BANK *Of* ZAMBIA

MONETARY POLICY COMMITTEE STATEMENT

Bank of Zambia (BoZ) Policy Rate reduced to 12.5%, Statutory Reserve Ratio reduced to 12.5%, and Policy Rate corridor narrowed to + / - 1 percentage point.

The Monetary Policy Committee (MPC), at its Meeting on 15 and 16 May 2017, decided to reduce the Policy Rate by 150 basis points to 12.5% from 14.0% and the Statutory Reserve Ratio by 300 basis points to 12.5% from 15.5%. In arriving at this decision, the Committee noted that annual inflation closed the quarter at 6.7%, down from the end-fourth quarter 2016 outturn of 7.5%. Inflation in April was 6.7% and current forecasts indicate that it will remain well anchored within the target range of 6-8% over the medium-term. Economic activity remained subdued in the first quarter of 2017. Credit to the private sector contracted further despite an increase in money supply. Although yield rates on Government securities declined, lending rates remained high. Recent measures taken to address subsidies in the energy sector, combined with revenue enhancing measures, are critical to reducing the overall budget deficit and are broadly in line with the fiscal consolidation efforts. To improve the clarity of the policy stance and enhance the effectiveness of the monetary policy framework, the Committee narrowed the Policy Rate corridor to + / - 1 percentage point from + / - 2 percentage points. The Bank of Zambia will closely monitor domestic and external developments and stands ready to take appropriate monetary policy measures to maintain price and financial system stability and ultimately support diversification and higher economic growth.

Inflation declined further to 6.7% at end-first quarter 2017

Annual overall inflation closed the first quarter of 2017 at 6.7%, down from the end-fourth quarter 2016 outturn of 7.5%. Month-on-month inflation also declined to 0.3% in March 2017 from 0.9% in December 2016. The deceleration in inflation was largely due to the pass-through from the continued appreciation of the Kwacha against the U.S. dollar, the reduction in retail fuel prices in January 2017 and the seasonal increase in the supply of some food items. Both food and non-food inflation slowed down to 6.7% and 6.6% in the first quarter of 2017 from 7.8% and 7.1% in the previous quarter, respectively.

In April 2017, annual inflation remained steady at 6.7%, although monthly inflation rose marginally to 0.4%. Despite the marginal increase in monthly inflation, the outlook for inflation is still consistent with the annual single digit profile.

Interbank rate remained within the Policy Rate corridor

The overnight interbank rate declined to 13.0% at end-March 2017 from 15.8% at end-December 2016 and remained within the Policy Rate corridor. Key drivers were the easing of monetary policy in February 2017 and injection of liquidity through net Government spending and purchase of foreign exchange by BoZ for international reserves build-up.

Despite improved liquidity, trading of interbank funds remained virtually unchanged at K10.2 billion, in part due to structural rigidities in the market. Further, the volume of funds accessed through the Overnight Lending Facility (OLF) marginally rose to K0.3 billion from K0.2 billion.

Demand for Government securities remained high and yield rates declined further

Demand for Government securities continued to increase in the first quarter of 2017, largely on account of easing liquidity conditions, with higher participation by local institutional investors. Participation by non-resident investors also increased. Subscription rates for Treasury bills and Government bonds rose to 131% and 550% in the first quarter of 2017 from 109% and 300% in the fourth quarter of 2016, respectively. As a result, the stock of Government securities rose to K38.3 billion from K32.9 billion.

The holdings of Government securities by non-residents increased by 4.9% to K6.9 billion in the first quarter, representing 18.6% of the total stock. Non-residents' preference continued to be in Government bonds.

Yield rates on both Treasury bills and Government bonds continued to decline, reflecting increased demand. The weighted average Treasury bills and Government bonds yield rates dropped to 16.6% and 20.4% in March 2017 from 24.2% and 25.0% in December 2016, respectively.

Commercial banks' lending rates fell marginally, private sector credit growth contracted further while money supply increased

Commercial banks' nominal lending rates declined marginally to 28.8% in March 2017 after peaking at 29.2% in December 2016. The range between the lowest and highest lending rates narrowed to 10.0-38.5% in March 2017 from 10.0-41.0% in December 2016. The relatively high lending rates reflected in part commercial banks' response to rising non-performing loans, higher returns on investment in Government securities, and lagged response to movements in short term money market rates and inflation.

Improved liquidity conditions drove down interest rates for negotiated deposits, ranging from 11.0% to 31.0% in March 2017 compared to the December 2016 rates, which ranged from18.5% to 36.0%. The average 180-day deposit rate for amounts exceeding K20, 000 also declined, albeit marginally to 11.6% from 12.6% over the same period.

Total domestic credit expanded by 6.5% to K52.1 billion during the quarter under review compared to a growth of 1.1% in the previous quarter. This was driven by lending to

Government, which increased by 18.1%. In contrast, credit to the private sector contracted further by 3.2% relative to 5.4% in the last quarter of 2016.

Money supply expanded by 5.1% to K46.8 billion in the first quarter compared to a growth of 0.8% in the previous quarter. Increased credit to the Government was the main driver for the rise in money supply.

Domestic economic activity was low

For the quarter under review, available real sector data indicate that economic activity generally declined. Seasonal factors affected production in some sectors such as mining, construction, manufacturing, and agriculture. In addition, most sectors continued to experience limited access to credit mainly due to banks' preference for Government securities, high lending rates, and prohibitive collateral requirements. However, electricity generation, which is virtually all hydro based, picked up as water levels in reservoirs improved following above normal rainfall during the 2016/17 rainy season.

Global economy showing signs of gradual recovery

The global economy is showing signs of recovery due to improvements in investment, manufacturing, and trade. In 2017 and 2018, global growth is projected to increase to 3.5% and 3.6%, respectively[1]. Much of this growth is expected to come from emerging markets and developing economies whose growth is projected at 4.5% in 2017 and 4.8% in 2018.

Current account deficit narrowed

The current account deficit narrowed to US$257.1 million in the first quarter of 2017 from US$574.7 million in the last quarter of 2016 due to improvements in the trade and primary income account balances. Total export earnings rose by 22.2% to US$2,236.0 million while imports grew by 15.4% to US$2,196.5 million. The primary account balance improved to negative US $169.3 million from negative US $379.8 million.

The deficit was financed by a surplus on the financial account with gross international reserves remaining little changed. Gross international reserves closed the quarter at approximately US$2.3 billion, representing 3.2 months of import cover, same as in the previous quarter.

Exchange rate remained relatively stable

The exchange rate of the Kwacha against the U.S. dollar remained relatively stable with a bias towards appreciation in the first quarter. The Kwacha appreciated by 2.5% against the U.S. dollar to K9.6016, supported largely by improved supply of foreign exchange and higher copper prices.

Progress towards fiscal consolidation

The recent tax amnesty announced by the Zambia Revenue Authority, combined with structural policy measures taken to address subsidies in the energy sector are critical to reducing the overall budget deficit and are important elements of the fiscal consolidation efforts. As

[1] IMF World Economic Output (WEO), April, 2017

indicated in the February MPC Statement, successful implementation of the national budget will support the rebalancing of fiscal and monetary policies that supports sustainable economic growth and diversification of the economy.

Preliminary data indicate that the fiscal deficit, on a cash basis, at 1.5% of GDP, was broadly in line with the projected 1.6% of GDP in the first quarter. This was a consequence of constrained expenditure in the face of lower revenues than budgeted.

Macroeconomic environment improving, but challenges to growth remain

The current forecasts indicate that inflation will remain within the target range of 6-8% over the medium-term. This takes into account the recent upward adjustment in electricity tariffs. Moreover, risks to inflation are, on balance, currently assessed to favour low and stable inflation. The announced bumper maize harvest during the 2016/17 farming season, and the sustained implementation of fiscal sustainability measures are some of the domestic factors supporting the favourable inflation projection. The recovery in global growth and commodity prices should help support export growth and relative stability of the exchange rate of the Kwacha against the U.S. dollar.

Over the medium-term, economic growth prospects are expected to improve with GDP growth for 2017 and 2018 projected at 3.9% and 4.6%, respectively. However, challenges to growth and the financial sector remain. These include high interest rates, low credit growth, rising non-performing loans and rigidities in the transmission mechanism of monetary policy.

The MPC Decision

The MPC at its May 15-16, 2017 Meeting, taking into account the above factors, arrived at the following decisions:

1. *Lower the Policy Rate by 150 basis points to 12.5% from 14.0%; and*
2. *Reduce the Statutory Reserve Ratio by 300 basis points to 12.5% from 15.5%.*

In particular, the MPC took note of the following:

- The continued decline in inflation and forecast inflation remaining well below the 2017 target of 9.0% and within the medium-term target range of 6-8% by early 2019;
- The prevailing high real lending rates, which continue to constrain access to credit by the productive sectors of the economy, as reflected in the sustained contraction of credit to the private sector; and
- Subdued economic growth.

To improve the clarity of the policy stance and enhance the effectiveness of the monetary policy framework, the Committee narrowed the Policy Rate corridor to + / - 1 percentage point from + / - 2 percentage points.

In the implementation of monetary policy, BoZ will continue to strengthen the ***forward looking monetary policy framework***, anchored on the Policy Rate as the key signal for monetary policy. Changes in the Policy Rate will continue to be guided by inflation outcomes and forecasts as well as further progress in fiscal consolidation. The Bank of Zambia will also closely monitor domestic and external developments and stands ready to take appropriate monetary policy measures to support price and financial system stability that supports the diversification and growth of the economy.

The next MPC Meeting will take place on August 8 – 9, 2017.

Issued by

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