

A Simple Glance at Zambia's Financial Globalization

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ABSTRACT

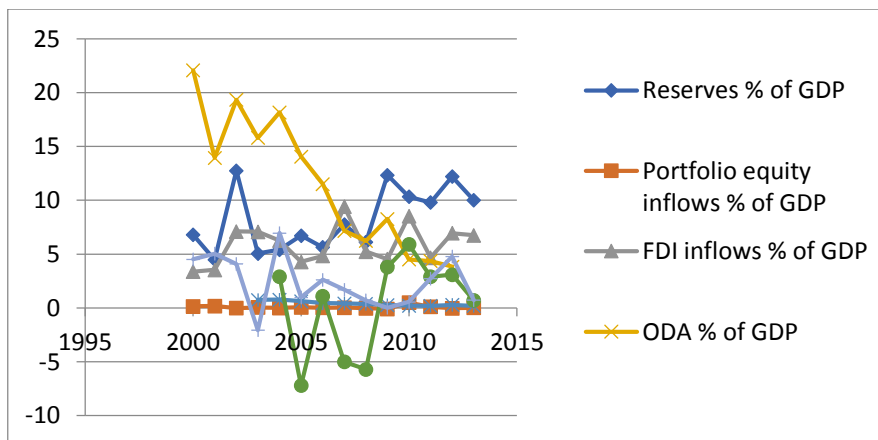
This paper looked at Zambia's financial globalization situation and policy stance over the last 10 to 15 years. In particular, it described and assessed the evolution in the country's main external environment as well as policy stance over the last 10 to 15 years period. It further looked at the impact on the country of the global economic and financial crisis and finally identified and proposed cures to the country's main current financial related vulnerabilities. The paper concludes that Zambia is a very financially open country. Because of this, the country has always been vulnerable to external shocks. During the global financial crisis, the country witnessed a reduction in capital flows, a situation that negatively affected the economy. The paper then recommends that the country should embrace a culture of building reserves, engage in export diversification, and reduce on its imports among other key measures.

1. INTRODUCTION

In today's financially globalised world, the world is operating as a single unit. Thus, one problem on one side of the globe would in a way find its way to the other side of it. Many countries today devote so much of resources and energies trying to mitigate and at times adapt to what can be termed as global problems. This paper looks at Zambia's situation and policy stance over the last 10 to 15 years. Specifically, it describes and assesses the evolution in the country's main external environment and policy stance during the last 10-15 year period, assesses the impact on the country of the global economic and financial crisis, and finally to identify and cure the country's main current Financial globalization related vulnerability.

2. DESCRIBING AND ASSESSING THE EVALUATION IN THE COUNTRY'S MAIN EXTERNAL ENVIRONMENT AND POLICY STANCE DURING THE LAST 10-15 YEAR PERIOD

Figure 1 (source: World Bank Data)



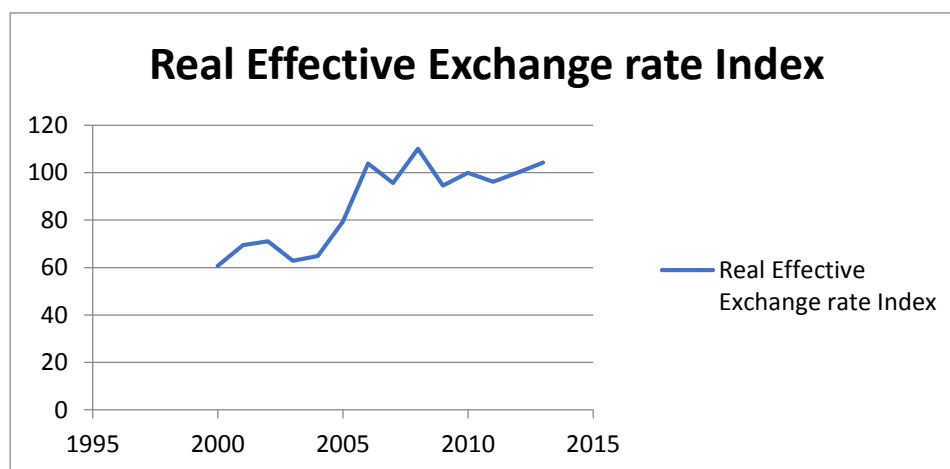
As can be seen from the above, Zambia being a financially globalised country has seen various types of capital inflows. The enhancement of a private sector led free market economy by the government from the early 1990s, paved way for economic reforms that in due course attracted the flow of foreign capital into the country. The reforms which were characterized by the removal of price and exchange rate controls, liberalization of interest rates, one hundred percent repatriation of profit and privatization of government owned enterprises all increased the country's financial openness to the rest of the world, which meant more capital coming in and out of the country (Bank of Zambia, 2008). The evolution and trends in capital flows can be seen in the graph above.

Looking at the evolution of the Balance of payment (current account as percentage of GDP), it is clear from the graph that the levels have been so low, with the years 2005, 2007 and 2008 going further into the negatives. There were pickups from 2009 going into 2010. This huge pick up in the balance of payment position of the country was as a result of the copper prices on the international market which became very high. This actually led to a current account surplus. The surplus is a clear reflection not only of the increases in prices but also of increases in export volumes of both copper and cobalt. The deficit which characterized the preceding years was also partly associated with the rise in assets held abroad by the private sector (IMF, 2010). After 2010 however, the Current account began to fall. There was a little balance in 2012 but it was not properly contained and it went down further, implying a fall in the prices of copper and an increase in imports. On the other side, international reserves have been increasing slowly though they still remain low because of the sharp declines in 2013 (IMF, 2014).

As regards exchange rate regimes, Zambia has always run a floating exchange rate regime. This was actually adopted in the early 1990s following the liberalization of the economy and a shift to a market based economy. In this kind of regime, the Central Bank (Bank of Zambia) does not set the exchange rates; rather, it has the responsibility to intervene at certain instances in the market by simply purchasing the currency in an attempt to influence the value of the local currency. The exchange rates are in line with external stability and are properly aligned with economic fundamentals. It is a flexible exchange rate regime which is characterized as a managed float and is broadly aligned with macroeconomic fundamentals such as improvements in terms of trade. Thus, the exchange rate of Zambia has been very volatile especially in response to fluctuations in copper prices (IMF, 2008).

The graph below shows the changes in the real effective exchange rates in Zambia since 2000.

Figure 2 (source: World Bank Data)



From the above figure, it is clear that the real effective exchange rate index has been on the upward movement since the 2000s though with slight fluctuations in some periods especially around the 2007, which was the period of the global economic and financial crisis. According to the IMF (2008), the upward and long run behavior of the REER is explained by the terms of trade and openness to trade. Real Effective exchange rate appreciation in some periods as shown in the graph is mostly consistent with an appreciation of the exchange rates and this is driven mainly by sharp increases in the prices of copper. In this vein, the IMF indicates that the exchange rate does not appear fundamentally misaligned. They correctly reflect market conditions and there are no important market restrictions that can be identified (ibid.). Important to mention also is that the floating nature of the exchange rate regime in a way helps in preventing speculative behavior on the currency especially given the unsustainable and unpredictable nature of the exchange rate in the country.

Zambia's financial globalization also to some extent tends to create some vulnerability to external shocks. To illustrate this, as a first step towards this financial integration, the country embarked on various reforms including removal of price controls, exchange controls and interest rates and credit allocations. There is also free entry to investment in all sectors of the economy and a free repatriation of profits and dividends by investors. These reforms in a way paved a way for the creation of these vulnerabilities to external shocks (Ndulo et al., 2009).

Besides, as part of the financially globalised world, Zambia has for a long time been dependant on foreign capital such as debt, grants for budget support, FDI, Portfolio and so on. This has also contributed to vulnerabilities in the country because slight shifts in such capital flows tend to create financing problems in the country and economic meltdowns. In addition, being an export-oriented economy, Zambia tends to be vulnerable in what Schmukler (2004) describes as financial crisis through contagion and more particularly through trade links. When countries are engaged in trade or they compete in the same external market, a devaluation of the exchange rate in one country affects the other country's competitive advantage. Zambia, being one of the heavy exporters of copper has been so vulnerable to this contagion effect. With the floating exchange rates that tend to appreciate periodically, its export sector tends to be affected. This effect is felt more in the copper industry which contributes immensely to the country's GDP.

On the financial sector, Zambia's financial sector comprises 18 commercial banks, which are predominantly foreign owned and a non bank sector which has 4 public pension funds, 240 private pension funds and 24 micro finance institutions. The bank sector is the largest and takes about 80% of the total financial assets (IMF, 2011). The high level of foreign participation in the banking sector creates some vulnerabilities in the sector. When these banks are hit by global shocks, it means the entire financial sector gets affected. This also affects private businesses in the country in that local investors will not be able to access loans from these banks. In addition, these foreign banks with headquarters mostly in developed countries can sometimes contribute to the loss of foreign exchange in the country especially in instances when they transfer some of their capital to the head quarters. Also, the high level of dollarization that comes with financial globalization means that any shortage of hard currency slows down economic activity both in the private and public sector. All these are vulnerabilities that come with financial globalization.

On the positive side however, foreign banks contribute immensely to financial development in that they have a more diversified portfolio as they have access to various sources of funds from around the world. Because of this, they are less exposed to risks and are not severely affected by negative shocks to the home country. In addition, foreign banks lead to the adoption of effective banking practices especially in areas of risk management and management techniques in broad which paves way for an efficient banking sector (Schmukler, 2004).

As regards growth, Zambia's economy has registered a high and sustained growth over the past decade with output growth reaching 7.2% in 2012 from the average growth rate of 6.3% a year since 2003, and GDP Per/Capital in PPP terms has almost doubled (IMF, 2014). This performance has been enhanced by strengthened macroeconomic fundamentals coupled with a conducive business environment. In addition, the country has had a strong growth in the production of copper, which is its tradition and main export, and prudent macroeconomic policies and stability (ibid.). Zambia's growth has also been accompanied by some improvements in the quality of governance. Country Data report for Zambia (1996-2013) on World Governance Indicators shows that the country has been making progress especially in upholding the rule of law, control of corruption, and political stability and absence of violence (World Bank report).

This growth is however vulnerable to the external situations because it is dependent on the performance of copper. Being so highly dependent on trade, any slight shock on the international market of copper tends to have a spillover effects on the country's Balance of Payment. Lower prices of copper mean no foreign exchange to finance the country's main needed imports such as oil. This results into borrowing, hence increasing the debt problem.

3. ASSESSING THE IMPACT ON THE COUNTRY OF THE GLOBAL ECONOMIC AND FINANCIAL CRISIS

The impact of the global financial crisis in Zambia can be understood by looking at the main transmission mechanisms and these include financial flows, trade, remittances and official development assistance (Ndulo et al., 2009). To start with, the financial sector in Zambia is not very much developed in terms of its potential and this can be evidenced from the limited financial intermediation in the country. Because of this, Zambia also had a feel of the impacts of the increased risk aversion and flight liquidity that characterized global financial markets (IMF, 2008). The financial sector in Zambia mostly drew on external sources for equity and debt finance and bank deposits. These sources however turned dry with the coming in of the crisis. Prior to that, most financial institutions had lent a lot of

money to many businesses and households. Most of these unfortunately defaulted or failed to pay back the loans. There was an increase in nonperforming loans. A lot of people defaulted and this affected many banks in the country. This affected these institutions and lending was reduced (Ndulo et al., 2009).

In addition, beginning around the year 2004 when copper prices went up on the international market, the country witnessed an increase not only in FDI, but also in portfolio investment. The country started registering a higher level of participation by foreign portfolio investors on the Lusaka Stock Exchange Market. Thus, there was an increase in foreign capital inflows which saw the local currency (kwacha) appreciating against other major currencies. However, with the global financial crisis, there was a turnaround of events as many investors starting withdrawing and there was a reduced demand for the shares on the Lusaka stock exchange market (ibid.). The Central Bank (Bank of Zambia) also increased the interest rates sharply due to portfolio outflows. This in a way affected business in the country in that the cost of borrowing became very high, hence slowing down economic activity.

In addition, the mining sector also felt the severe impacts of this crisis. The crisis caused the prices of copper to fall drastically on the international markets. Copper exports which accounted for about 80 percent of the country's total exports in 2007 have been key in sustaining the country's growth (World Bank, 2008). This drastic fall in copper prices resulted in depreciation of the domestic currency (kwacha) and more than doubled the external current account deficit in 2008 (ibid.). The fall in copper prices meant reduced profit for the mining companies. This also had spillover effects as companies had to retrench some of the workers or reduce on wages. At the same time, government revenue in terms of taxes were also reduced which ultimately crippled the government's ability to provide basic social services.

Also affected was the exchange rate mainly because of the fall in copper prices. There is a positive correlation between exchange rates and copper prices. This is so because copper is the country's main foreign exchange and when prices fall, it implies reduced inflow of foreign exchange into the country. When such turbulences happen in the economy, investor confidence gets affected this makes them to transfer their money to safe havens out of country (Ndulo et al., 2009). This caused the local currency to depreciate because of low supply of foreign currency. There was also a reduction in debt inflows into the country. This was a huge blow for the country that is so much dependent on debt to cover up for its budget deficits.

However, it appears financially globalization did not do much to help reduce the vulnerability of the country to the crisis. Being financially globalised, the country allows the movement of capital freely in and out of the country. Because of this, it was easy for investors including foreign investors to repatriate or transfer their money and profits out of the country to safe havens during the crisis. This affected the exchange rate market of the local currency. In addition, financial globalization has made Zambia to be so much dependent on debt to cover up for its budget deficits and to finance various development projects. This dependence left the country vulnerable during the crisis as debt flows to the country reduced as can be seen in Figure 1. On the positive side, Official Development Assistance had increased a bit during the crisis. There was also tremendous increase in debt flows around 2010 that helped the country to smooth up consumption and recover from the effects of the crisis (figure1).

4. IDENTIFYING AND CURING THE COUNTRY'S MAIN CURRENT FINANCIAL GLOBALIZATION RELATED VULNERABILITY

The most important current remaining Financial Globalization vulnerability is the debt problem. Zambia's current account deficit is mostly and more often generated by debt servicing due to heavy debt burden. According to an Encyclopedia of the Nations (2015), Zambia's debt burden has always given it a current account deficit and hard currency is always in short supply. Much of the country's export earnings go towards debt servicing or payments. Zambia also imports huge oil which it needs in order to run its economy and to be able to import this oil, the country needs to fetch high on its exports which is mainly copper. Thus, the unpredictable and ever fluctuation prices of copper and oil means that the country is always over borrowing in order to earn more foreign exchange that would enable it to meet its import needs. Because of this, the country has always endured a high debt burden which always affects its balance of payment position. Also vulnerable is the exchange rate of the country which is mostly caused again by reduced copper earnings, hence reducing the supply of foreign exchange in the country.

In order to address such structural imbalances, the country should embrace a culture of building up reserves. As the Zambian economy is dependent on copper exports which also determines the performance of the kwacha (domestic local currency), it is cardinal that the country engages in self insurance by creating reserves especially when copper is doing fine on the international market and the currency performing well against other major currencies such as the

US dollar. The country could utilize such opportunities and build up its level of reserves. Such reserves are very important for an economy such as Zambia especially given its vulnerability to negative shocks. The reserves will make the country well equipped to be able to withstand the pressures that come with financial globalization.

Reserves are very important in a managed float regime such as Zambia. Zambia currently runs a managed float regime which implies that the Central bank comes in periodically to intervene in the market so as to prevent the currency from either appreciating or depreciating excessively. To be able to do this, the central Bank needs to have enough foreign exchange reserves which it can supply to the market during shocks or volatile times. This will help in hedging the economy and ensure that business is not affected in the economy. These reserves can especially the dollars can be invested in the US in terms of treasury bills or bonds so as to make profit out of it.

At the same time, the country should also reduce on its imports and increase its exports. The country should expand its export sector by engaging in economic diversification. Economic diversification should be in such a way that it reduces dependence on copper and mineral exports in general. Over dependence on mining has been the main cause of vulnerability in Zambia especially that the country does not have the powers to set prices on the international market. Thus any fluctuations on prices generate a negative effect on the country's balance of payment because it is the profits from such exports that the country uses to meet its import needs. Thus, it is important that the country diversifies by engaging in other nontraditional exports so as to expand its export sector. This will help in stabilizing its foreign exchange reserves and the balance of payment as a whole.

In addition, for a country that is always suffering from a balance of payment problem, it is cardinal and more realistic to borrow from the International Monetary Fund for the purpose of smoothing. This institution helps especially those that cannot borrow from the private market to be able to borrow and pay back in the future with conditionality. This conditionality should however not be viewed in the negative sense. They are very important because they encourage prudence in the management and use of the loan. In this vein, money is used in a way that would help you pay back the loan without struggles. IMF loans are crucial for short- medium term economic adjustments, a situation that makes you avoid falling back into the BOP problem. Above all, it is very important that the country creates a friendly and conducive business climate or environment that would attract more investment and economic activity into the country. This will help in pulling more capital into the country which would mean more foreign exchange flowing into the economy. This will help in stabilizing the local currency because of increased supply of foreign exchange. When supply of foreign currency increases to levels that threaten the country's export competitiveness, the Central Bank can come in to intervene especially that Zambia runs a managed float exchange rate regime. Such measures will help an economy to stay health in a financially globalized world

5. CONCLUSION

In conclusion, Zambia is a very financially open or globalized country. The country has no restrictions on exchange rates, prices, credit allocation or interest rates. There is free flow of capital in and out of the country. The main channels of transmission of this capital into the country are trade, Foreign Direct Investment, Portfolio Investment, Debt, Official Development Assistance and remittances. Because of this, the country has always been vulnerable to external shocks. Any slight shocks tend to impact negatively on the flow of capital into the country. This is more on trade aspect given its crucial role to the economy and growth of the country. During the global financial crisis, the country witnessed a reduction in capital flows but more so on trade aspect. The prices of copper went down on the international market and at the same time the prices of oil went up which negatively affected the country's balance of payment. Given these lessons, it is very important that the country should embrace a culture of building reserves, engage in export diversification so as to reduce dependence on copper, and reduce on its imports among other key measures. With such adopted, the country will be able to stand strong in case of any global shocks.

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