions and some of the private institutions faced severe financial constraints. Two of the leasing companies and the ZNBS were practically insolvent. Several of the other insolvent financial institutions had suspended lending, either on instructions from BoZ or due to illiquidity. Despite opening the building society market to competition, it remains underdeveloped with only three institutions in the market – ZNBS, Finance Building Society (FBS) and Pan African Building Society (PABS). As at December 1996 the ZNBS was insolvent. Both FBS and PABS are were undercapitalized with capital of only K200 and K88 million respectively, with the latter holding non performing loans amounting to 94 per cent of its total loan portfolio (Simatele and Ndulo 1998, 15). Although not yet insolvent, a significant number of the other leasing companies were under capitalized, had low earnings or impaired loan portfolios.

The financial distress was due to several factors. Most significantly, however, was the fact that many of the NBFIs served risky segments of the credit market – small businesses (especially in transport, trade and agriculture) at very high interest rates. Nominal lending rates were between 60 per cent and 120 per cent per annum and real lending rates were between 30 per cent and 60 per cent. The combination of the high interest rates and the risky clientele resulted in high default rates. In addition, the BoZ revealed that poor management, deficient credit procedures, weak internal controls and a general failure to comply with basic prudential management affected the financial performance of the NBFIs.

With respect to MFIs, although their number has grown significantly in the last few years, their size, in terms of loans made, remains relatively small compared to the rest of the financial sector (Table 2). In a country where 70 per cent of the population, estimated at 10 million, is said to be living in poverty, with 54 per cent classified as being part of the 'core poor' – living with income of less than US$ 1 per day (Musona and Mbozi 1998, 5) – the potential for MFI growth remains high.

Table 2: The acceptance of deposits by MFIs in Zambia

Micro finance institution	No. of savers	Value of savings held K'M (US$)	Interest on deposits
Care Pulse	3007	460 (141,538)	Bank rates
Country Services	0	0	0
C.P.G Castor Oils Zambia Limited	250	2.5 (769)	Market rates
Ecumenical Church Loan Fund	0	0	0
Irish Aid	0	0	0
Informal Sector Business Development Association	500	5 (1,538)	0
Keepers	0	0	0
Micro Bankers Trust	0	0	0
Mukungwila Village Bank	0	0	0
Peoples Participation Fund	407[1]	10	0
Pride Africa	0	0	0
Progress Financing	570	31 (9,538)[2]	n/a
Women Finance Cooperative	4300	151 (46,461)	8%
Zambia Federation of Associations of Women in Business	0	0	0

Source: Maimbo (2000c).

Notes: [1] Groups; [2] Approximately, exchange rate: US$1 = K3250.

There are several contributing factors responsible for the slower than expected growth in loan portfolios and outreach levels by MFIs. Two factors, in particular, contribute to the lower than expected performance of MFIs. First, demographically and geographically, the low population density in rural areas, the practice of barter and the rural culture of self-sufficiency does not augur well for MFIs (BoZ 1999, 5). Therefore, MFIs are concentrated in the urban areas, which are more familiar with cash

transactions while their rural counterparts traditionally depend on once-annual maize sales, or remittances from urban relatives. Secondly, the unfavourable legislative and regulatory environment has not been conducive for MFI growth. The licensing requirements for NBFIs were too stringent for the establishment of MFIs.

For example, the minimum capital requirement of K25 million (US$ 6,000) was considered too high. Thus, they preferred to continue operating as non-governmental organizations (NGOs), as registration did not require such a high capital requirement. However, without BoZ registration, they are not allowed to collect deposits from the public. Two of the countries largest MFIs-CARE Peri-urban Lusaka Small Enterprise (CARE PULSE) Project and Credit Management Services do not collect savings because they are not registered as NBFI's with the BoZ (Muntemba 1999, 2; Musona and Mbozi 1998, 19; Maimbo 2000a).

4.6 Parastatal sector reforms

The recovery to around 16 per cent following the implementation of financial liberalization measures in 1991 is partly explained by the huge redundancy payments that employees received in the wake for the parastatal and public sector reforms and either invested in treasury bills or long term deposit accounts. The Meridien Investment Bonds, for example, attracted investments in excess of K39 billion in less than nine months of appearing on the market. However, by 1995, the financing to fund the redundancy packages was either exhausted or redirected towards other activities. Meanwhile, recipients of the funds either invested the funds into real estate or ventured into business, at the encouragement of Government funded programmes.

4.7 HIV and AIDS

The impact of the HIV/AIDS epidemic, though not yet formally calculated, on the economy as a whole and savings in particular is not hard to recognize. About 650,000 people have died from HIV/AIDS between 1996 and 1999, and a recent survey conducted between 1996 and 1999 estimated that one million people are infected with the disease. The survey estimated that 20 per cent of 15 to 49 year old Zambians were HIV positive (Gondwe 2000). The most distressing trend has been the drop in life expectancy from 54 years in the mid 1980s to an estimated 37 years in 1998 (Mulenga 2000; GRZ 2001, 5). The Health ministry projects that the number of HIV infected persons will increase to 1.1 million by 2010 (Mulenga 2000).

Bloom *et al.* (2000) note that Zambia has suffered one of the worst declines in health status over the 1980s and 1990s, and that the loss of production by sick individuals, increased direct financial cost of healthcare, and the opportunity cost of caring for the sick in sub-Saharan Africa have increased significantly in the last few years. The financial costs of looking after orphans on families have increased and so have medical costs of looking after infected relatives. Further, the high-risk group includes young men and women, in both the formal and informal sector, most capable of generating incomes that ought to be leading to higher savings portfolios.

5 Conclusions and policy recommendations

In addition to specific constraints banks and NBFI's face in mobilizing public deposits the study considers the poor state of the economy, increased levels of poverty and unemployment, the 1995 and 1997/8 bank closures, increased investment in property for private and commercial purposes, foreign exchange liberalization, the absence of rural financial savings institutions, the parastatal sector reforms; and the HIV/AIDS epidemic seem as contributing factors to the poor level and rate of private sector savings in Zambia. The consequent increase in purchases of foreign currency denominated financial assets, and increased investments in domestic non-financial asset such as real estate key possible explanatory variables for the decline in private sector domestic savings. To redress the above trends, it is important that both Government initiatives to improve the rate and levels of savings mobilization are especially targeted at micro, small and medium sized individuals and enterprise deposits; increasing the incentives to invest in local financial assets, as opposed to foreign currency assets or non-financial domestic assets.

Some of the immediate requirements are improving macroeconomic stability, improving the regulation and supervision of local banks, improving the regulatory environment for MFIs and encouraging the provision of savings facilities to micro, small and medium sized individuals and enterprises in the way the NSCB has been attempting to recently. The Government must also be supportive of private sector programmes such as the Financial Deepening Challenge Fund (FDCF) aimed at developing the financial sector.

5.1 Improving macroeconomic stability

Efforts to improve the level and rate of savings mobilization must be made within the overall context of improving the state of the economy. Investments in domestic financial assets will only increase if the domestic currency is stable, interest rates are positive and local banks and NBFIs are managed prudently and safely. Worried about the continued investment in foreign financial assets, especially by corporate entities, the Government announced foreign exchange measures aimed at easing the pressure on the local currency on 18 January 2000. Some of the key measures include: limiting the overall foreign exchange exposure limit for all banks and financial institutions has been reduced from 25 per cent to 15 per cent of regulatory capital; limiting total foreign exchange placements and deposits in internationally recognized off-shore banking centres whose laws e.g. secrecy laws, may impede supervision of foreign exchange activities of the bank or financial institution by the BoZ to 5 per cent of its total foreign exchange placements or deposits; and requiring all Business entities and members of the public wishing to make external payments in excess of US$ 5,000 to do so through banks. Members of the public will continue to hold foreign currency deposits in the form of demand, savings and time deposits. However, the foreign currency demand deposits of each commercial bank or financial institution shall not exceed 25 per cent of its foreign currency deposit liabilities (BoZ 2001). The efficacy of these reforms must be evaluated within the overall long-term reforms aimed at restoring and maintaining macroeconomic stability.

5.2 Strengthening the regulation and supervision of local banks

Despite, the recent failure of local banks it is important that the BoZ does not discourage their registration. Brownbridge (1996, 16) rightly argues that local banks can provide services that foreign and Government banks are either unwilling or unable to supply, and can also inject the much needed financial competition in the financial sector. They extend access to individuals and small businesses that experience difficulty in relating with the formal banking sector. Private sector deposit growth in the early 1990s occurred most amongst local banks, especially Meridien Bank. They provided longer opening hours, shorter queues, higher deposit rates and/or lower minimum balances shorter and quicker bank account opening procedures, and providing quicker and more personalized services (Brownbridge 1996, 11).

Furthermore, unlike foreign banks, they invested in the rural sectors where the latter were either divesting from that market altogether or maintaining, but concentrating on corporate clients. Brownbridge (1996, 17) points out that although the local banks will face a higher level on non-performing loans than foreign banks due to the markets they serve, that need not result in financial distress. The key to ensuring that local bank failures are avoided, however, is not in discouraging their registration, but rather in ensuring that they are prudently and honestly run.

5.3 Improving the regulatory framework for MFIs

In the aftermath of the 1995 and 1997/8 bank failures, the BoZ continues with the process of reforming the regulatory and supervisory framework for banks and NBFIs. The BoZ completely revised the 1994 Act and parliament enacted the new Act in December 2000. The most significant revisions with respect to financial sector mobilization, is the recognition of NBFIs as a key component of the financial system. The revised Act now covers all institutions providing financial services. The BoZ now has ultimate responsibility of all providers of financial services, regardless of whether or not they are the product of other Acts of parliament. However, despite the strengthening of the Zambian banking sector and the introduction of numerous financial institutions, such as the stock market, a venture capital company and business assistance funds, access to institutional credit for working capital and equipment continues to be a major constraint for micro, small and medium scale enterprises. Most individuals and small and medium enterprises continue to depend on informal and non-financial assets for their savings facilities and arrangements. Policy makers need to encourage the role played by MFIs, which, with a relatively smaller cost base, as a more viable option in the effective delivery of financial savings facilities to low income individuals and, small and medium scale enterprises, especially in rural areas. MFIs help to bridge financing gap between large banks and small Savings and Credit Unions (Maimbo 2000). The challenge for MFIs is to create structures that facilitate successful MFIs clients to access larger, more diverse and longer-term sources of finance. Because MFIs funds are typically of a short-term nature (to ensure repayment), they do not encourage long-term investments. MFIs need to create linkages between themselves and other financing institutions, such as venture capital firms and leasing companies, for some of their clients with the potential to reach the export market (Maimbo 2000b).

5.4 Encouraging the provision of savings facilities to micro, small and medium sized enterprises: the National Savings and Credit Bank and ZNCB

The potential for the NSCB to play an important role in the development of the rural areas is great. As banks continue to pull out of rural areas due to low profitability and concentrate their activities in more developed centres and urban areas of the country the availability of vital banking and financial services to rural communities has been declining.

NSCB has been given a fresh mandate to help and develop small, medium, rural and emerging private sector enterprises through the provision of innovative and credit savings institutions. Box 1 provides details regarding NSCB's savings products and services. The bank is expected to play an active role in stimulating economic activity among the poorest sectors of the economy. It has also been structured to act as a financial intermediary for donor funds and external financing intended for micro and small enterprise development and in some cases for bringing previously marginalized populations into the money economy through the implementation of poverty alleviation programmes. It is expected that the bank will act as a major catalyst for the mobilization of savings among ordinary Zambian in both rural and urban areas by offering banking services to meet the special needs of low-income customers whether personal, organizational or corporate.

Of the remaining Government institutions, ZNCB remains the largest despite on-going financial difficulties. It retains 25 per cent of the industry's deposits although its loan portfolio remains poor. At least 70 per cent of the loan portfolio is non-performing resulting in significant cash flow problems. The Government, BoZ and ZNCB accept that the only way of solving ZNCB's problems is through privatization of the institution and in September 2000, the Government made a commitment that the privatization of the Government-owned ZNCB could begin by December that year. The challenge will be finding a suitable partner that is willing and able to take on the challenge of restructuring ZNCB. With its large branch network, ZNCB remains in an advantageous position in the provision of savings facilities to micro, small and medium sized individuals and enterprises.

5.5 Encouraging international and private sector initiatives

The Government should also encourage international and private sector initiatives such as the fund Deloitte and Touché (Zambia) manages on behalf, and in conjunction with, the British Department for International Development (DfID). The Financial Deepening Challenge Fund initiative provides funding in the form of grants from UK 50,000 Pounds to 1,000,000 Pounds per proposal and works with the private sector to invest in commercial financial services in emerging markets. It aims to improve the access of poor and middle-income groups (including micro, small and medium sized companies) to services such as credit, savings, insurance and investment capital. Sponsored by DFID, the scheme offers assistance to organizations wishing to mobilize, invest in and develop the capacity of financial services and catalyse the financial services sector and to widen the range of products available, improve the efficiency of financial inter mediation and extended services to the poor (Deloitte and Touché 2000).

Box 1: National Savings Bank Savings Products

ORDINARY SAVINGS ACCOUNT

This account is intended to give an opportunity for people with small amounts of money to save. It is ideal for rural and urban customers who travel extensively. Main features are:
(1) Low minimum balance.
(2) Deposits and withdrawals can be at any NSCB and designated Post offices.
(3) Interest is awarded twice a year, in June and December.
(4) Withdrawals can be made once in seven days.
(5) There are no charges for opening this account.
(6) Account holders are issued with pass books.
(7) It can be opened at any NSCB branch or designated Post office.

COMMERCIAL SAVINGS ACCOUNT

This account is designed to cater for small and medium scale entrepreneurs to save a surplus of their income. Main features are:
(1) Competitive minimum balance at K30,000 ($9).
(2) Deposits and withdrawals can be at any NSCB and designated Post offices.
(3) Interest is awarded twice a year, in June and December.
(4) There are no charges for opening this account.
(5) Statements are given half yearly or on request.
(6) Withdrawals can be made four times a month.
(7) It can also be used as a salary account.

REGULAR SAVINGS ACCOUNT

This account is intended for customers who wish to save on a regular basis part of their income. Main features are:
(1) Opening balance is low.
(2) Monthly instalments are determined by customer.
(3) Withdrawals can be made twice a year.
(4) Interest is paid half yearly in June and December.
(5) Withdrawals can be made at NSCB branches only.
(6) Statements are given quarterly or on request.

EDUCATION SAVINGS ACCOUNT

This account is designed for dynamic school boards and PTA who wish to save for the purpose of developing their schools. Main features are:
(1) Minimum balance is K150,000 ($42).
(2) Attractive interest is paid half yearly in June and December.
(3) There are no charges for opening this account.
(4) Statements are given quarterly or on request.
(5) Credit facilities may be availed in relation to balances held.

FIXED DEPOSIT

This produce is designed for customers who wish to save money for a fixed period so as to take advantage of the growth prospects it offers. Main features are:
(1) Minimum balance of K100,000 ($28).
(2) No withdrawals allowed before maturity of the contract.
(3) Attractive interest is awarded at the end of each contract period.
(4) The customers is issued with the certificate of deposit.

INVESTMENT ACCOUNT

This product is designed for high value customers who wish to earn a higher interest on their investment. Main features are:
(1) Minimum balance of K1,000,000.
(2) Investment is made for a stipulated period of time.
(3) Interest varies with amounts invested.
(4) The customer is issued with a certificate of investment.
(5) Withdrawals are allowed at the end of each contract period.

ACCOUNT OPENING REQUIREMENTS

Individuals:
(1) National Registration Card.
(2) Passports.

Associations and Sole Proprietorships
(1) Certificate of registration.
(2) Constitution.
(3) Appropriate resolutions.

Corporate Customers
(1) Memorandum and articles of Association copy.
(2) Certificate of incorporation.

Source: National Savings and Credit Bank.

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