Bank of Zambia

MONETARY POLICY COMMITTEE STATEMENT

Monetary Policy Rate cut by a further 125 basis points to 8.0%

At its August 17-18, 2020 Meeting, the Monetary Policy Committee (MPC) lowered the Monetary Policy Rate by a further 125 basis points to 8.0% to safeguard the stability of the financial sector, peoples' lives and livelihoods in the wake of the COVID-19 pandemic. Although projected to remain above the upper bound of the 6-8% medium-term target range, inflation is expected to steadily decline and reach the upper bound by the end of the forecast horizon[1]. This is premised on the expected moderation in food prices due to the improvement in the supply of food items following the notable increase in crop production from the 2019/2020 farming season. The Committee noted the significant worsening in economic conditions over the second quarter and the much weaker growth prospects in 2020 than earlier anticipated. Urgent macroeconomic adjustment measures, underpinned by the reorientation of expenditures to address the adverse impact of the pandemic to save peoples' lives, fiscal consolidation and the restoration of debt sustainability over the medium term, remain imperative to promote sustainable development.

A deeper than earlier envisaged global recession projected in 2020

Global economic growth is projected to contract by 4.9%[2] in 2020 compared to the earlier projection of 3.0%, largely reflecting a deeper and more protracted negative impact of the COVID-19 pandemic. Measures taken to contain the pandemic, which are severely constraining private consumption, investment, trade, and travel are resulting in weakening global demand. Consequently, output and employment have fallen, as manufacturing activity has declined sharply due to supply chain disruptions and the shutdown of factories. The services sector, particularly transport and tourism sub-sectors, have continued to be the most adversely affected.

It is projected that as the pandemic abates global growth will recover to 5.4% in 2021 against an earlier projection of 5.8%. Policy measures taken by governments and central banks around the world are expected to support the recovery. However, there is a high degree of uncertainty surrounding the forecast as the recovery will be dependent on the evolution of the pandemic as well as the speed of developing and delivering a vaccine and treatment.

Domestic economic activity deteriorates further and a deeper recession projected for 2020

As at August 18, 2020, COVID-19 cases in Zambia had risen to 9,981 from 832 at the time of the May MPC Meeting. The rapid rise in cases reflects the severity of the pandemic. This has had a telling effect on domestic economic activity, which has worsened in the second quarter, as reflected in company shutdowns, job and

[1] The forecast horizon or period is eight quarters ahead, that is, the third quarter of 2020 to the second quarter of 2022.
[2] IMF World Economic Outlook, June 2020

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income losses, declining business output, and a notable weakening in consumer demand. Further, electricity load shedding, and rising production costs, associated with high energy tariffs, continued to weigh on growth. Results from the *Second Quarter 2020 Bank of Zambia Quarterly Survey of Business Opinion and Expectations* indicate worsening economic conditions with all monitored indicators showing deterioration, except for new orders, largely due to increased demand for pharmaceutical products used to fight the COVID-19 pandemic. The *Stanbic Bank Zambia Purchasing Managers Index* also indicates significant deterioration in business conditions for the private sector amid company shutdowns, decline in business output, and weak demand.

The Zambian economy is projected to contract by 4.2% in 2020, deeper than the earlier projection of negative 2.6%. This is against a revised preliminary outturn of 1.4%[3] in 2019. The substantial decline in consumer and investment spending due to disruptions in business operations are expected to continue to constrain economic growth. The most adversely affected sectors are tourism, wholesale and retail trade, and construction.

Inflationary pressures remain high, but projected to moderate

Annual overall inflation continued on an upward trend, rising to an average of 16.1% from 13.5% in the previous quarter. This was mainly on account of the pass-through from the depreciation of the Kwacha against the US dollar. Average food inflation rose by 1.4 percentage points to 16.9%, while non-food inflation increased by 3.9 percentage points to 15.1%. At 15.9%, inflation ended the second quarter 1.9 percentage points higher than at the end of the first quarter.

In July, however, inflation marginally went down to 15.8% from 15.9% in June. This was mainly attributed to the reduction in prices of maize and related products as well as those for seasonal vegetables.

Although projected to remain above the upper bound of the 6-8% medium-term target range, inflation is expected to steadily decline, reaching the upper bound by the end of the forecast horizon. Expected moderation in food prices due to the significant improvement in the supply of food items, particularly maize is assumed to be the major driver. Factors keeping inflation above the upper bound of the target range in the earlier part of the forecast horizon, include higher fiscal deficits and the weakening of the global economy. These are likely to exert pressure on inflation through the interest rate, expectations, and/or the exchange rate channels. Risks to the assessed inflation outlook include further deterioration of the fiscal deficit, adverse impact of monetary expansion, a deeper than projected global recession, as well as prolonged and extended electricity load shedding.

Overnight interbank rate declines as liquidity conditions ease

The overnight interbank rate declined to a quarterly average of 10.98% from 12.56%, reflecting the Policy Rate cut in May and the increase in market liquidity. Market liquidity increased largely on account of scaled-up open market operations and the introduction of the Secondary Market Bond Purchase Programme, which were part of the broader set of measures[4] the Bank initiated to mitigate the adverse impact of COVID-19 pandemic on the economy and especially the financial sector. The overnight interbank rate was, however, broadly contained within the bounds of the Policy Rate Corridor of 8.25% to 10.25% throughout the quarter.

[3] Zambia Statistics Agency

[4] The measures include: the establishment of a K10 billion Targeted Medium-Term Refinancing Facility; revision of rules governing the operations of the interbank foreign exchange market; revision of loan classification and provisioning rules; extension of the requirement of mining companies to pay all their statutory obligations in US dollars; initiated arrangements to engage domestic and non-resident financial institutions in foreign exchange swaps; stepping up the sensitization on the use of digital channels and contactless mobile payment mechanisms; and implementation of Business Continuity protocols.

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Stock of Government securities increases

The outstanding stock of Government securities increased by 18.4% to K102.5 billion, reflecting mainly Government financing needs amidst reduced revenues. Activity increased in the securities market, leading to rising subscription rates for Treasury bills and Government bonds to averages of 168.0% and 39.0% from 84.0% and 27.0% in the first quarter, respectively. In this regard, funds raised from the auctions significantly increased, resulting in a surplus of K3.9 billion, at cost, in the second quarter. Auctions were augmented by issuance of additional securities by way of private placements.

At end-June 2020, Government securities held by non-residents rose by 4.2% to K13.5 billion, representing 13.2% of the total securities. Virtually all these holdings (97.4%) were in Government bonds.

Interest rates decline

Market interest rates generally declined, driven by the lowering of the Policy Rate and improvements in liquidity conditions. The commercial banks' average lending rate declined to 26.4% from 28.8% in March 2020. The savings rate for 180-day deposit also declined to 10.3% from 10.7%.

The composite yield rate on Treasury bills declined slightly to 25.9% from 26.1%. However, the composite Government bond yield rate rose to 32.4% from 30.9%, as investors sought higher risk premium on longer dated securities.

Credit to the private sector slows down, money supply growth remains high

Credit growth to the private sector slowed down to 10.4%, year-on-year, in June from 19.5% in March 2020. This was on the back of depressed aggregate demand and reduced appetite by banks to lend in light of heightened default risk due to weakened economic activity. However, credit to Government continued to expand at a faster rate, growing by 46.9%, year-on-year, in June compared to 28.6% in March.

In spite of the expansion in lending to Government, money supply (M3)[5] growth slowed to 29.4% in June from 31.6% in March 2020.

Fiscal pressures remain elevated

The on-going fiscal spending pressures were compounded by measures taken to contain the COVID-19 pandemic. At the same time, the pandemic has precipitated a sharp drop in revenue. In light of the high external debt and expansion in domestic borrowing, bringing the fiscal deficit to sustainable levels over the medium-term has become even more challenging. To restore macroeconomic stability and achieve sustainable economic development, urgent macroeconomic adjustment measures, underpinned by fiscal consolidation and the restoration of debt sustainability, therefore remain imperative.

Current account surplus narrows

Preliminary data indicate that the *current account* surplus narrowed to US$210.3 million (1.3% of GDP) in the second quarter of 2020 from US$446.2 million[6] (2.8% of GDP) in the first quarter. This was largely driven by the deficits on the *primary income* and *services* accounts, which more than outweighed improvements in the *balance of goods* surplus.

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

[6] Following the First Quarter 2020 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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The *primary income account* recorded a deficit of US$336.7 million from the surplus of US$120.0 million. A significant reduction in outflows attributable to non-resident shareholders on account of reported losses underpinned this outturn. The deficit on the *services account* also deteriorated by 26.3% to US$106.5 million following a slump in tourism receipts induced by the COVID-19 pandemic.

However, the earlier reported surplus on the *balance on goods account* expanded to US$597.4 million from US$362.9 million following a sharp drop in imports. Merchandise imports declined by 21.5% to US$1,028.6 million following reductions across most categories, with the consumer goods category recording the sharpest fall. The depreciation of the Kwacha, subdued domestic economic activity, and supply chain disruptions, due to the COVID-19 pandemic, explained the decline in imports.

Lower earnings from non-traditional exports (NTEs) also led to a fall in merchandise exports by 2.8% to US$1,626.0 million. NTEs fell on account of lower receipts from gemstones, electricity, burley tobacco, cement, and lime due to disruptions related to the COVID-19 pandemic and supply constraints. Copper exports, at US$1,200.8 million, were 1.0% higher than the preceding quarter, reflecting the rise in average realised prices.

The realised surpluses on the *current* and *capital accounts* more than covered net outflows in the *financial account,* resulting in an increase in gross international reserves. Gross international reserves, at US$1,433.0 million (equivalent to 2.3 months of import cover) at end-June 2020, were US$49.6 million higher than at end-March 2020. This was largely attributed to net purchases from the market amounting to US$139.2 million, of which US$91.0 million were mining tax receipts, which combined with other receipts more than offset Government debt service payments. For the first half of the year, net foreign exchange purchases amounted to US$283.4 million, of which US$140.8 million were mining tax receipts[7].

Kwacha under pressure, but shows relative stability

After coming under severe pressure in the first quarter, the exchange rate of Kwacha to the United States dollar rose to above K18.00/US $ at the beginning of the second quarter and subsequently stabilised around K18.20/US $ over the remainder of the quarter. Consistent with its policy objective of allowing the exchange rate to adjust to market conditions, the Bank of Zambia has continued to provide measured support to the market.

The MPC Decision

The MPC reduced the Policy Rate by a further 125 basis points to 8.0% to safeguard the stability of the financial sector, people's lives and livelihoods in the wake of the COVID-19 pandemic. Although projected to remain above the upper bound of the 6-8% medium-term target range, inflation is currently projected to steadily decline and reach the upper bound by the end of the forecast period. This is premised on the expected moderation in food prices due to the improvement in supply of food items. The Committee took due note of the significant worsening in economic conditions over the second quarter and the much weaker growth prospects in 2020 than earlier anticipated.

The Committee thus reiterates the need for concerted efforts and strengthened collaboration among all stakeholders to effectively deal with the COVID-19 pandemic. In this context, urgent macroeconomic adjustment measures underpinned by the reorientation of expenditures to address the adverse impact of the pandemic to save peoples' lives, fiscal consolidation and the restoration of debt sustainability over the medium-term remain imperative to promote sustainable development.

[7] In addition to Mineral Royalty Tax, the Bank of Zambia has since June 2020 been receiving all statutory obligations of the mining companies in US dollars.

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

The next MPC Meeting is scheduled for November 16 - 17, 2020.

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