Bank of Zambia

MONETARY POLICY COMMITTEE STATEMENT

Policy Rate cut by 225 basis points to 9.25%

The Monetary Policy Committee (MPC), at its May 18-19, 2020 Meeting, decided to lower the Policy Rate by 225 basis points to 9.25%. This is to mitigate the adverse impact of COVID-19 on financial sector stability, economic activity, and ultimately on people's lives and livelihoods. The cut in the Policy Rate also complements the other broader set of measures the Bank of Zambia (BoZ or the Bank) has already announced to mitigate the impact of COVID-19. Although the projected path for inflation is higher than the February 2020 MPC forecast, it is expected to trend towards the upper bound of the 6-8% medium-term target range at the end of the forecast horizon[1]. The Committee noted that the economy is projected to record a recession in 2020 on account of the COVID-19 shock, the first contraction in more than 20 years. To effectively deal with the COVID-19 shock and its effects, the Committee calls for concerted efforts and strengthened collaboration among all stakeholders. Moreover, implementation of fiscal and structural reforms that deliver inclusive and sustainable growth[2] remains an urgent imperative.

COVID-19 challenges human life and plunges economies into recession

The COVID-19 pandemic is having an unprecedented impact on human life and livelihoods. The exponential rise in infections, that characterised the onset of the pandemic, led to a strain on health care systems and adversely affected fiscal budgets. In an effort to curb the further spread of the virus, governments have responded by implementing, among other measures, widespread lockdowns, which have disrupted global supply chains and induced economic contraction. This is affecting global demand through reduced consumer and business spending and generally heightened uncertainty about the economic outlook.

In the wake of this shock, global economic growth is projected to plummet to -3.0% in 2020 against the outturn of 2.9% in 2019[3]. It is projected that, as the pandemic abates and economic activity normalizes, global growth will recover to 5.8% in 2021. This critically depends on the effectiveness of the policy measures taken by the authorities. However, these projections remain highly uncertain as the pandemic rages on with no known vaccine or cure available to date.

Domestic economic activity deteriorates

With the COVID-19 pandemic, the already challenged domestic macroeconomic environment has worsened. Under these circumstances, the Zambian economy is projected to contract by 2.6% in 2020 from a growth of 1.9% in 2019. This is the first contraction in real Gross Domestic Product (GDP) in more than 20 years. The significant reduction in consumer and investment spending due to disruptions in business operations is

[1] The forecast period or horizon is eight quarters ahead, that is, the second quarter of 2020 to the first quarter of 2022.
[2] Most of these structural reforms are already outlined in the Government's key policy documents such as the Seventh National Development Plan (7NDP), the Medium Term Expenditure Framework (MTEF) and the national Budget presentations.
[3] IMF World Economic Outlook, April 2020 Update

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expected to weigh on economic activity. So far, the sectors known to be most adversely affected are construction, wholesale and retail trade, tourism, manufacturing, electricity as well as mining.

Results from the *First Quarter 2020 Bank of Zambia Quarterly Survey of Business Opinion and Expectations* indicate that economic conditions worsened in the first quarter. In particular, volume of services, new orders, and profitability all registered historic lows. The *Stanbic Bank Zambia Purchasing Managers Index* also reported deterioration of business conditions in the private sector as output and new orders sharply declined amid falling consumer spending and company shutdowns associated with COVID-19.

Inflationary pressures persist

Inflationary pressures persisted in the first quarter of 2020, driven by increases in retail fuel pump prices and electricity tariffs, the pass-through from the sharp depreciation of the Kwacha against the US dollar, and the rise in food prices. Annual overall inflation increased to an average of 13.5% from 11.1% in the preceding quarter. Average food inflation edged up to 15.5% from 14.0%, while non-food inflation rose to 11.2% from 7.8%. Inflation ended the first quarter at 14.0% from 11.7% at the end of the fourth quarter of 2019.

In April, inflation rose to 15.7%, largely due to the lagged pass-through from the sharp depreciation of the Kwacha against the US dollar that led to the increase in prices of especially imported goods.

Although the projected path for inflation is higher than the February 2020 MPC forecast, it will trend towards the upper bound of the 6-8% medium-term target range at the end of the forecast horizon. Underlying this projection are persistently high fiscal deficits, rising external debt service payments, accumulation of domestic arrears[4], and high production costs. The deterioration in the global economy is also likely to dampen copper prices and export earnings. The afore mentioned factors are expected to exert pressure on inflation through one or more of these channels, the interest rate, expectations, and exchange rate. However, expected improvements in maize output and subdued domestic consumer demand in light of the COVID-19 pandemic could result in inflation declining faster than anticipated.

Overnight interbank rate edges up as liquidity conditions tighten further

The overnight interbank rate edged up to a quarterly average of 12.61% in the first quarter of 2020 from 11.44% in the fourth quarter of 2019. Despite the elevated interbank rate, offsetting open market operations were not conducted in order to help stem extreme exchange rate pressures that emerged during the period. As a result, the interbank rate was maintained above the upper bound of the Policy Rate Corridor of 10.50% to 12.50% throughout the quarter.

Demand for Government securities remains weak

Demand for Government securities remained subdued, largely due to tight liquidity conditions. The subscription rates for Treasury bills and Government bonds declined to averages of 84.0% and 27.0% from 91.0% and 42.0%, respectively. Consequently, funds raised from the auctions fell short of meeting maturing securities, resulting in a deficit of K0.2 billion. To meet the shortfall and other Government financing needs, additional securities were issued through private placements. The outstanding stock of Government securities as result rose by 8.4% to K86.9 billion.

Government securities held by non-residents increased to K12.9 billion, representing 14.8% of the total securities. The rise in the holdings was mainly attributed to private placements. As at end-March 2020, nearly all their holdings were in Government bonds.

[4] Domestic arrears include delayed payments for goods and services to suppliers, VAT refunds, and other obligations.

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Interest rates increase

Tight liquidity conditions and high Government domestic financing needs kept interest rates elevated. The commercial banks' average lending rate marginally increased to 28.8% in March 2020 from 28.0% in December 2019. Excluding outliers, the average lending rate rose to 27.3% from 26.0%. The composite yield rate on Treasury bills edged up to 26.2% from 25.7%, while that for Government bonds marginally declined to 30.8% from 31.1%. Savings rates for 180-day deposits also rose to 10.7% from 10.1%.

Credit and money supply growth edges up

Growth of credit to the private sector, in nominal terms, picked up to 19.5%, year-on-year, in March 2020 from 17.2% in December 2019. This was mainly on account of the increase in demand for working capital by corporates for bridge financing occasioned by the build-up in domestic arrears. The outbreak of COVID-19 has compounded the situation. Credit to Government, mainly in form of Government securities, expanded at a faster rate, growing by 28.6%, year-on-year, compared to 17.2% in December 2019.

Money supply (M3)[5] growth rose to 31.6% in March 2020 from 12.5% in December 2019. This was driven by the expansion in domestic credit to Government and valuation effects following the sharp depreciation of the Kwacha against the US dollar.

Fiscal pressures heighten

Fiscal pressures are expected to heighten in 2020 as revenue performance is adversely affected by COVID-19, while spending to combat the unprecedented virus rises. Revenue reduction is estimated at K14.8 billion[6]. Additional spending pressures relate external debt service, which have been exacerbated by the recent sharp depreciation of the Kwacha against the US dollar. In this regard, the fiscal deficit in 2020 is bound to exceed the 5.5% Budget target.

Current account surplus increases

Preliminary data indicate that the *current account* surplus rose to US$122.3 million (0.5% of GDP) in the first quarter of 2020 from US$78.2 million[7] (0.3% of GDP) in the fourth quarter of 2019. This was driven by the rise in the *balance of goods* surplus to US$342.8 million from US$254.3 million, following the sharp drop in imports, which outweighed the decline in exports.

Imports of goods declined by 16.5% to US$1.3 billion on account of subdued domestic economic activity, the depreciation of the Kwacha, and disruptions of supply chains due to the COVID-19 pandemic.

Export earnings fell by 9.3% to US$1.6 billion, largely due to lower earnings from non-traditional exports. At US$395.9 million, non-traditional export earnings were 17.2% lower, mainly due to the seasonal decline in exports of gemstones and cane sugar. Copper exports declined by 3.4% to US$1.2 billion following the drop in average realised prices.

The surpluses on the *current* and *capital accounts* were insufficient to cover net outflows in the *financial account* resulting in a drawdown on gross international reserves. Consequently, gross international reserves, at US$1,393.4 million (equivalent to 2.0 months of import cover) at end-March 2020, were US$56.3 million lower than the US$1,449.7 million at end-December 2019. This mainly reflected Government debt service

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

[6] *Statement by the Hon. Minister of Finance on Further Measures aimed at Mitigating the Impact of the Coronavirus (Covid-19) on the Zambian Economy, April 2020.*

[7] Following the Fourth 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 Policy*.

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payments. The decline in reserves was moderated by net foreign exchange purchases amounting to US$144.2 million, of which US$49.7 million was mineral royalty.

Kwacha depreciates sharply

The Kwacha, which had exhibited relative stability over the first two months of the year following significant tightening of monetary policy in November and December 2019, came under intense pressure in March. This reflected the unresolved macroeconomic challenges associated with high debt service and debt levels, rising fiscal deficits as well as declining international reserves. Market attention to these was heightened by the publication of sovereign credit downgrade at this time. The COVID-19 outbreak has since compounded these exchange rate pressures.

During the period, the Kwacha depreciated by 9.6% against the US dollar to a quarterly average of K15.18/US dollar. With the mounting pressure in March, the Kwacha ended the quarter with a year-to-date rate of depreciation of 28.9% to K18.11/US dollar.

To moderate exchange rate pressures, the Bank of Zambia provided support to the market. In addition, the Bank revised rules governing the operations of the interbank foreign exchange market to support its smooth functioning, strengthen market discipline, and provide a mechanism for addressing heightened volatility in the exchange rate in periods of stress.

The MPC Decision

In the face of COVID-19 pandemic, **the MPC cut the Policy Rate by 225 basis points to 9.25%,** despite the projected path for inflation being higher than the medium-term target range of 6-8%. This is intended to mitigate the adverse impact of COVID-19 pandemic on financial sector stability, economic activity, and ultimately on people's lives and livelihoods.

The Committee noted that, in the absence of urgent and appropriate policy response, prospects are likely to significantly deteriorate, as the economy is projected to record a recession in 2020. The cut in the Policy Rate therefore also complements the broader set of measures the Bank has already undertaken. These include the Targeted Medium-Term Refinancing Facility, prudential measures taken to easy the flow of credit to businesses and households, and scaled up use of digital financial services.

The Committee calls for concerted efforts and strengthened collaboration among all stakeholders to effectively deal with the COVID-19 shock and its effects. In this context, implementation of fiscal and structural reforms that deliver inclusive and sustainable growth remains an urgent imperative.

Decisions on the Policy Rate will continue to be guided by inflation forecasts, outcomes, identified risks, including those associated with the COVID-19 pandemic.

The next MPC Meeting is scheduled for August 17 - 18, 2020.

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