BANK of ZAMBIA
OFFICE OF THE GOVERNOR

MONETARY POLICY COMMITTEE STATEMENT

Policy Rate maintained at 11.50%

At its February 17-18, 2020 Meeting, the Monetary Policy Committee (MPC) decided to maintain the Policy Rate at 11.50%. Inflation is projected to remain high over the earlier part of the forecast period[1] *and thereafter decline towards the upper bound of the target range as food supply improves. Much of the inflation has been driven by rising food prices. The Committee recognised that economic activity has continued to be weak and liquidity challenges have persisted. These continue to pose risks to financial stability. The Committee reiterates the need for effective and sustained implementation of fiscal adjustment and structural measures to address elevated debt levels and debt service, the continued accumulation of domestic arrears, and liquidity constraints in order to restore macroeconomic stability and promote robust and sustained economic growth.*

Inflation rises further as pressures on food prices mount

Inflationary pressures continued to mount in the fourth quarter of 2019, driven mainly by a further sharp increase in prices of maize grain and related products and the significant depreciation of the Kwacha against the US dollar. The increase in maize prices was mainly due to relatively low supply. Subdued supply amidst heightened demand for foreign exchange relating to the importation of electricity, petroleum products, and agricultural inputs were the key drivers of the depreciation of the Kwacha. Annual overall inflation increased to an average of 11.1% from 9.5% in the third quarter. Average food inflation rose to 14.0% from 10.7% while non-food inflation slowed down to 7.8% from 8.3%. In December 2019, overall inflation was 11.7%, and it averaged 9.1% for the year as a whole.

In January 2020, inflation rose further to 12.5% following the upward adjustment in electricity tariffs and fuel pump prices.

Inflation is projected to remain elevated over the earlier part of the forecast period and thereafter decline towards the upper bound of the target range of 6 - 8%. Underlying this projection are the effects of on-going electricity supply challenges and increased external debt service payments on inflation through the expectations and exchange rate channels. The upside risks to the inflation outlook include further increases in the prices of maize grain and related products, the second round effects of the increases in fuel and electricity prices, and slower progress on fiscal consolidation.

However, it is envisaged that inflation could decline faster than currently projected on account of the anticipated improvement in agricultural output due to the favourable rainfall pattern observed so far during the 2019/2020 crop season.

[1] The forecast period or horizon is eight quarters ahead, that is, the first quarter of 2020 to the fourth quarter of 2021.

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Overnight interbank rate continues to rise as liquidity conditions remain tight

The overnight interbank rate rose further to an average of 11.44% in the fourth quarter from 10.76% in the third quarter. It, however, remained broadly within the Policy Rate Corridor of 10.50% to 12.50%. The foregoing notwithstanding, the interbank rate was consistently around the upper bound of the Corridor due to tight liquidity conditions. The upward adjustment in the *statutory reserve ratio* to 9.0% from 5.0%, effected on December 23, 2019, to address emerging exchange rate pressures, contributed to the tight liquidity conditions. For maximum effect, the compliance arrangement for statutory reserve requirement was also changed to daily from weekly and that had the effect of generating additional demand for liquidity.

Demand for Government securities improves, but remains constrained

Demand for securities improved in the fourth quarter, but remained subdued with respect to the Government's financing needs. The subscription rate for Treasury bills and Government bonds rose to averages of 91.0% and 42.0% from 75.0% and 35.0%, respectively. The improvement was mainly driven by increased participation by institutional investors.

In spite of the improved demand, funds raised from auctions were insufficient to meet the maturities resulting in a deficit of K0.1 billion. To meet the deficit and Government financing needs, additional Government securities were issued through private placements. Consequently, the outstanding stock of Government securities rose to K80.2 billion from K72.3 billion, representing a 10.9% increase.

Non-resident holdings of Government securities increased to K8.8 billion (11.0% of the total stock) from K7.4 billion (10.3% of the total stock), largely due to relatively attractive yield rates and they continued to be concentrated in Government bonds.

Interest rates remain high

Lending interest rates continued to rise as liquidity conditions tightened. This largely reflected Government financing requirements, which kept yield rates high. In addition, the upward adjustments in both the Policy Rate in November 2019 and the *statutory reserve ratio* in December 2019 in response to high exchange rate volatility and hence inflationary pressures, contributed to the rise in lending rates.

Yield rates on Treasury bills and Government bonds at 25.19% and 31.12% were relatively unchanged from 25.17% and 30.49%, respectively. The commercial banks' average lending rate increased to 28.0% in December 2019 from 26.1% in September. Excluding outliers, the average lending rate remained high at 26.0% in December 2019 compared to 23.9% in September. Savings rates for 180-day deposits increased, marginally, to 10.1% from 9.9%.

Credit and money supply growth pick up, but credit conditions remain tight

In nominal terms, growth of credit to the private sector increased to 17.2% from 8.2% in September 2019. High demand for working capital by firms to bridge the liquidity gap created by delayed[2] payments for goods and services supplied to Government was the major driver. Credit to Government rose to 17.2% from 10.8% in September mainly in the form of Government securities to meet financing needs.

[2] Bank of Zambia Credit Conditions Survey, Fourth Quarter 2019.

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Money supply (M3)[3] growth rose to 12.5% in December 2019 from 6.0% in September, largely due to the expansion in domestic credit to Government.

Fiscal pressures persist

Preliminary estimates indicate a cash fiscal deficit of 8.2% of GDP in 2019 against a budget target of 6.5%.[4] This largely reflects higher than programmed spending on capital projects and the Farmer Input Support Programme, as well as external debt service payments. The depreciation of the Kwacha against the US dollar, experienced during the period, compounded the expenditure pressures.

The continued accumulation of domestic arrears constrains working capital for the private sector and poses risks to the stability of the financial sector through high non-performing loans. Effective and sustained implementation of fiscal adjustment measures therefore remain critical to restoring macroeconomic stability.

Global growth slows down, but moderate pick-up expected in the medium term

The global economy is estimated to have expanded at a slower pace of 2.9% in 2019 than the 3.6% recorded the preceding year.[5] Growth decelerated mainly on account of trade and geopolitical tensions, weather related disasters, as well as uncertainty surrounding Brexit.

Over the medium-term, global growth is projected to pick-up, albeit at a reduced pace than earlier expected. Underlying the projected pick-up in growth is the recovery in manufacturing activity, business confidence, investment, and global trade. Risks to global growth, however, remain tilted to the downside, and include the possibility of a re-escalation of trade tensions, renewed geopolitical tensions in the Middle East, rising debt vulnerabilities, lower commodity prices, and extreme weather conditions. In addition, the recent outbreak of the Coronavirus (COVID-19) has presented a new down side risk to global growth and its impact is yet to be fully assessed.

Current account records a surplus

Preliminary data indicate that the *current account* surplus expanded to US$166.1 million (0.7% of Gross Domestic Product (GDP)) from US$76.9 million (0.3% of GDP) in the third quarter of 2019. This arose from a significant increase in net exports of goods[6].

The *goods account* recorded a surplus of US$238.4 million against a deficit of US$2.7 million in the third quarter. The increase in export earnings against a decline in imports explained this outturn. Export earnings rose by 11.9% to US$1.8 billion, largely due to higher copper exports. Copper exports, at US$1.2 billion, were 21.2% higher than the preceding quarter, driven mainly by an increase in export volumes despite a marginal decline in average realised prices.

Imports of goods fell by 3.0% to US$1.6 billion, mainly on account of a reduction in demand for raw materials and intermediate goods in the face of subdued economic activity.

[3] M3 comprises currency in circulation and Kwacha as well as foreign currency deposits.
[4] Minister of Finance Statement on the State of the Zambian Economy, February 2020.
[5] IMF World Economic Outlook Update, January 2020.
[6] Following the Third quarter 2019 Private Capital Flows Survey, the *primary income* and *financial account* data was revised in line with the Bank of Zambia Balance of Payments Revision Guidelines.

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For the year as a whole, the *current account* recorded a surplus of US$241.6 million in 2019 (1.0% of GDP) against a deficit of US$341.5 million in 2018 (1.3% of GDP), due to improvements in net exports of both goods and services.

Gross international reserves declined to US$1.45 billion (equivalent to 2.1 months of import cover[7]) at end-December 2019 from US$1.48 billion (equivalent to 1.8 months of import cover) at end-September 2019 largely due to Government debt service payments. To augment reserves the Bank of Zambia purchased a net of US$812.0 million in 2019, of which US$285.0 million were mineral royalties. This was a significant improvement over 2018 when US$510 million was purchased, inclusive of US$164.0 million mineral royalties.

The Kwacha remains under pressure

The Kwacha depreciated against all the major trading partner currencies on account of subdued supply of foreign exchange amidst escalating demand for the importation of petroleum products, electricity, and agricultural inputs. Against the US dollar, the Kwacha depreciated by 6.8% to a quarterly average of K13.86. Pressure on the Kwacha mounted towards the end of November into December resulting in the Kwacha reaching the K14 and K15 levels, respectively.

To moderate exchange rate pressures, the Central Bank had to increase the *statutory reserve ratio* and shifted compliance of the statutory reserve requirement to daily from weekly, as explained earlier. Since then, the Kwacha has stabilised around K14.70 against the US dollar.

GDP growth weakens

Indicators of economic activity suggest a further slowdown in growth in the fourth quarter owing to the contraction in mining output, electricity generation, cement production, consumer spending, and manufacturing of selected products.[8]

Real GDP growth is estimated at 2.0% in 2019, lower than the 4.0% outturn in 2018. However, in 2020 and the medium-term, real GDP growth is projected to recover, albeit at a weaker pace, driven largely by the anticipated recovery in the agriculture, electricity, and mining sectors. Downside risks to the projected recovery include the elevated domestic and external debt and debt service, continued accumulation of arrears, slower than expected fiscal adjustment, and weaker than anticipated global economic growth associated with lagged effects of trade disputes and the COVID-19 outbreak.

The MPC Decision

The MPC held the Policy Rate unchanged at 11.50%. In arriving at this decision, the Committee took into account that, although inflation will continue to rise over the earlier part of the forecast period, it is expected to decline towards the upper bound of the target range thereafter as food supply improves. The Committee was also mindful that much of the inflation has been driven by rising food prices. In addition, the Committee recognised that economic activity has continued to be weak, liquidity challenges have persisted and these continue to pose risks to financial stability.

[7] Following the downward revision of the projections for imports of goods and services in November 2019 due to lower than anticipated outturn in the third quarter of 2019 on account of subdued domestic economic activity, the months of import cover were accordingly revised upwards.
[8] The Bank of Zambia Composite Index of Economic Activity, Bank of Zambia Quarterly Survey of Business Opinions and Expectations and Stanbic Bank PMI.

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While allowing time for the measures effected during and after the last MPC Meeting to take effect, the Committee reiterates the need to implement effective and sustained fiscal adjustment and structural measures to address elevated debt levels and debt service, the continued accumulation of arrears, and liquidity constraints in order to restore macroeconomic stability and promote robust and sustained economic growth.

Decisions on the Policy Rate will continue to be guided by inflation forecasts, outcomes, identified risks, as well as effective and sustained implementation of fiscal consolidation measures.

The next MPC Meeting is scheduled for May 18 - 19, 2020.

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