Bank of Zambia

MONETARY POLICY COMMITTEE STATEMENT

Policy Rate adjusted upwards by 125 basis points to 11.50%

The Monetary Policy Committee (MPC), at its November 18 – 19, 2019 Meeting, decided to raise the Policy Rate by 125 basis points to 11.50%. Inflation is now projected to remain above the upper bound of the 6-8% target range over the entire forecast horizon[1] with some of the upside risks identified in our previous MPC Statements materialising. The decision to raise the Policy Rate is therefore intended to counter inflationary pressures that include exchange rate pass-through effects and bring inflation back to the target range in the medium-term and hence support overall macroeconomic stability. The Committee recognises that to address the prevailing economic challenges, monetary policy actions alone are not sufficient. They need to be complemented by the implementation of corrective measures by fiscal authorities and other key public policy makers. Moreover, implementation of measures that address high fiscal deficits, debt levels, and debt service, as well as liquidity constraints and dismantling domestic arrears remains critical to maintaining overall macroeconomic stability and attaining sustainable economic growth.

Inflation rises further and upside risks heighten

Annual overall inflation rose to an average of 9.5% during the quarter under review from 8.1% the preceding quarter, reflecting the persistent rise in food prices and the pass-through from the depreciation of the Kwacha. Food inflation averaged 10.7%, up from 8.9% the previous quarter whilst non-food inflation rose to 8.3% from 7.3% over the same period. The drought experienced in the 2018/19 agricultural season has had a larger than anticipated impact on food supply, resulting in food prices being persistently higher than in the recent past. With regard to non-food inflation, price increases in transport and hospitality (restaurants and hotels) sub-groups accounted for much of the reported increase.

In October, annual overall inflation edged up to 10.7% from 10.5% in September.

On account of heightened upside risks, inflation is projected to remain above the upper bound of the 6-8% target range over the entire forecast horizon. These risks, which manifest through the expectations and exchange rate channels, include persistent high food prices, electricity shortages leading to extended load shedding, slower than anticipated progress on fiscal consolidation, and high external debt service payments.

[1] The forecast horizon or period is eight quarters ahead, that is, the fourth quarter of 2019 to the third quarter of 2021.

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Interbank rate generally contained within the Policy Rate Corridor

The average overnight interbank rate rose to 10.76% from 10.05% the previous quarter. Except for a brief period in August, the interbank rate was generally contained within the Policy Rate Corridor of 9.25% to 11.25%. Consequently, the Bank of Zambia conducted open market operations, and steered the average interbank rate back to the Policy Rate Corridor by the end of the quarter and has stayed there since then.

Demand for Government securities remains subdued

During the third quarter of 2019, demand for Government securities remained subdued, reflecting tight liquidity conditions. The subscription rate for Treasury bills fell to 75% from 79%, while that for Government bonds, though rising to 35% from 15%, remained low.

The above notwithstanding, funds raised in the auctions were just sufficient to meet maturities. However, at end-September 2019, the total outstanding stock of Government securities rose by 20.0% to K72.3 billion, mainly on the back of private placements.

Government securities held by non-residents reduced by 5.8% to K7.7 billion, representing 10.7% of the total outstanding stock, with nearly all their holdings in Government bonds.

Interest rates maintain upward trend

The commercial banks' average lending rate rose marginally to 26.1% in September 2019 from 25.4% in June, largely reflecting high funding costs, partly induced by high yield rates on Government securities. Excluding outliers[2], the average lending rate remained high, rising to 23.9% in September 2019 from 22.8% in June.

The weighted average Treasury bill yield rate edged up further to 25.3% from 24.3%, while that for Government bonds increased to 30.9% from 29.6%. The increase in yield rates was due to subdued demand, largely reflecting relatively tight liquidity conditions.

The range of interest rates on new Kwacha deposits widened to 1.0% - 26.5% from 2.0% - 24.0% the preceding quarter. However, the 180-day deposit rate for amounts exceeding K20,000 remained broadly unchanged at around 10.0%.

Growth of private sector credit and money supply slows down further

Growth of credit to the private sector dropped to 8.2%, year-on-year, in September 2019 from 21.4% in June 2019, driven mainly by reduced utilisation of foreign currency credit lines by corporates due to subdued economic activity. Similarly, growth of credit to Government slowed down to 10.8% from 17.4%, explained mainly by lower uptake of Government securities due to tight liquidity conditions. Overall, growth of total domestic credit dropped to 10.1%, year-on-year, in September from 20.0% in June 2019.

Money supply (M3)[3] growth slowed down further to 6.0%, year-on-year, in September from 15.4% in June 2019. The slowdown in growth of domestic credit to both the private sector and Government explained this outturn.

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

[3] M3 comprises currency in circulation and Kwacha as well as foreign currency deposits

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Fiscal challenges persist

Preliminary data indicate that for the year to September 2019, the fiscal deficit, on a cash basis, was 3.9% of GDP[4] against the year-end target of 6.5% of GDP. However, fiscal pressures have continued as reflected in higher than projected interest payments on both external and domestic debt, accumulation of arrears and higher foreign financed capital expenditure. As announced by fiscal authorities, implementation of tight expenditure controls and improved domestic revenue mobilisation are necessary to address high fiscal deficits, debt levels, and debt service. In addition, dismantling of domestic arrears remain critical to maintain overall macroeconomic stability and support sustainable economic growth.

Global growth slows down and prospects weaken further

Global growth slowed down in the third quarter of 2019, driven largely by trade and geopolitical tensions as well as uncertainty surrounding Brexit. Prospects for global growth over the medium-term also remain weak. The IMF revised further downwards global economic growth projections for 2019 and 2020 to 3.0% and 3.4% from 3.2% and 3.5%[5], respectively. Growth is now projected to slowdown in advanced, emerging and developing economies. This is expected to continue to weigh on copper prices and consequently moderate the growth of Zambia's export earnings.

Current account records a deficit

Preliminary data[6] for the third quarter of 2019 indicate that a *current account* deficit of US$92.4 million was recorded, representing 1.6% of Gross Domestic Product (GDP) against a surplus[7] of US$80.7 million (1.4% of GDP) the previous quarter. The turnaround in the *current account* balance was mainly due to a reduction in the *balance on goods* surplus.

The surplus on the *goods account* narrowed by 67.2% to US$92.4 million following a relatively large reduction in export earnings compared to imports. Goods export earnings fell by 12.9% to US$1.7 billion, largely due to lower earnings from copper that outweighed the rise in non-traditional exports (NTEs) and gold earnings.

Copper exports, at about US$1.0 billion, were 23.2% lower than in the preceding quarter following a decline in export volumes and average realised prices. Non-traditional export earnings rose by 6.7% to US$614.3 million owing to an increase in earnings from cane sugar, industrial boilers, cement and lime, soap as well as tobacco.

Imports of goods declined by 3.8% to US$1.8 billion, mainly on account of a reduction in the importation of raw materials and intermediate goods that declined by 51.1% and 3.6%, respectively. The *current account* deficit was financed by a surplus on the *financial account*.

Despite high external debt service payments, gross international reserves (GIR) increased to US$1.5 billion at end-September 2019 (equivalent to 1.8 months of import cover), from US$1.4 billion (equivalent to 1.7 months of import cover) in June 2019. Net foreign exchange purchases by the Bank of Zambia and mineral royalty tax receipts amounting to US$281.1 million and US$51.5 million, respectively accounted for the increase in GIR. During the year to September, foreign exchange purchases amounted to US$748.2 million of which US$224.1 million were mineral royalty receipts.

[4] Ministry of Finance Monthly Economic Indicators, September 2019 and 2019 budget.
[5] World Economic Outlook, October 2019
[6] Following the Second 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.
[7]The second quarter 2019 preliminary current account deficit of US$168.0 million provided in the August 2019 MPC Statement was revised to a surplus of US$80.7 million.

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The Kwacha depreciates against the US dollar

The Kwacha remained relatively stable in the third quarter, depreciating only by 0.7% to a quarterly average of K12.97 per US dollar compared to a depreciation of 7.7% the previous quarter. This was assisted by higher net supply of foreign exchange to the market during the third quarter of US$376.5 million compared to US$237.1 million in the previous quarter. However, as from the beginning of November, the Kwacha has come under heavy pressure. As of 19th November 2019, the Kwacha was trading at about K14.00 per US dollar due to increased demand for petroleum and fertiliser imports as well as adverse market expectations associated with the indicated need for electricity imports to help mitigate the shortfall in domestic supply.

Domestic economic activity slows down further and near-term growth prospects remain weak

Indicators of economic activity[8] point to a further slowdown in domestic economic activity in the third quarter. For instance, mining output, electricity generation, cement production, and production of some manufactured products declined. Consistent with this, real GDP growth is projected to significantly decline to about 2.0% in 2019 from 4.0% in 2018 premised on the projected contraction in agriculture, constrained electricity generation, and lower than anticipated mining output.

The MPC Decision

The MPC decided to raise the Policy Rate by 125 basis points to 11.50%. This decision has been taken to address the significant increase in inflationary pressures and bring inflation back to the target range in the medium-term. The Committee took note of the projections that in the absence of policy action, inflation would remain above the upper bound of the 6-8% target range over the entire forecast horizon.

The MPC was mindful of the marked deceleration in growth and risks to financial stability. In this regard, the MPC recognised the importance and need for other tools that include macro prudential and fiscal policy measures to address these risks. Furthermore, and as indicated in previous MPC Statements, monetary policy alone is not sufficient to address prevailing economic challenges and to restore macroeconomic stability. It must be complemented by corrective fiscal and structural policy measures.

Decisions on the Policy Rate will continue to be guided by inflation forecasts and outcomes, identified risks, and progress in the execution of fiscal consolidation measures. The Committee may further adjust the Policy Rate upward, if inflation persistently remains above the target range.

The next MPC Meeting is scheduled for February 17 – 18, 2020.

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November 20, 2019

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[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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