Bank *of* Zambia

MONETARY POLICY COMMITTEE STATEMENT

Monetary Policy Rate held at 8.5 percent

The Monetary Policy Committee (MPC), at its May 17 - 18, 2021 Meeting, decided to maintain the Monetary Policy Rate at 8.50 percent. While inflation is projected to remain above the upper bound of the 6-8 percent target range over the forecast horizon[1], inflationary pressures are expected to ease in view of the improved supply of food, particularly maize and wheat following a good crop harvest. In addition, the significant improvement in copper prices and renewed interest in domestic Government securities by non-resident investors are supportive of the foreign exchange market and in turn lower inflation going forward. The decision also recognises existing vulnerabilities in the financial sector and fragile growth. To restore and anchor macroeconomic stability, the implementation of fiscal adjustment measures in line with the Economic Recovery Programme and understandings reached in discussions with the IMF remain critical.

A stronger recovery in global growth projected

Global economic recovery gained traction in the first quarter of 2021 on the back of the rollout of COVID-19 vaccinations and enhanced monetary and fiscal stimuli. Overall, growth is projected at 6.0 percent and 4.4 percent in 2021 and 2022, respectively from a preliminary contraction of 3.3 percent in 2020. In the medium-term, however, growth prospects remain uncertain in view of possible outbreaks of new and more contagious variants of the virus, uneven access to vaccines, and limited fiscal policy support, especially in developing economies.

Domestic economic activity weakened in the first quarter, but recovery expected in the medium-term

Preliminary indicators of economic activity point to weaker growth in the first quarter of 2021. The *Bank of Zambia Composite Index of Economic Activity*[2] contracted largely reflecting the decline in copper production, retail sales and international passenger arrivals. In addition, all monitored indicators in the *Bank of Zambia Survey of Business Opinions and Expectations*, with the exception of labour demand, declined relative to the preceding quarter partly attributed to the

[1] The forecast period or horizon is eight quarters ahead, that is, the second quarter of 2021 to the first quarter of 2023.
[2] The Bank of Zambia Composite Index of Economic Activity tracks changes in economic activity by aggregating high frequency sectoral data that are highly correlated with real GDP.

effect of the second wave of COVID-19. The [Stanbic Bank Purchasing Manager's Index (PMI)] also signalled a deterioration in the private sector business environment over much of the first quarter.

Nonetheless, real GDP is projected to recover beginning 2021 on the back of strong performance in information and communication, electricity, education as well as public administration sectors. In this regard, the [Stanbic PMI] for April pointed to an improvement in private sector business environment, the first recorded since February 2019. However, constrained fiscal space and the global resurgence of COVID-19 infections continue to pose significant downside risks to the growth outlook.

Inflation accelerates further, but expected to moderate

Annual overall inflation accelerated to a five-year high averaging 22.2 percent in the first quarter of 2021 from 17.6 percent in the previous quarter. The depreciation of the Kwacha and low seasonal supply of fish and some vegetables, largely accounted for this outturn. Food inflation rose sharply to 27.0 percent from 17.2 percent while non-food inflation declined to 16.6 percent from 18.0 percent.

In April, overall inflation marginally declined to 22.7 percent from 22.8 percent in March.

While inflation is projected to remain above the upper bound of the 6-8 percent target range over the next eight quarters, inflationary pressures are now expected to subside more quickly than envisaged in the February MPC Meeting. This is mostly on account of the excess supply of maize in view of a good crop harvest, higher copper prices and improved external financing. Inflation is projected to average 21.9 percent and 16.7 percent in 2021 and 2022, respectively. Elevated fiscal deficits, higher crude oil prices, and rising inflation in some major trading partner countries are the key sources of inflationary pressures over the forecast period. However, these are expected to be mitigated somewhat by significantly higher copper prices. Over this period, the key upside risk to inflation is the possible increase in energy prices (fuel pump prices and electricity tariffs) and any resurgence of the COVID-19 infections following the advent of the new variants.

Overnight interbank rate maintained within the Corridor

The overnight interbank rate increased to 8.59 percent in March 2021 from 8.17 percent in December 2020 and was maintained within the Policy Rate Corridor of 7.5 to 9.5 percent throughout the quarter. The increase mainly reflected the upward adjustment in the Policy Rate by 50 basis points to 8.5 percent in February.

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Demand for Government securities improves

Demand for Government securities was relatively stronger than the previous quarter on the back of improved domestic liquidity conditions and increased interest from non-resident investors. Subscription rates to Treasury bill and Government bond auctions improved to 112 percent and 70 percent from 80.8 percent and 30.0 percent, respectively. As a result, a surplus of K1.6 billion was realised. In addition, Government continued to issue securities through private placements. Consequently, the stock of Government securities rose by 9.7 percent to K142.8 billion.

Although domestic investors account for the largest share of Government securities, the proportion of non-residents holdings increased. As at end-March 2021, Government securities held by non-residents rose by 2.1 percent to K18.8 billion, representing 13.2 percent of outstanding securities. Most of their holdings (93 percent) were in Government bonds.

Interest rates edge up

Yield rates on Treasury bills and Government bonds rose to 22.3 percent and 33.7 percent from 20.1 percent and 33.3 percent in December, respectively. This was largely attributed to increased domestic financing requirements. Similarly, the commercial banks' average lending rate rose to 26.0 percent in March 2021 from 25.1 percent in December 2020, largely reflecting the upward adjustment in the Monetary Policy Rate in February. The savings rate for 180-day deposits, however, remained broadly unchanged at 9.7 percent.

Credit to the private sector slows down significantly as money supply growth moderates

Year-on-year growth in credit to the private sector reduced substantially to 0.5 percent in March 2021 from 8.5 percent in December 2020 largely due to net repayments. Meanwhile credit to Government continued to expand at a strong pace on the back of sustained issuance of Government securities to meet domestic financing needs. Over the same period, money supply (M3)[3] growth slowed down to 39.6 percent, year-on-year, from 46.4 percent. This largely reflected a lower growth in net foreign assets.

[3] M3 comprises currency in circulation, Kwacha deposits, and foreign currency deposits.

Fiscal pressures still persist

Revenue performance improved in the first quarter. However, fiscal pressures remain, reflecting high expenditures on fuel imports and the Farmer Input Support Programme (FISP) as well as the need to clear accumulated domestic arrears. Over the medium-term, gradual fiscal adjustment premised on expenditure rationalisation and the significant increase in domestic revenue is envisaged. In this regard, the announcement that substantive understanding has been reached on the macroeconomic framework between the IMF and the Government, the impending one-off allocation of SDRs by the IMF to help countries fight the COVID-19 pandemic and improved copper earnings are important developments that can help in creating the much needed fiscal space.

Current account surplus expands further

Preliminary data indicate that the current account surplus expanded further by 8.0 percent in the first quarter of 2021 to US$0.8 billion (15.9 percent of GDP) from US$0.7 billion (15.7 percent of GDP)[4] due to net exports. Net exports grew by 11.1 percent to US$1.3 billion as copper export earnings remained robust amid a drop in imports. Copper earnings increased by 4.3 percent to US$1.9 billion driven by higher prices despite the fall in export volumes. Merchandise imports fell by 5.5 percent to US$1.2 billion, reflecting a reduction in capital goods as the recovery in economic activity remained weak.

Pace of Kwacha depreciation slows down

The Kwacha weakened further, albeit at a slower pace, as net demand moderated. The Kwacha depreciated against the US dollar by 4.4 percent in the first quarter compared with 9.4 percent depreciation in the preceding quarter. The Kwacha averaged K21.63/US$ in the first quarter.

The Bank of Zambia continued to intervene to moderate exchange rate pressures. On a net basis, the Bank sold US$259.7 million compared to US$339.8 million in the preceding quarter. This largely reflected the receipts of tax obligations from the mining companies, which were sold back to the market.

[4] The current account is computed as a percent of quarterly GDP. In the February 2021 Statement, this was expressed as a percentage of annual GDP.

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Gross international reserves broadly remained unchanged at US$1.2 billion (equivalent to 2.1 months of import cover)[5] at end-March 2021.

The MPC Decision

The MPC noted that, although inflation is projected to remain above the upper bound of the 6-8 percent target range over the forecast horizon, inflationary pressures are projected to ease faster than earlier anticipated, particularly towards the end of the forecast horizon. This is in view of improved supply of food, particularly maize and wheat following a strong crop harvest, higher than anticipated copper prices and improved external sector support. In view of this, and to allow for the last Policy Rate adjustment to take full effect on the economy, **the MPC decided to keep the Monetary Policy Rate unchanged at 8.50 percent.** This is also in recognition of existing vulnerabilities in the financial sector and fragile growth.

The Bank remains committed to adjusting the policy rate upwards should the expected drop in inflation not materialise sooner than anticipated.

Decisions on the Policy Rate will continue to be guided by inflation forecasts, outcomes, and identified risks, including those associated with financial stability and the COVID-19 pandemic. Implementation of fiscal adjustment in line with the Economic Recovery Programme and the understandings reached in discussions with the IMF on the macroeconomic framework remain critical to restore and anchor macroeconomic stability and to create the much needed fiscal space.

The next MPC Meeting is scheduled for August 30 - 31, 2021.

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[5] Despite reserves remaining broadly unchanged, the months of import cover declined to 2.1 from 2.3. This reflects higher projected imports for 2021 as economic activity recovers.

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