Bank of Zambia

MONETARY POLICY COMMITTEE STATEMENT

Bank of Zambia Policy Rate maintained at 9.75%

The Monetary Policy Committee (MPC), at its November 19 – 20, 2018 Meeting, decided to maintain the Policy Rate at 9.75%. Although inflation is projected to exceed the upper bound of the 6-8% target range during the first three quarters of the forecast period[1], it is expected to return to the target range thereafter. As some of the upside risks identified in the August MPC Meeting materialised, inflation continued to rise and ended the third quarter just below the upper bound of the target range. Annual overall inflation rose to 7.9% in September 2018 from 7.4% in June 2018, largely reflecting higher prices of some food items and the depreciation of the Kwacha against the US dollar. Indicators of economic activity[2] suggest that economic growth remains subdued with heightened downside risks. Credit to the private sector continued to recover albeit at too low a pace to stimulate significant economic activity. The El Niño forecast in the 2018/2019 farming season, delayed implementation of fiscal adjustment measures as well as rising debt and debt service payments continue to pose downside risks to economic growth. Although the non-performing loans (NPLs) ratio declined to 11.3% from 12.4%, it remained above the 10% prudential threshold, thereby posing a threat to the stability of the financial system. The fiscal deficit for 2018 is now projected at around 7.0%[3] against a target of 6.1% in the 2018 Budget Address. Fiscal consolidation therefore continues to be a critical requirement for macroeconomic stability. Should the rising risks to inflation materialise, an upward adjustment in the Policy Rate may be necessary to prevent inflation from persistently staying above the target range.

Inflation edges up, while upside risks rise

Annual overall inflation rose for the third consecutive quarter, rising to 7.9% in September from 7.4% in June 2018. Food prices increased further, thereby contributing to the rise in inflation. In addition, the 19.5% depreciation of the Kwacha against the US dollar in the month of September added upward pressure to the price of some food and non-food items. In October, annual overall inflation rose to 8.3%, attributed to the lagged effects of the significant depreciation of the Kwacha against the US dollar in the previous month and the upward adjustment in petroleum prices. The latter was also affected by the increase in global prices of crude oil.

Inflation is projected to exceed the upper bound of the 6-8% target range in the first three quarters of the forecast period, but trend towards the mid-point of the target range thereafter. Upside risks to the projected inflation over the near-term continue to dominate. These include tighter than expected global financial conditions, higher than expected crude oil prices, lower than anticipated copper prices, higher than programmed fiscal deficits as well as rising debt service payments. However, should inflation in the

[1] The forecast period is the fourth quarter of 2018 to the third quarter of 2020.

[2] Bank of Zambia Composite Index of Economic Activity (CIEA) and the September 2018 Stanbic Bank Zambia Purchasing Managers Index (PMI).

[3] Minister of Finance stakeholder engagement briefing, November 9, 2018.

fourth quarter of 2018 turn out to be lower than is currently projected, it may return to the target range faster than anticipated.

Interbank rate maintained within the Policy Rate corridor

Consistent with the monetary policy stance, the overnight interbank rate was maintained within the Policy Rate corridor through appropriate open market operations. The rate averaged 9.73% in the third quarter, two basis points below the Policy Rate of 9.75%.

Demand for Government securities remains low

Demand for Government securities generally declined in the third quarter of 2018, weighed down by low liquidity levels and reduced participation by offshore investors. Subscription rates for Government bonds fell significantly to 32% from 124% the previous quarter. On the other hand, subscription rates for Treasury bills picked up to 68% from 43.3%.

The stock of outstanding Government securities, at K54.6 billion at end-September 2018, was 5.4% higher than recorded at end-June 2018. Of the total outstanding Government securities, non-residents held K8.5 billion, representing 15.6% of the total stock, down from 17.0% at end-June 2018. Almost all the Government securities held by non-residents are in Government bonds.

Lending rates remain elevated and yield rates edge up

Commercial banks' average nominal lending rates remained high despite declining to 23.0% in September 2018 from 24.3% in June. Even excluding outliers[4], the average lending rate remained relatively high at 21.0%. The accommodative monetary policy stance during the period provided an opportunity for banks to lower nominal lending rates.

Yield rates for both Treasury bills and Government bonds rose to 18.5% and 19.6% from 17.0% and 18.1% in the second quarter, respectively. The increase in yield rates largely reflected high Government borrowing requirements.

Savings rates for 180-day deposits for amounts exceeding K20,000 were virtually unchanged at 8.3% during the third quarter. However, the highest rate on outstanding negotiated deposits rose to 18.5% in September 2018 from 18.0% in June.

Credit to private enterprises and households continues to recover and money supply expands further

Total domestic credit increased by 9.9% in the third quarter of 2018 compared to a growth of 2.9% in the second quarter. The expansion in credit was largely attributed to the increase in lending to private enterprises, households, and Government. Credit to private enterprises increased by 19.2% compared to a growth of 4.7% in the second quarter, while credit to households expanded further by 7.5% from 5.3%. Increased demand for working capital by private enterprises and lower interest rates on salary-backed loans to households partly accounted for the growth in credit to these sectors. Credit to Government rose by 6.2% compared to 1.3% in the previous quarter.

Foreign currency denominated loans and advances drove credit growth, which grew by 10.2% against a contraction of 0.2% the preceding quarter. Kwacha denominated loans rose by 3.7% compared to the 3.4% increase in the second quarter. With rising foreign currency loans, potential currency mismatches by borrowers have emerged as a source of risk to financial stability.

[4] These are banks with the highest and lowest lending rates.

Money supply growth rose to 13.0% from 7.3% in the second quarter of 2018. The rise was on the back of increases in Kwacha deposits and valuation effects on foreign exchange deposits as the Kwacha depreciated against the US dollar.

Fiscal deficit projected to narrow

The fiscal deficit, on a cash basis, for 2018 is estimated at around 7.0% of Gross Domestic Product (GDP) against the budget target of 6.1% and the actual outturn of 7.8% of GDP in 2017. In 2019, the fiscal deficit is projected to narrow further to 6.5% of GDP. However, as reflected in the Ministry of Finance November 2018 Statement, domestic arrears rose to K14.7 billion in June 2018 from K13.9 billion in March 2018. Speedy and effective implementation of the austerity measures as outlined by the Government as well as strict adherence to the 2019 Budget are necessary to moderate the pressures on Government financing, private sector liquidity challenges, debt distress, inflationary pressures, and threats to the stability of the financial sector.

Global growth remains strong, but with enhanced downside risks

The global economy continued to register positive growth anchored on strong growth in the United States, and is projected to grow by 3.7% in both 2018 and 2019 from 3.9% in 2017[5]. This growth momentum, and in particular the continued growth of the Chinese economy, is expected to support copper prices and Zambia's copper export earnings. However, downside risks associated with trade wars and uncertainties surrounding Brexit[6] have heightened over the medium-term.

Current account deficit narrows

Preliminary data[7] indicate that the *current account* deficit narrowed to US $277.5 million in the third quarter from US $290.3 million in the second quarter. This was underpinned by an increase in the surplus on the *balance on goods*,[8] which more than offset the widening of the *primary income account*.

The *balance on goods* surplus more than doubled to US $158.5 million from US $73.6 million mainly on account of the 2.6% increase in export earnings to US $2,289.5 million following the rise in non-traditional export (NTEs) earnings. At US $583.5 million, NTEs were 17.6% higher than the previous quarter, driven by increased earnings from cane sugar, cotton, copper wire, burley tobacco, electricity, cement, and maize. Copper exports, however, declined by 0.8% to US $1,628.6 million on account of a reduction in average realised prices despite an increase in export volumes. Imports declined by 1.2% to US $2,131.0 million on account of lower imports of chemicals, machinery, equipment, copper ores, and iron and steel. The current account deficit was financed by a surplus on the *financial account*.

Gross international reserves declined to US $1.63 billion at end-September 2018, representing 1.9 months of import cover, from US $1.82 billion (2.2 months of import cover) recorded at end-June 2018. This was mainly attributed to debt service payments. To build international reserves, the Bank of Zambia continued to purchase foreign exchange directly from the market and through the mineral royalty tax receipts. Cumulatively, the purchases amounted to US $345.0 million in the year to September 2018.

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[5] IMF, WEO, October 2018

[6] Brexit (vote by the United Kingdom to leave the European Union). A draft agreement has been reached between the EU and the U.K. which is now subject to a ratification/approval process by both parties.

[7] Central Statistical Office, Zambia Revenue Authority, Ministry of Finance, Bank of Zambia.

[8] Trade data was revised after adjustments made to imports of cobalt ores from Congo (DR). The revised data was realigned to the International Monetary Fund's Balance of Payments Manual 6 Standards.

The Kwacha depreciates further against the US dollar

The Kwacha was relatively stable for most part of the year, depreciating only by 2.9% up to end-August. However, in September, it depreciated sharply by 19.5% against the US dollar. The rapid depreciation of the Kwacha in September was initially triggered by a sustained increase in pipeline demand for oil procurement. This was compounded by the strengthening of the US dollar following the hike in the US Federal Funds Rate and sustained negative market sentiments arising from the downgrade of Zambia's credit rating. The depreciation was despite net supply of foreign exchange, mainly from the mining and construction sectors. For the quarter as a whole, the Kwacha depreciated by 4.2% against the US dollar to a quarterly average of K10.31 from K9.89 in the second quarter.

Domestic economic growth remains low with heightened downside risks

Indicators of economic activity[9] suggest positive year-on-year growth in the third quarter of 2018, but downside risks rose. Growth was underpinned by a pick-up in mining output, electricity generation, cement production, and tourist arrivals. Real GDP is projected to grow by about 4.0% in 2018, premised on positive performance in construction, information and communication, electricity, manufacturing, and mining sectors. There are, however, downside risks to the growth outlook, which include the El Niño forecast in the 2018/2019 farming season, delayed implementation of fiscal adjustment measures, high debt service payments, credit constraints on account of high lending rates and non-performing loans as well as high Government borrowing requirements.

The MPC Decision

The MPC, at its November 19 – 20, 2018 Meeting, decided to keep the Policy Rate unchanged at 9.75% taking into account the above factors.

Inflation is projected to exceed the upper bound of the 6-8% target range in the first three quarters of the forecast period, but to return within the target range and trend towards the mid-point of 7.0% thereafter.

In addition, the MPC took into consideration:

- The lower than expected and fragile economic growth. Based on persistent negative business sentiments, indications are that growth for 2018 may be lower than projected; and
- The need to minimise potential vulnerabilities to the financial sector.

Decisions on the Policy Rate will continue to be guided by inflation forecasts and outcomes as well as progress in the execution of fiscal consolidation measures. Should the heightened risks to inflation materialise, an upward adjustment in the Policy Rate may be necessary to prevent inflation from persistently staying above the target range.

The next MPC Meeting is scheduled for February 18 – 19, 2019.

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[9] Measured on a year-on-year basis.