



*Bank Of Zambia*

# Bank of Zambia Monetary Policy Statement

**JANUARY - JUNE 2005**







This Monetary Policy Statement is made pursuant to Part II, Section 9 of the Bank of Zambia Act No. 43 of 1996

## Appendix III: Macroeconomic Indicators

	2001 December	2002 December	2003 December	2004 Mar	June	Jul	Aug	Sep	Oct	Nov	Dec
<b>Monetary Aggregates (K'bn)</b>											
Reserve money*	805.4	1,118.6	1,415.2	1,360.0	1,480.9	1,540.0	1,514.7	1,507.5	1,625.9	1,484.2	1,719.1
Broad money**	2,752.5	3,619.7	4,467.9	4,635.6	5,263.6	5,369.8	5,419.7	5,394.3	5,421.5	5,454.9	-
Net Claims on Government	1,793.6	1,998.9	2,474.6	2,658.3	2,792.3	2,728.6	2,692.1	2,575.3	2,658.9	2,641.8	2,658.8
<b>Real GDP Growth</b>											
Nominal GDP (in K' Billion)	13,132.7	16,260.4	20,481.0	-	-	-	-	-	-	-	25,814.0
Nominal GDP (in US \$' million)	3,637.0	3,775.4	4,318.0	-	-	-	-	-	-	-	5,409.0
GDP per capita (in Kwacha)	1,245,135.0	1,505,549.0	1,969,326.9	-	-	-	-	-	-	-	2,458,500.0
GDP per capita (in US dollars)	346.4	349.6	415.2	-	-	-	-	-	-	-	515.1
Population	10.5	10.8	10.4	-	-	-	-	-	-	-	10.5
<b>Prices (%)</b>											
Inflation	18.7	26.7	17.2	17.6	18.6	19.5	18.9	17.8	18.0	18.3	17.5
<b>Nominal interest and yield rates (aver. %)</b>											
Commercial banks' weighted lending base rate	46.7	42.4	37.7	31.8	29.8	30.0	29.6	30.0	29.8	30.0	29.8
Average Savings rate (>K100,000)	8.7	8.1	7.6	6.8	6.6	7.2	6.1	6.1	5.9	5.6	5.6
Deposit rate (30 days, over K20 million)	19.8	19.3	17.9	9.9	8.3	8.1	8.0	8.0	8.2	8.3	8.2
<b>Treasury bill yield rates</b>											
Weighted TB rate	48.2	31.7	19.7	9.0	6.7	8.7	11.0	14.6	15.9	16.7	17.8
28-day	41.5	25.3	-	-	-	-	-	-	-	-	-
91-day	50.5	32.0	18.2	7.6	5.8	6.7	9.2	12.7	15.5	15.5	16.3
182-day	50.4	32.9	19.8	8.9	6.5	9.8	11.8	14.3	16.3	17.1	18.3
273-day	46.4	33.2	21.0	10.6	7.9	10.5	11.8	14.9	16.6	18.3	19.4
<b>Government bonds</b>											
12 months	54.1	41.0	22.0	14.6	8.2	8.7	10.8	14.4	18.3	19.0	19.6
18 months	54.9	41.5	25.2	16.5	11.0	11.9	13.6	17.0	19.8	20.0	20.8
24 months	55.4	41.6	26.1	19.3	13.7	15.9	16.7	18.7	21.3	21.7	22.0
<b>Real Rates (%)</b>											
Commercial banks' weighted lending rate	28.0	15.7	20.5	14.2	11.2	10.5	10.7	12.2	11.8	11.7	12.3
Average savings rate	-10.0	-18.6	-9.6	-10.8	-12.0	-12.3	-12.8	-11.7	-12.1	-12.7	-11.9
Deposit rate (30 days, over K20 million)	1.1	-7.4	0.7	-7.7	-10.3	-11.4	-10.9	-9.8	-9.8	-10.0	-9.3
<b>Treasury bill yield rates</b>											
Weighted TB rate	29.5	5	2.5	-8.6	-11.9	-10.8	-7.9	-3.2	-2.1	-1.6	0.3
28-day	22.8	-1.4	-	-	-	-	-	-	-	-	-
91-day	31.8	5.3	1.0	-10.0	-12.8	-12.8	-9.7	-5.1	-2.5	-2.8	-1.2
182-day	31.7	6.2	2.6	-8.7	-12.12	-9.7	-7.1	-3.5	-1.7	-1.2	0.8
273-day	27.7	6.5	3.8	-7.0	-10.7	-9.0	-7.1	-2.9	-1.4	0.0	1.9
<b>Government bonds</b>											
12 months	35.4	14.3	4.8	-3.0	-10.4	-10.8	-8.1	-3.4	0.3	0.7	2.1
18 months	36.2	14.8	8.0	-1.1	-7.6	-7.6	-5.3	-0.8	1.8	1.7	3.3
24 months	36.7	14.9	8.9	1.7	-4.9	-3.6	-2.2	0.9	3.3	3.4	4.5
<b>Exchange rates (average K/US \$)</b>											
Commercial banks' weighted selling rate	3,890.73	4,842.02	4,598.38	4,740.20	4,850.40		4,806.83	4,875.90	4,916.69	4,818.83	4,670.94
Bank of Zambia mid rate	3,820.33	4,740.05	4,645.48	4,722.06	4,832.62	4,807.29	4,787.26	4,856.29	4,896.31	4,797.64	4,651.51
<b>Real sector</b>											
<b>Mining output (tonnes)</b>											
Copper	298,150	27,513	33,369	35,789	35,013	35,027	33,919	32,295	33,462	31,960	32,572
Cobalt	4,375	230	184	209	175	205	214	212	200	268	227
<b>Metal Earnings (US \$mn)</b>											
Copper	506.7	41.6	59.0	87.9	80.8	83.1	89.4	89.2	92.3	86.3	89.3
Cobalt	82.9	2.6	7.7	16.4	8.7	8.8	10.9	10.8	7.5	6.9	8.4
Total	589.6	44.2	66.7	104.3	89.6	91.9	100.4	100.1	99.8	93.2	97.7
<b>External sector (US \$ mn)</b>											
Trade Balance	(389.45)	11.9	(10,472.4)	(32.6)	(63.6)	-58.8	-24.3	-54.6	-53.3	-23.3	-43.7
Exports, c.i.f.	901.38	94.2	1,074.8	138.9	130.2	144.2	142.9	151.0	139.5	146.6	145.7
Imports, c.i.f.	(1,290.83)	-82.3	(11,547.2)	(171.5)	(193.8)	-203.0	-167.2	-205.6	-192.7	-169.9	-189.4
Gross Official Reserves (US \$mn)	116.50	464.8	272.2	225.3	243.2	253.1	258.1	281.3	270.9	262.9	312.2

Source: Bank of Zambia

\* 2004 monetary aggregate figures are based on preliminary Monetary Survey and daily tables.

\*\* Reserve money is narrowly defined.

- Not available.

## Executive Summary

Monetary policy in the second half of 2004 was targeted at achieving an annual overall inflation rate of 12.0%, which was consistent with the attainment of 20.0% as at end-2004. In line with this objective and to achieve non-food and food inflation of 12.9% and 11.1%, respectively, reserve money and broad money were each programmed to grow by 8.1% during this period. In this regard, the Bank of Zambia utilised mainly indirect instruments of monetary policy, including Government securities and Term deposits in open market operations.

A review of performance of monetary policy during the second half of 2004 shows a favourable outcome, as reflected in the annual overall inflation rate of 9.7% at the end of the review period against a target of 12.0%. Similarly, the end-2004 overall inflation outturn at 17.5% was below the end-year target of 20.0%. The favourable overall inflation outcome was on account of better than expected outturn in both non-food and food inflation.

Non-food inflation during the second half was 8.7% while annual non-food inflation was 18.9%. This outturn was attributed to the relatively stable exchange rate, following an increase in export earnings. The growth in export earnings also contributed to the narrowing of the trade deficit by 29.7%.

Similarly, food inflation was 10.5% during the second half of 2004 while annual food inflation was 16.3% as at end-December 2004. The favourable outturn in food inflation was on account of adequate supply of food items, owing to supportive Government policies and favourable weather conditions in the 2003/2004 agricultural season.

With regard to monetary aggregates, performance in the second half of 2004 was mixed. While broad money increased by 3.6% compared to the projected increase of 8.1%, reserve money grew by 17.4% against a projection of 8.1%, largely due to substantially large foreign exchange purchases for reserve accumulation.

In addition, the declining trend in yield rates on Government securities that characterised the market during the first half of 2004 was reversed. On the other hand, commercial banks' interest rates having declined in the first half of 2004 generally remained unchanged during the review period.

During the first half of 2005, monetary policy will aim at attaining the end-June 2005 annual overall inflation rate of 15.9% as well as annual non-food and food inflation rates of 16.2% and 15.6%, respectively. In this regard, efforts will be directed at limiting reserve money and broad money growth to 10.7% each during this period.

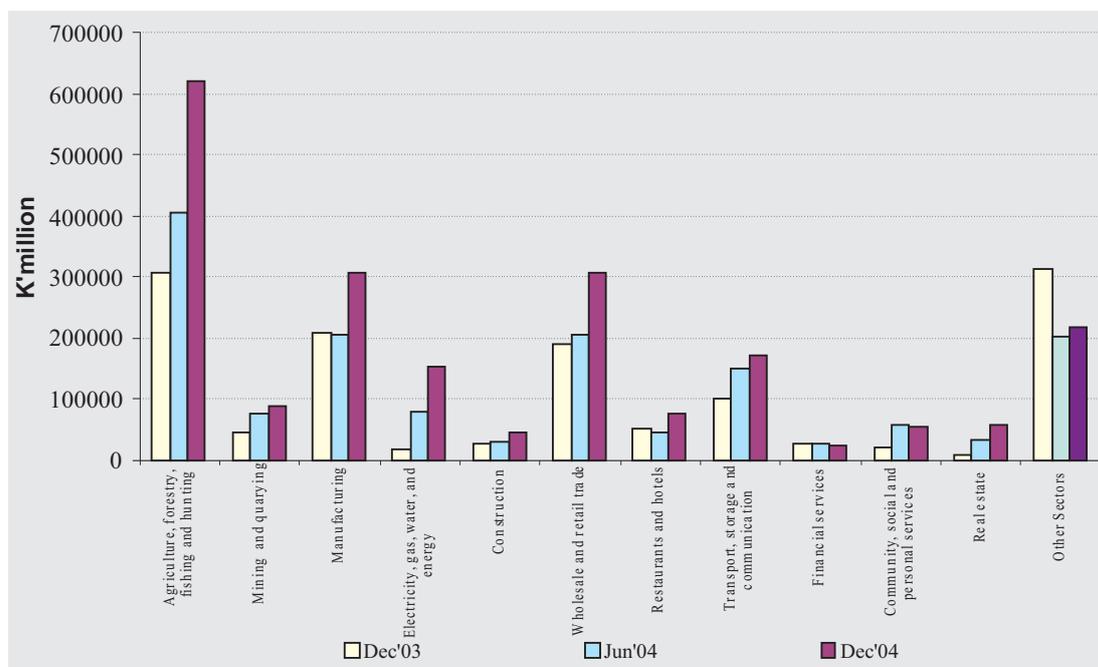
Over the next two years ending in December 2006, market based principles will continue to guide the formulation and implementation of monetary policy by the Bank of Zambia.

**TABLE 5: PERCENTAGE SHARE OF LOANS AND ADVANCES BY SECTOR (SIX-MONTH AVERAGE)**

	Dec 02	2003		2004	
		June	Dec	June	Dec
Agriculture, forestry, fishing and hunting	22	26	22	26	29
Mining and quarrying	4	3	4	5	4
Manufacturing	14	14	16	14	14
Energy and Water	2	4	1	5	5
Construction	1	1	2	2	2
Wholesale and retail trade	18	12	15	14	14
Restaurants and hotels	5	4	4	3	4
Transport, storage and communications	6	8	8	10	8
Financial services	2	2	2	2	1
Community, social and personal services	2	2	2	4	5
Real estate	1	1	1	2	2
Other sectors	23	23	23	13	10
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Bank of Zambia

**CHART 1: COMMERCIAL BANKS LOANS AND ADVANCES BY SECTOR (DECEMBER 2003 - DECEMBER 2004)**



Source: Bank of Zambia Appendix III: Macroeconomic Indicators

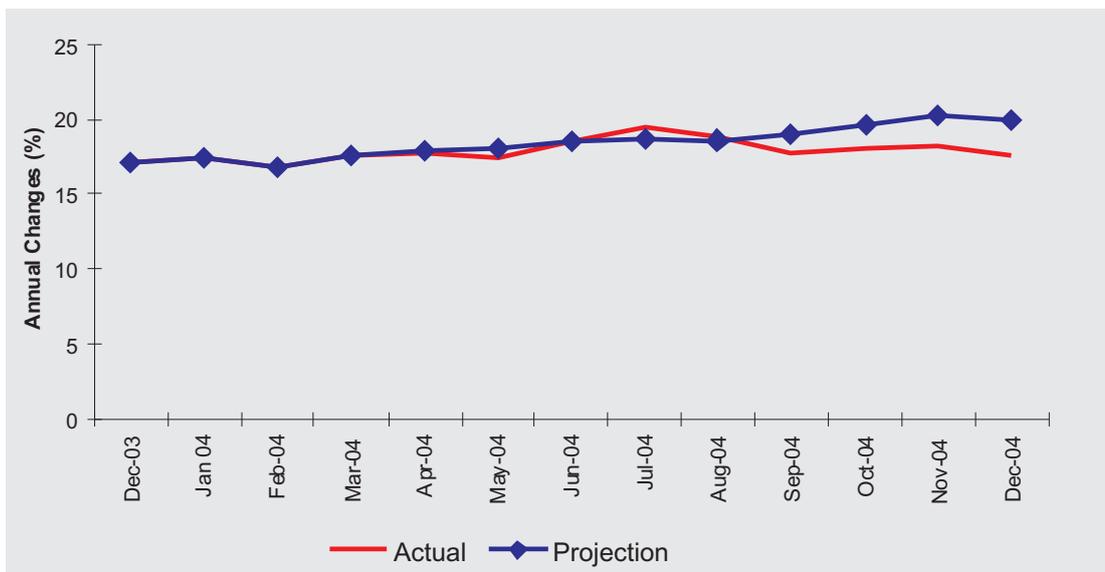
- Government fiscal operations were expected to remain as programmed;
- The exchange rate was expected to remain relatively stable on account of continued good performance of the external sector and improved balance of payments support following the approval of the PRGF arrangement by the IMF Board of Directors; and
- Adequate food supply was expected to continue following favourable weather conditions in the 2003/2004 agricultural season and supportive Government agricultural policies.

The continued upward pressure on world oil prices remained a major challenge to achieving the end-year inflation objective. If oil prices were to increase beyond the June 2004 levels, the possibility of achieving the projected inflation rate for 2004 was expected to be threatened. In addition, if the South African rand continued to strengthen, this equally posed a threat to the achievement of the inflation target.

## 2.1 Overall Inflation

Over the period under review, the annual overall inflation of 17.5% at end-December was below the projection of 20.0% (see Chart 1 and Appendix II, Table 1). This represented a significant movement toward the medium term inflation objective. The outturn in overall inflation was due to positive developments in both non-food and food inflation. Food inflation declined by 2.4 percentage points to 16.3% in December 2004 and was 1.1 percentage points below the projection as at end-December 2004. Although, non-food inflation increased by 0.4 percentage points to 18.9% over the same period, it was 4.0 percentage points lower than the projection of 22.9%.

**CHART 1: ANNUAL OVERALL INFLATION, DECEMBER 2003 - DECEMBER 2004**



Source: Central Statistical Office and Bank of Zambia

### 2.1.1 Non-food Inflation

The outturn in non-food inflation at 18.9 percent was favourable and was below the December 2004 projection of 22.9% by 4.0 percentage points (see Chart 2). The factors responsible for the favourable outturn in non-food inflation were largely the relatively stable exchange rate as well as appropriate monetary and fiscal policies over the period. This was despite the increase in prices of petroleum products due to rising crude oil prices on the world market. The factors explaining the favourable non-food inflation outturn, which are discussed below include the stable exchange rate, positive external sector developments as well as appropriate fiscal and monetary policies.

## Appendix II: Statistical Tables and Charts

**TABLE 1: PROJECTED AND ACTUAL INFLATION, DECEMBER 2003 - DECEMBER 2004**

	Annual Overall		Annual Food		Annual Non-Food	
	Actual	Projection	Actual	Projection	Actual	Projection
Dec 03	17.2	17.1	13.5	14.5	21.7	21.7
Jan 04	17.4	17.4	12.5	12.5	23.8	23.8
Feb	16.8	16.8	12.9	12.9	21.6	21.6
Mar	17.6	17.6	15.9	15.9	19.6	19.6
Apr	17.8	17.9	16.3	16.0	19.4	20.1
May	17.4	18.1	16.9	16.3	18.0	20.2
June	18.6	18.5	18.7	16.7	18.5	20.6
July	19.5	18.7	19.9	16.7	19.0	20.9
Aug	18.9	18.6	18.7	16.4	19.2	21.2
Sept	17.8	19.0	15.7	16.4	20.1	21.9
Oct	18.0	19.6	16.0	16.6	20.3	23.1
Nov	18.3	20.3	16.8	17.9	20.0	23.1
Dec	17.5	20.0	16.3	17.4	18.9	22.9

Source: Central Statistical Office and Bank of Zambia

**TABLE 2: TRADE DATA (US \$ MILLION)**

	2002	2003		2004*	
	July-Dec	Jan-June	July-Dec	Jan-June	July-Dec
Trade Balance	(66.8)	(270.2)	(202.2)	(367.2)	(257.9)
Exports, c.i.f	499.0	489.7	585.2	763.7	869.9
Metals	279.6	302.7	366.5	535.1	583.1
Copper	258.0	278.0	329.0	475.4	529.6
Cobalt	21.6	24.7	37.5	59.7	53.5
Non Metals	219.4	187.0	218.7	228.6	286.8
EBZ export audit	18.9	18.9	18.9	18.9	18.9
Total	200.5	168.1	199.8	209.7	267.9
Burley tobacco	13.7	9.2	10.1	12.4	33.7
Cement	2.9	2.8	3.9	3.5	4.0
Cotton yarn	10.9	11.6	10.6	12.8	10.9
Cotton lint	22.8	9.5	19.1	16.1	40.0
Copper rods	0.1	0.0	0.0	0.0	0.0
Fresh flowers	13.0	9.0	14.0	10.8	10.6
Gasoil	5.0	7.2	9.4	15.9	4.6
Gemstone	23.8	13.2	10.1	6.0	11.3
Soya beans	1.4	0.6	0.3	0.1	0.2
Spoon sugar	16.2	19.8	10.8	20.1	14.2
Electricity	3.5	4.2	4.2	4.2	4.2
Others	87.4	80.9	107.2	108.0	134.3
Imports c.i.f./1	(565.8)	(759.9)	(787.3)	(1,130.8)	(1,127.8)

Source: Bank of Zambia

Note: \* = Figures for 2004 are preliminary

Traditional export earnings increased to US \$583.1 million during the second half of 2004 from US \$535.1 million in the first half of 2004 while earnings from non-traditional exports grew to US \$286.8 million from US \$228.6 million over the same period (see Appendix II, Table 2). The increase in copper export earnings was attributed to increased export volumes owing to higher production as well as a rise in the realised prices of copper.

The volume of copper exports increased to 194,933 metric tons in the second half of 2004 from 190,173 metric tons in the first six months of 2004. The realised copper prices increased to 126.0 US cents per pound at the end-of-December 2004 from 117.0 US cents per pound at end-June 2004.

With regard to cobalt, while export volumes increased to 1,226 metric tons in the second half of 2004 from 1,169 metric tons in the first half of 2004, cobalt earnings declined to US \$53.5 million over the review period from US \$59.7 million over the same period in 2003 due to reduced prices. Realised cobalt prices fell to US \$19.78 per pound in the second half of 2004 from US \$23.14 per pound in the first half of 2004.

In terms of tourism services, as measured by international arrivals<sup>1</sup>, total international arrivals increased by 10.3% during the second half of 2004 to 128,906 from 116,894 arrivals recorded during the first half of 2004. The tourist arrivals during the review period were 9.8% above the 117,418 arrivals recorded during the same period in 2003. This increase in tourist arrivals was another factor that contributed to the improvement in the supply of foreign exchange on the market.

### 2.1.1.3 Fiscal Developments

The domestic fiscal performance was largely favourable, with the domestic budget recording a deficit of K308.3 billion, on a cash basis, during the period under review. This was 36.1% lower than the projected deficit of K482.2 billion for the second half of 2004. The favourable domestic fiscal outturn was largely attributed to expenditure restraint and also to the significant saving made on interest payments as a result of the sharp decline in yield rates on Government securities in the first half of 2004. Total domestic expenditure at K2,800.5 billion was 7.5% below the target of K3,026.6 billion. Although total domestic revenue at K2,492.2 billion was 2.1% below the target of K2,544.4 billion, tax revenue at K4,552.0 billion was in line with the target of K4,520.9 billion. The domestic financing of the Government during this period was K201.9 billion, which was 47.5% below the projected domestic budget financing of K384.6 billion. Of this financing, K244.5 billion was from the non-bank public while a repayment of K42.6 billion was made to the banking sector. The favourable fiscal performance contributed not only to the deceleration in broad money growth, but also contributed significantly to the increased lending to the private sector and downward pressure on interest rates.

### 2.1.1.4 Monetary and Credit Developments

Preliminary data show that broad money ( $M_3$ ) growth in the second half<sup>2</sup> of 2004 slowed down to 3.6% from 17.8% recorded during the first half of 2004<sup>3</sup>. Broad money increased to K5,454.9 billion from K5,263.6 billion in June 2004. The slow down reflected the monetary policy actions, including Government securities and Term deposits in open market operations, that the Bank of Zambia took during the second half of the year to achieve the end-December 2004 money supply growth target.

The observed growth in broad money was explained by the 11.9% increase in net domestic assets which contributed 15.7% to the growth. This was mitigated by the 37.9% decline in net foreign assets of the banking sector. Expansion in net domestic assets was largely attributed to the increase in domestic credit as well as other items net. The broad money growth outturn was favourable compared to the projection of 8.1% for the second half of 2004. On an annual basis, broad money growth slowed down to 32.4% at the end of the review period from 35.0% in June 2004 (see Chart 4).

<sup>1</sup> International arrivals are used as a proxy for tourism.

<sup>2</sup> Broad money and domestic credit figures are as at end-November 2004.

<sup>3</sup> Broad Money ( $M_3$ ) is equal to  $M_2$  + Foreign Currency Deposits, where  $M_2$  is equal to  $M_1$  (i.e. the sum of currency outside banks, demand deposits at BoZ and demand deposits at banks) + local currency savings and time deposits.

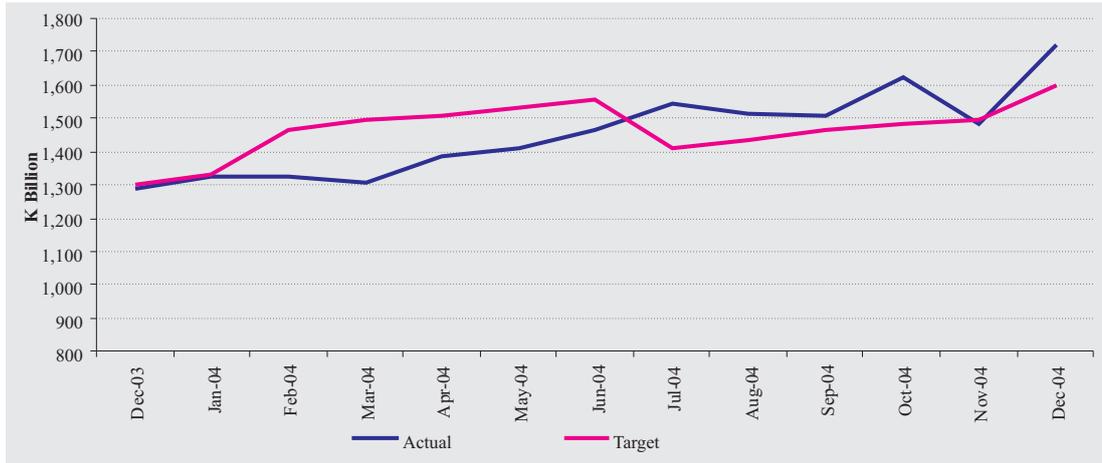
#### 4.0 Monetary Policy Principles for the Next Two Years

The attainment of single digit inflation has remained and continues to be a key objective of the Bank of Zambia. Following the Government's adoption of the PRGF arrangement in June 2004, the Government's broad policies and objectives will continue to be guided by the PRGF arrangement (see Appendix I). The PRGF arrangement spells out the Government's broad policies and objectives. In this regard, and in line with the PRGF arrangement over the next two years, key macroeconomic objectives of the Government include:

- (i) Increasing real GDP growth from 4.6% in 2004 to 5.0% in 2005 and beyond. In this regard, agriculture, mining, manufacturing and tourism are expected to be the main sources of growth during this period;
- (ii) Reducing the rate of inflation to 10.0% by end-December 2006. The Bank of Zambia will strive to preserve the gains made in reducing inflation and interest rates. To this end, the monetary programme will limit the growth in broad money; and
- (iii) Maintaining official international reserves at a minimum of 1.5 months of import cover by 2006. This is based on projected continued growth of exports and remaining on track on the Economic Reform Programme, thus allowing the country to reach the Heavily Indebted Poor Countries (HIPC) initiative completion point during the first half of the year and thereafter obtain substantial debt relief.

In line with the Government's medium term economic programme, free market principles will continue to guide the formulation and implementation of monetary policy by the Bank of Zambia. In this regard, the Bank of Zambia will continue to utilise market-based instruments of monetary policy to achieve the inflation objective.

**CHART 5: MONTHLY AVERAGE RESERVE MONEY PERFORMANCE, DECEMBER 2003 - DECEMBER 2004**

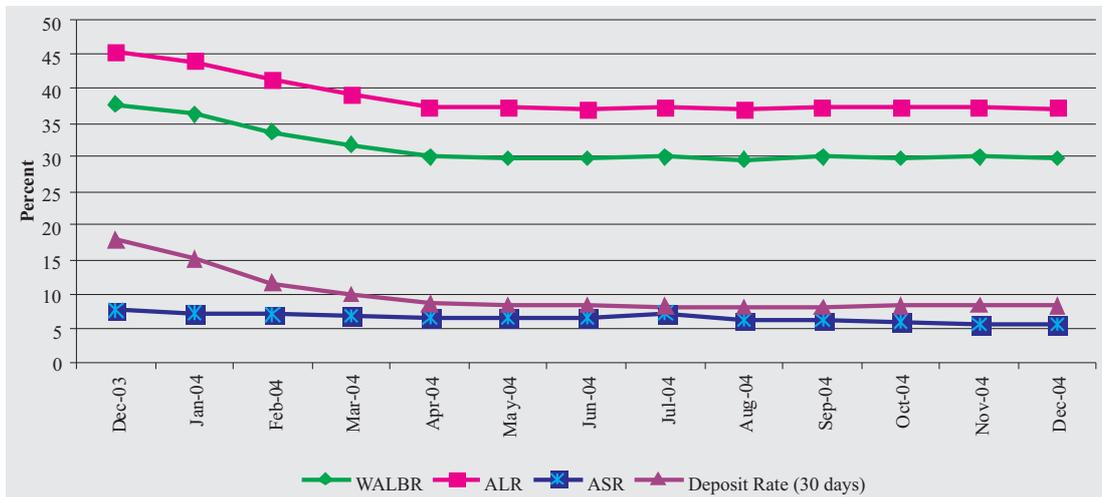


Source: Bank of Zambia

**2.1.1.5 Interest Rates Developments**

Commercial banks' lending interest rates generally remained unchanged during the review period. The commercial banks' weighted average lending base rate (WALBR) remained at 29.8% while the average lending rate (ALR) marginally rose by 0.2 percentage points to 37.1% in December from 36.9% in June 2004. Similarly, deposit rates remained unchanged during the second half of 2004 while savings rates declined. The 30-day deposit rate for amounts of more than K20 million was 8.2% compared to 8.3% at end-June 2004. However, the average savings rate (ASR) for amounts above K100,000 declined to 5.6% from 6.6% in June 2004 (see Chart 6). The observed stability in commercial banks' interest rates also contributed to the favourable inflation developments, as costs of borrowing remained subdued during the review period. The high commercial banks' lending rates as well as the wide spread between lending and savings rates were of concern to the Bank of Zambia. In this regard, the Bank of Zambia continued to engage the commercial banks on the challenges.

**CHART 6: NOMINAL INTEREST RATES, DECEMBER 2003 - DECEMBER 2004**

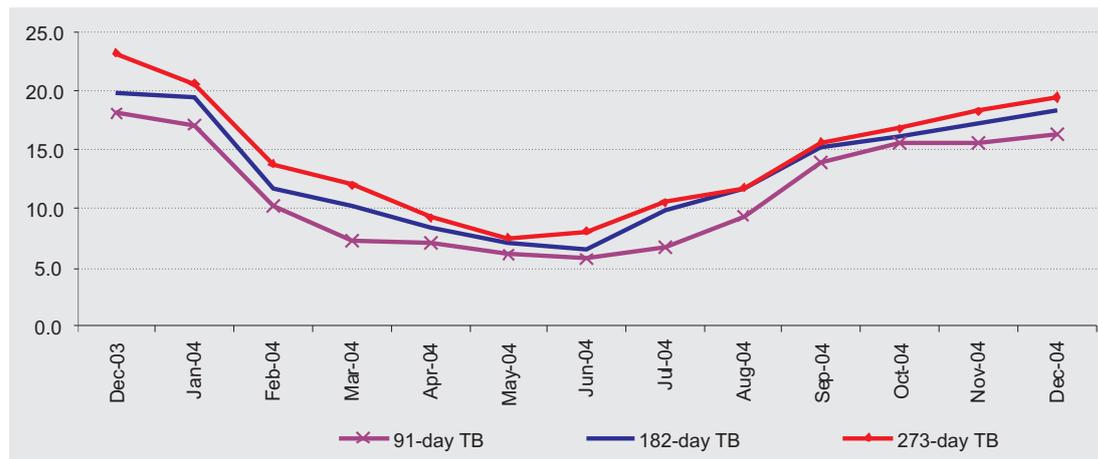


Source: Bank of Zambia

However, the declining trend in yield rates on Government securities that characterised the market during the first half of 2004 reversed following the Bank of Zambia's monetary policy actions aimed at containing the growth of both reserve money and broad money observed during the first half of 2004. The composite yield rate on the Treasury bills portfolio increased to 17.8% from 7.0% recorded at the end of June 2004 while the composite yield rate on the Government bonds portfolio added 8.7 percentage points to 20.5%, as measures were being implemented to tighten monetary conditions.

The 91-day yield rate rose by 10.7 percentage points to end the period at 16.4% while the 182- and the 273-day yield rates rose by 11.9 and 11.4 percentage points to 18.4% and 19.5%, respectively (see Chart 7).

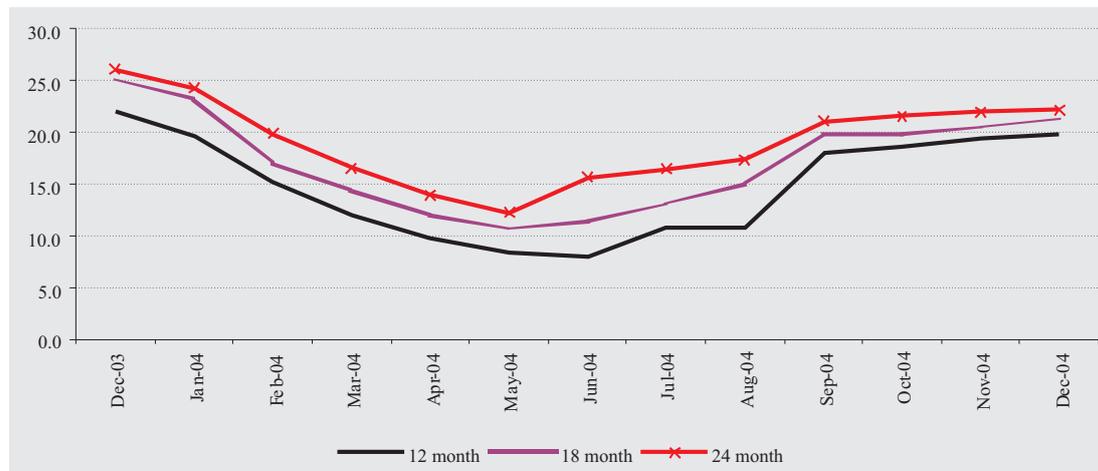
**CHART 7: TREASURY BILL YIELD RATES, DECEMBER 2003 - DECEMBER 2004 (% P.A.)**



Source: Bank of Zambia

The 12-month bond yield rate increased by 11.4 percentage points to 19.4% while the 18-month and 24-month bond yield rates rose by 9.0 percentage points and 6.3 percentage points to 20.5%, and 22.0%, respectively (see Chart 8). Although commercial banks' interest rates tend to follow movements in Government securities yield rates, the increase in Government securities yield rates during the review period did not result in an increase in commercial banks' interest rates, as commercial banks had maintained their rates when Government securities yield rates were declining.

**CHART 8: GOVERNMENT BONDS YIELD RATES, DECEMBER 2003 - DECEMBER 2004 (% P.A.)**

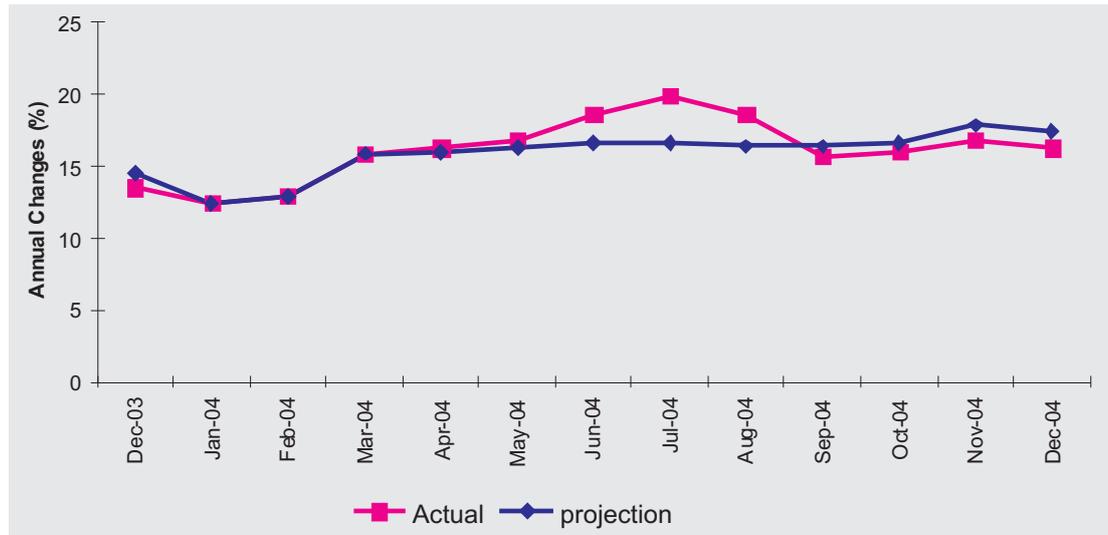


Source: Bank of Zambia

### 2.1.2 Food Inflation

The outturn in food inflation was favourable during the second half of 2004. The annual food inflation rate at 16.3% in December 2004 was 1.1 percentage points below the projected annual food inflation of 17.4% for December 2004 (see Chart 9 and Appendix II, Table 1). The outturn in food inflation was attributed to the stable supply of some food items, following favourable weather conditions in the 2003/ 2004 agricultural season and supportive Government policies. In addition, relative stability in the exchange rate of the Kwacha against the US dollar contributed to favourable food inflation.

**CHART 9: ANNUAL FOOD INFLATION, DECEMBER 2003 - DECEMBER 2004**



Source: Central Statistical Office and Bank of Zambia

**3.0 Monetary Policy Objectives and Instruments for the period January - June 2005**

During the first half of 2005, monetary policy will be geared towards achieving the end-June 2005 annual overall inflation of 15.9%. This is premised on achieving annual food inflation of 15.6% and annual non-food inflation of 16.2% as at end-June 2005 (see Appendix I, Table 1). To achieve this:

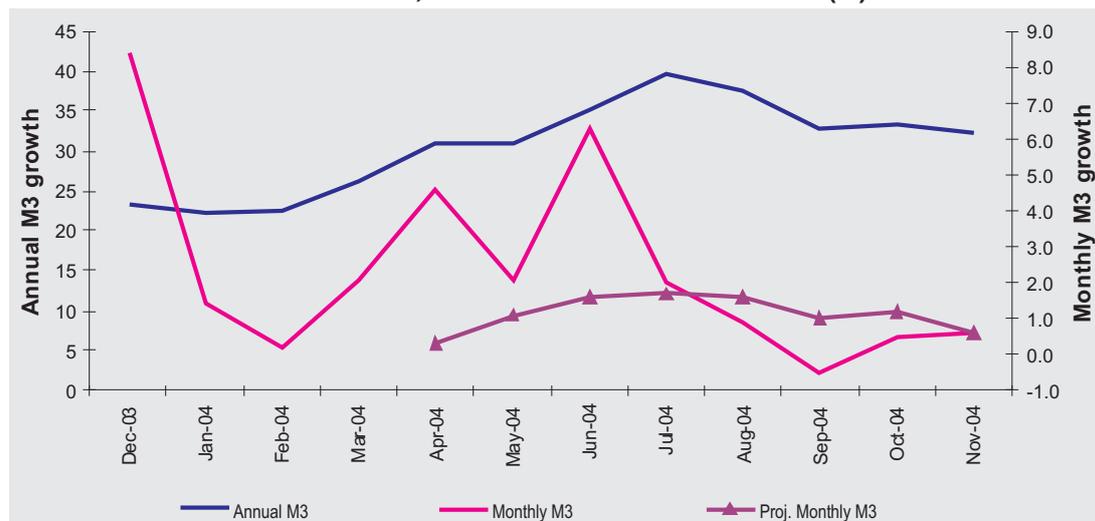
- Reserve money growth will have to be limited to 10.7% over the first half of 2005, consistent with the projection of 19.0% for the year as a whole;
- Broad money growth will have to be limited to 10.7% over the first half of 2005, consistent with the programmed 19.0% growth in 2005;
- Private sector credit expansion will be limited to 11.2%, which is supportive of the economic growth objective and consistent with the fiscal framework; and
- International reserves to be held at a minimum level of 1.1 months of import cover by end-June 2005.

To this end, the Bank of Zambia will continue to rely on indirect instruments of monetary policy to meet the set targets. In order for monetary policy to be effective, it is expected that:

- Government fiscal operations will remain as programmed;
- The exchange rate will remain relatively stable on account of continued good performance of the external sector and improved balance of payments support following the completion of the first review of the new PRGF arrangement by the IMF Board of Directors; and
- Food supply will be adequate due to anticipated favourable weather conditions in the 2004/2005 agricultural season and continued Government support to small-scale farmers.

The downside to these expectations is that inflationary pressures may rise due to expected increases in world oil prices as a result of higher consumption in the northern hemisphere during the winter period. In addition, the high demand for oil in China may increase the pressure on world oil prices.

**CHART 4: CHANGES IN BROAD MONEY, DECEMBER 2003 - DECEMBER 2004 (%)**



Source: Bank of Zambia

Domestic credit growth slowed down to 3.6% in the second half of 2004 compared to 18.9% in the first half of 2004, following reduced banking sector lending to Government by 5.6%. The share of Government borrowing in domestic credit declined to 54.9% in December 2004 from 60.2% in June 2004. However, lending to public enterprises, private enterprises and households increased by 24.2%, 13.3% and 37.1%, respectively. The expansion in domestic credit was 12.8 percentage points above the projected decline of 9.2% in the second half of 2004.

On a sectoral basis, there was an increase in lending to agriculture, manufacturing, construction, wholesale and retail trade, restaurants and hotels, community and social services, energy and water, construction, and transport and communications, and real estate sectors during the second half of 2004 compared with the first half of 2004 (see Appendix II, Chart 1). However, lending to mining and financial services sectors declined during the period under review.

The largest share of loans and advances during the second half of 2004 continued to be extended to the agricultural sector with 29% of total loans and advances [22%; second half of 2003], manufacturing sector (14%) and wholesale and retail trade sector (14%), [16% and 15% in the second half of 2003, respectively]. Other significant shares of loans and advances went to the transport and communications sector (8%), [8%, second half of 2003]. Further, advances and loans were extended to, among others, the energy sector (5%), [1%, second half of 2003], mining and quarrying sector (4%), [4%, second half of 2003], restaurants and hotels sector (4%), [4%, second half of 2003], (see Appendix II, Chart 2 and Appendix II, Table 5).

The share of loans and advances to other sectors fell during the period July to December 2004 to 10% from 23% in the second half of 2003 [13%, first half of 2004] following the increase in the shares for sectors such as agriculture. Other sectors category represents lending to households for consumption and is thus not included in lending to the productive sectors.

During the second half of 2004, reserve money increased by 17.4% to K1,717.8 billion compared with the first half's increase of 4.5% (see Chart 5). The increase was largely due to Bank of Zambia net foreign exchange operations, which continued to be the main source of liquidity, accounting for the bulk of reserve money creation. The Bank's net foreign exchange purchases injected K227.7 billion in the banking system. Liquidity injections from Treasury bill and bond transactions however contributed only K26.3 billion (see Appendix II, Table 4).

With respect to the distribution of reserve money, the bulk of it was held in currency, which recorded a further increase of K29.8 billion to close the year at K816.5 billion while commercial banks' total statutory reserve deposits increased by K75.0 billion to K646.2 billion. The banks' current account balance also increased by K147.4 billion to close the year at K249.1 billion.

## Appendix I: Economic Reform Programme

During the third quarter of 2004, consultations were held between the Zambian Authorities and the International Monetary Fund (IMF) to amongst other things, conduct the first review of performance of the economy under the Poverty Reduction and Growth Facility (PRGF) arrangement and assess progress in the implementation of both quantitative and structural performance benchmarks. This review is important, as successful implementation of macroeconomic and financial policies supported by the PRGF arrangement is a key factor for reaching the Completion Point under the enhanced Heavily Indebted Poor Countries (HIPC) initiative in early 2005

Following a record of good performance during the third quarter of 2004, as measured by the observance of quantitative and structural benchmarks agreed in the PRGF arrangement, the IMF disbursed US \$127.2 million on completion of the first review of the PRGF supported Programme to help Zambia pursue sound macroeconomic management while meeting substantial external obligations. In addition, the World Bank Board approved an International Development Association credit to Zambia of US \$40 million during the period under review. This credit is meant to support Zambia's structural reform programme and the implementation of the country's poverty reduction strategy. Of this amount, US \$20 million was disbursed during the second half of 2004. Further, the European Union disbursed US \$17.9 million under the Poverty Reduction Budgetary Support (PRBS) programme for Government to spend on poverty reduction priority areas. The indicative macroeconomic targets for 2005 are shown in Appendix I, Table 1.

**TABLE 1: MACROECONOMIC OUTTURN IN 2003 AND 2004 AS WELL AS TARGETS FOR 2005**

	2003	2004	2005	
	Outturn	Preliminary	End-June Projection*	End-December Target
Real GDP growth rate (%)	5.1	4.6	5.0	5.0
CPI inflation, end-period (%)	17.2	17.5	15.9	15.0
CPI inflation, annual average (%)	21.5	18.0	16.8	16.2
Gross official reserves (in months of imports)	1.3	1.1	1.1	1.3
Broad money growth (%)	23.4	25.6	10.7	19.0
Domestic budget deficit (% of GDP)	(2.9)	(0.8)	(0.5)	(2.4)
Domestic financing of the budget (% of GDP)	5.1	1.9	0.7	1.6

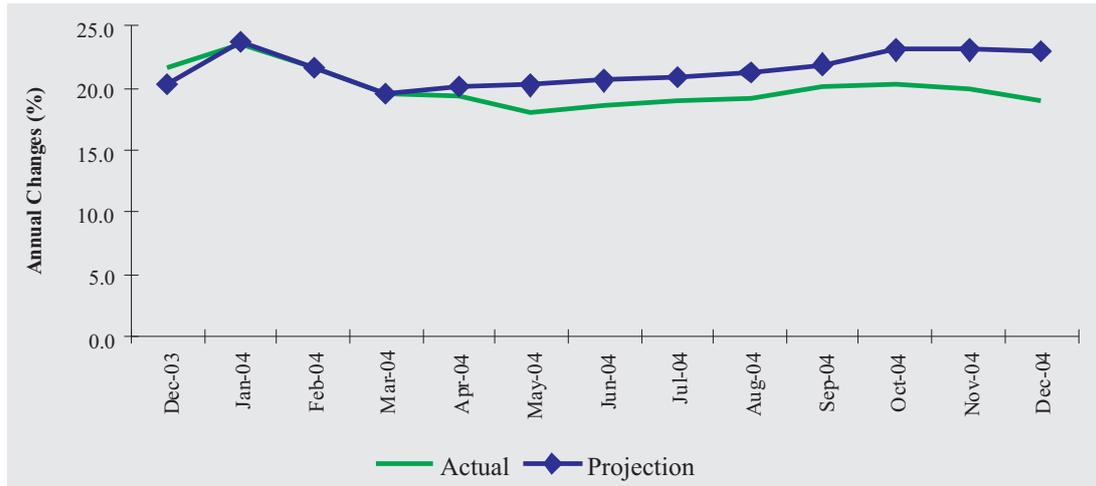
Source: Ministry of Finance and National Planning and Bank of Zambia

Notes: \* Projections in the PRGF arrangement, December 2004.

### Performance against Programme Benchmarks in the Fourth Quarter of 2004

During the fourth quarter of 2004, preliminary assessment shows that the quantitative and structural performance criteria and benchmarks for end-December 2004 under the PRGF arrangement were observed. It is planned that consultations with the IMF staff in the first quarter of 2005 will confirm this performance.

**CHART 2: ANNUAL NON-FOOD INFLATION, DECEMBER 2003 - DECEMBER 2004**



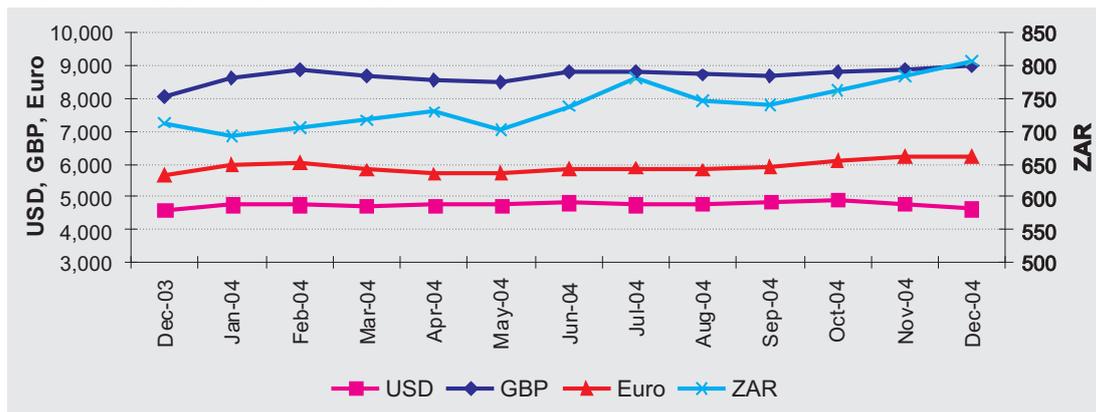
Source: Central Statistical Office and Bank of Zambia

**2.1.1.1 Exchange Rate Developments**

Although the Kwacha depreciated against the British pound, the Euro and the South African rand in the second half of 2004, it remained relatively stable against the U.S. dollar. The Kwacha posted a 3.4% appreciation against the US dollar in the second half of 2004 to end the year at a monthly average of K4,646.15 per Kwacha. The appreciation of the Kwacha against the US dollar was mainly attributed to the improvement in export earnings on account of good copper prices as well as the observed broad weaknesses of the US dollar on the international market.

The Kwacha, however, depreciated by 2.0% against the British pound to K8,967.72 and by 6.7% and 9.4% against the Euro and the South African rand to K6,229.02 and K807.73, respectively (see Chart 3). The depreciation of the Kwacha against the pound, Euro and the rand was largely due to the strong performance of these currencies on the international market.

**CHART 3: EXCHANGE RATES: KWACHA AGAINST MAJOR CURRENCIES, DECEMBER 2003 - DECEMBER 2004**



Source: Bank of Zambia

**2.1.1.2 International Trade Developments**

Preliminary data indicate that the deficit on the trade account narrowed to minus US \$257.9 million during the second half of 2004 from minus US \$367.2 million during the first half of 2004. While merchandise imports decreased by 0.3% to US \$1,127.8 million during the second half of 2004, export earnings increased by 13.9% to US \$869.9 million from US \$763.7 million over the same period.

The improvement in export earnings emanated from both traditional (metal) and non-traditional exports. The reduction in imports was largely attributed to the decline in imports of food items by 11.3% following increased domestic food production; petroleum products by 22.2%; plastic and rubber products by 15.0%; iron and steel and products thereof by 9.2%; and nuclear boilers and equipment by 1.5% on account of near completion of major investments in the new mines (see Appendix II, Table 3).

**TABLE 3: MAJOR IMPORT GROUPS, US \$ MILLIONS**

Description	2003	2004*		Percentage Change
	July - Dec	Jan June	July - Dec	
Food Items	76.5	83.6	74.1	(11.4)
Petroleum Products	71.8	137.3	106.8	(22.2)
Fertilisers	41.3	29.5	55.9	89.5
Chemicals	88.6	98.4	112.0	13.8
Plastic and Rubber Products	50.3	72.8	61.9	(15.0)
Paper and Paper Products	37.0	162.9	166.4	2.2
Iron and Steel	49.4	79.5	72.2	(9.2)
Nuclear Boilers and Equipment	121.6	184.3	181.6	(1.5)
Electrical Machinery and Equipment	59.9	77.7	77.6	(0.1)
Vehicles	63.3	81.9	88.7	8.3
Other Imports	127.8	123.1	130.7	6.2
<b>Total Imports</b>	<b>787.3</b>	<b>1,130.8</b>	<b>1,127.8</b>	<b>0.3</b>

Source: Central Statistical Office and Zambia Revenue Authority  
 Note: \* = Figures for 2004 are preliminary

**TABLE 4: SOURCES OF RESERVE MONEY GROWTH**

	Jan 2004 Jun 2004		Jul 2004 Dec 2004	
	Total (K'bn)	Contribution to Reserve Money Growth (%)	Total (K'bn)	Contribution to Reserve Money Growth (%)
1/ Net Foreign Assets (a+b+c+d)	354,251	25.3	227,677	15.6
a) Net Purchases from Govt	0	0.0	0	0.0
b) Net Purchases from non-Government	310,607	22.2	198,736	13.6
c) Bank of Zambia own use of forex	0	0.0	(15)	0.0
d) Change in stat. reserve deposits forex balances	43,644	3.1	28,955	2.0
2/ Net Domestic Credit (a+b)	(235,223)	-20.8	26,335	1.8
a) Autonomous influences	(179,283)	-16.8	77,107	5.3
Maturing Open Market Operations	88,805	6.3	(68,529)	-4.7
Direct Govt Transactions	(108,164)	-7.7	29,380	2.0
TBs and Bonds Transactions	(223,481)	-16.0	114,961	7.9
Claims on nonbanks (Net)	7,618	0.5	1,295	0.1
b) Discretionary influences	(55,628)	-4.0	(50,772)	-3.5
Open Market Operations	(88,000)	-6.3	(75,592)	-5.2
i. Repos entered into (+ve)	0	0.0	298,500	20.4
ii. Treasury bills outright sale (-ve)	(45,700)	-3.3	(22,839)	-1.6
iii. Term Deposits Taken (-ve)	(42,300)	-3.0	(351,253)	-24.0
Treasury bill Rediscounts	32,525	2.3	37,867	2.6
Other claims (Floats, Overdrafts)	(153)	0.0	(13,047)	-0.9
<b>Change in Reserve Money</b>	<b>63,401</b>	<b>4.5</b>	<b>254,012</b>	<b>17.4</b>

Source: Bank of Zambia

## 1.0 Introduction

This monetary policy statement reviews the conduct and performance of monetary policy during the second half of 2004. In addition, the challenges that are likely to be faced in the conduct of monetary policy in the first half of 2005 and the measures that the Bank of Zambia may take are outlined. The Statement concludes with a specification of the principles the Bank of Zambia intends to follow to guide monetary policy formulation and implementation over the next two years up to December 2006.

Monetary policy in the second half of 2004 was conducted with a view to reign in the rapid growth observed in both reserve money and broad money as the first half of 2004 came to a close. In this regard, reserve money and broad money growth rates were expected not to exceed 8.1% each during the second half. Thus, contributing to the attainment of the projected non-food and food inflation of no more than 12.9% and 11.1%, respectively.

In addition, net domestic financing of the Government was programmed not to exceed 0.5% of GDP, with net domestic credit and net private sector credit set to expand by 9.2% and 14.8% at end-December 2004 over the end-June 2004 levels, respectively (see Table 1). To achieve this, the Bank of Zambia largely employed indirect instruments of monetary policy, including Government securities and Term deposits in open market operations.

**TABLE 1: PERFORMANCE OF SELECTED MONETARY INDICATORS AGAINST RESPECTIVE TARGETS (PERCENT CHANGE)**

	2003	2004		July - December 2004	
	Actual	Programmed	Actual	Programmed	Actual
Overall Inflation	17.2	20.0	17.5	12.0	9.7
<i>Non-food Inflation</i>	21.7	22.9	18.9	12.9	8.7
<i>Food Inflation</i>	13.5	17.4	16.3	11.1	10.5
Reserve Money	26.5	5.7	21.6	8.1	17.4
Broad Money*	23.4	18.1	22.1	8.1	3.6
Domestic Credit*	38.4	43.0	23.2	(9.2)	3.6
Domestic Financing (% of GDP)	5.1	2.2	1.9	1.5	0.8

Source: Central Statistical Office and Bank of Zambia

Notes: \* = Preliminary figures. Broad money and domestic credit are as at end-November 2004.

Notwithstanding the rapid expansion of broad money, reserve money and credit in the first half of 2004, the monetary policy outcome during the second half of the year was favourable. The overall inflation rate of 9.7% at the end of the second half of 2004 was 2.3 percentage points below the overall inflation projection of 12.0% for the period. Over the same period, non-food inflation was 8.7% compared to the target of 12.9% while food inflation was 10.5% against the target of 11.1%. Preliminary data indicate that broad money grew by 3.6% in the second half of 2004, representing 4.5 percentage points lower than the projection of 8.1% over the review period.

Similarly, the end-December 2004 annual overall inflation of 17.5% was 2.5 percentage points below the projection of 20.0% for the year. Over the same period, non-food inflation was 18.9% compared to the target of 22.9% while food inflation was 16.3% against the target of 17.4%.

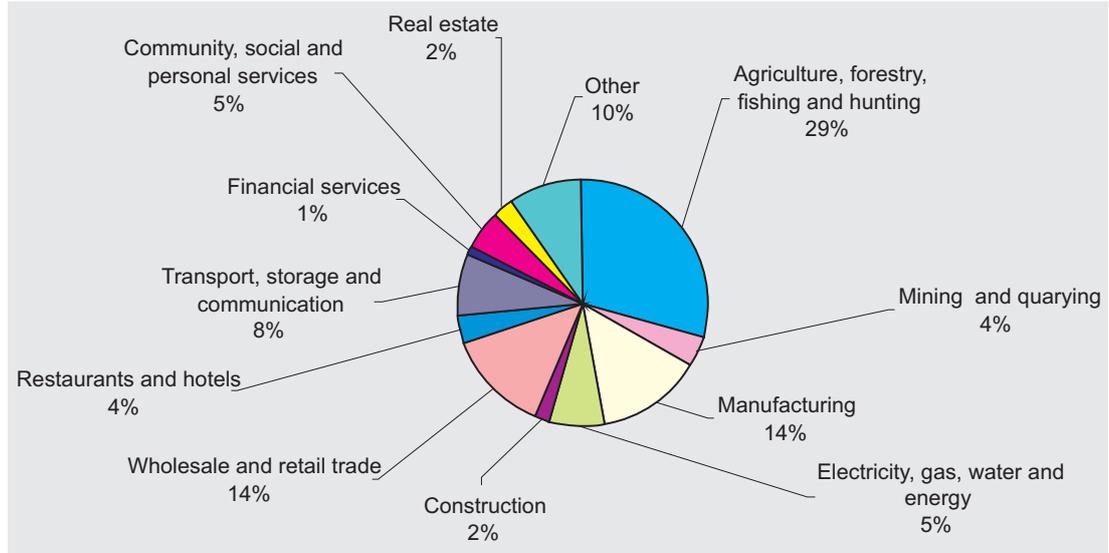
Reserve money growth on the other hand remained strong as it increased by 17.4% during the second half of 2004 compared with a projection of 8.1% over the same period. In addition, the declining trend in Government securities yield rates that characterised the market during the first half of 2004 reversed. Commercial banks' interest rates which declined in the first half of 2004 generally remained unchanged during the remaining half of 2004 (see Appendix III).

## 2.0 Assessment of Monetary Policy Outcome

The approval by the IMF Board of Directors of a new three (3) year Poverty Reduction and Growth Facility (PRGF) arrangement in June 2004 meant that the conduct of monetary policy also took account of the agreed upon monetary policy actions. During the second half of 2004, monetary policy was geared towards achieving the end-December 2004 annual overall inflation of 20.0%. This aimed to achieve non-food inflation of 22.9% and food inflation of 17.4% as at end-December 2004. To achieve this:

- Reserve money growth was to be limited to 5.7% for the year as a whole;
- Broad money growth was to be limited to 18.1% in 2004;
- Domestic credit expansion was to be limited to 43.0% in 2004;
- Private sector credit expansion was to be 26.2%, which was to be supportive of the economic growth objective and consistent with the fiscal framework;
- International reserves accumulation was to reach at least 1.7 months of import cover at end-December 2004;

**CHART 2: STRUCTURE OF LOANS AND ADVANCES (MONTHLY AVERAGE JULY - DECEMBER 2004)**



Source: Bank of Zambia

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Monetary Policy Statement

# Bank of Zambia

## MISSION STATEMENT

The principal purpose of the Bank of Zambia is to “formulate and implement monetary and supervisory policies that will ensure price and financial systems stability”.

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