Bank *of* Zambia

MONETARY POLICY COMMITTEE STATEMENT

Monetary Policy Rate maintained at 8.5 percent

At its August 30-31, 2021 Meeting, the Monetary Policy Committee (MPC) decided to hold the Monetary Policy Rate at 8.5 percent. Inflation is projected to decelerate faster and edge closer to the target range than was earlier envisaged in the May 2021 MPC Meeting, mostly on account of the favourable outlook for the exchange rate and improved prospects for fiscal consolidation. In arriving at this decision, the Committee remained mindful of the subdued economic activity and existing vulnerabilities in the financial system. Implementation of fiscal adjustment measures premised on fiscal discipline, the dismantling of domestic arrears, enhancement of revenue collections, achieving a sustainable budget balance, securing an IMF Programme, and external debt restructuring remain critical to restoring macroeconomic stability.

Recovery in global growth gains momentum

The global economy continued to register gains in the second quarter of 2021 as economies gradually reopened following relative success in vaccinations against COVID-19 in most advanced countries. Growth is projected at 6.0 percent in 2021, and to then moderate to 4.9 percent in 2022. This is despite the emergence of more contagious COVID-19 variants coupled with the slower pace of vaccinations, particularly in most emerging markets and developing economies, as well as geopolitical tensions. Sustained expansionary fiscal policies, particularly in the United States, and recovery in global trade will mostly drive global growth.

Domestic economic activity remained weak in the second quarter, but expected to strengthen in the medium-term

High frequency indicators suggest weaker growth in the second quarter of 2021 against a preliminary real GDP growth of 0.7 percent in the first quarter. With the exception of seasonal agricultural related activities, the rest of the monitored indicators in the *Bank of Zambia Survey of Business Opinions and Expectations* were below the first quarter level. Similarly, the *Stanbic Bank Purchasing Manager's Index (PMI)* signalled a weak business environment with the average reading remaining below the 50.0 mark. A spike in COVID-19 cases between May and June and related restrictions weighed on overall business performance.

This notwithstanding, the domestic economy is projected to register a modest growth of 1.6 percent in 2021 and strengthen over the medium-term. This is on account of expected positive performance of the information and communication, electricity, public administration, as well as education sectors. Uncertainty surrounding the emergence of more contagious COVID-19 variants remains a key downside risk to the growth outlook.

Inflation maintains an upward trend, but recent developments in the exchange rate point to near-term disinflation

Inflation maintained an upward trend in the second quarter, rising to 23.5 percent from 22.2 percent in the first quarter. The depreciation of the Kwacha as well as seasonal low supply of some vegetables and fish continued to be the key drivers of inflation. In addition, imported inflation contributed to inflationary pressures observed during the review period. Food and non-food inflation increased to 29.0 percent and 17.2 percent from 27.0 percent and 16.6 percent, respectively.

In August 2021, inflation declined marginally to 24.4 percent from 24.6 percent in July mainly as a result of the appreciation of the Kwacha against the US dollar.

Over the next eight quarters, inflation is projected to decelerate faster than was earlier anticipated although it will remain above the 6-8 percent target range. Inflation is now projected to average 22.6 percent, 15.5 percent and 11.9 percent in 2021, 2022, and the first half of 2023, respectively.

Some of the previously dominant upside risks to inflation forecasts, that were highlighted in the previous MPC Statements, such as the depreciation of the Kwacha, have receded. This follows the recent significant appreciation of the domestic currency. Positive sentiments—arising from the receipt of Special Drawings Rights from the IMF, prospects of securing an IMF programme earlier than previously anticipated and progress with debt restructuring—are also expected to address fiscal imbalances and contribute to lower inflation expectations. In view of this, the recent appreciating trend in the exchange rate and improved prospects for fiscal consolidation are favourable to inflation. Nonetheless, the possible increase in domestic energy prices (fuel pump prices and electricity tariffs) and COVID-19 related supply disruptions remain key upside risks to the inflation forecast.

Overnight interbank rate maintained within the Corridor

The overnight interbank rate was broadly unchanged at 8.50 percent and within the Policy Rate Corridor of 7.5 to 9.5 percent throughout the quarter.

Demand for Government securities strengthens

Demand for Government bonds surged with the subscription rate rising to 162.2 percent from 66.2 percent in the first quarter. This was mostly on the back of high yield rates and improved investor sentiments following the credit rating upgrade by Fitch in April 2021. These developments particularly attracted non-resident investors who accounted for about 70.0 percent of total demand for bonds. As at end-June 2021, holdings of Government securities by non-residents more than doubled to K44.8 billion, representing 24.9 percent of outstanding securities. Nearly all their holdings (97.5 percent) were in Government bonds.

The Treasury bill auctions continued to be dominated by commercial banks and were adequately subscribed with an average rate of 100 percent (112.1 percent previously).

The stock of Government securities rose by 26.2 percent to K180.2 billion mainly driven by additional securities issued through private placements to finance the Farmer Input Support Programme (FISP) and imports of petroleum products.

In July and August, Government securities remained well subscribed, with the Treasury bills and bond auctions registering an average of 86.1percent and 116.3% percent and 99.4 percent and 428.6 percent subscription rates, respectively.

Interest rates decline

Interest rates generally declined, partly reflecting the fall in yield rates on Government securities on the back of heightened demand. Yield rates on Treasury bills and Government bonds declined to 21.9 percent and 31.2 percent from 22.3 percent and 33.7 percent, respectively. Similarly, commercial banks' nominal average lending rate declined to 25.6 percent in June from 26.0 percent in March. The average 180-day deposit rate remained broadly unchanged at 9.8 percent.

By end August, the weighted average yield rates on Government securities registered a marked decline to 23.9 percent and 29.3 percent for Treasury bills and Government bonds, respectively, owing to overwhelming demand.

Credit to the private sector picks up and money supply expands further

Lending to the private sector picked up by 16.3 percent, year-on-year, in June compared to 0.5 percent in March largely supported by increased disbursements from the Bank of Zambia Targeted Medium-

Term Refinancing Facility[1]. The expansion in domestic credit to Government slowed down further to 48.3 percent from 69.6 percent as commercial banks scaled down the accumulation of Government securities.

During the same period, money supply (M3)[2] continued to expand, growing by 48.3 percent from 39.6 percent largely driven by the accumulation of international reserves.

[1] Disbursements increased to K6.4 billion in June from K4.6 billion in March partly due to changes to the Terms and Conditions which provided flexibility for Financial Service Providers to drawdown on approved amounts based on confirmed pipeline irrespective of whether the borrowers were in targeted or non-targeted sectors.
[2] M3 comprises currency in circulation, Kwacha deposits, and foreign currency deposits.

Strong fiscal adjustment required

Revenue continued to exceed the target mainly due to higher mining tax collections. However, expenditure on agricultural subsidies (FISP) and the financing of imports of petroleum products continued to exert significant pressure on the budget. Although the allocation of SDR resources is expected to ease financing pressures, it is imperative that an immediate and stronger fiscal adjustment is implemented to create the much needed fiscal space in order to restore macroeconomic stability. In this regard, the announced commitment to fiscal discipline, urgent conclusion of discussions with the IMF, and subsequent restructuring of external debt are key elements needed to attain fiscal sustainability.

Current account surplus narrows

Preliminary data indicate that the current account surplus narrowed to US$0.7 billion (15.2 percent of GDP) from US$0.8 billion (16.8 percent of GDP)[3] as growth in imports outweighed exports. Imports expanded by 33.0 percent to US$1.5 billion largely attributed to a relatively stable exchange rate. Goods exports rose by 14.1 percent to US$2.7 billion driven by higher copper prices and non-traditional exports, particularly agricultural and manufactured products.

Gross international reserves rose to US$1.4 billion (equivalent to 2.6 months of import cover) at end-June 2021 from US$1.2 billion (2.1 months of import cover) at end-March 2021.

At end-August 2021, international reserves rose further to about US$2.9 billion (5.4 months of import cover) following the receipt of the IMF SDR937.5 million allocation (US$1.33 billion) as well as market purchases. The Bank of Zambia net purchases amounted to US$152.4 million in July and August.

Kwacha depreciation slows down further

The depreciation rate of the Kwacha against the US dollar reduced further to 3.6 percent to an average of K22.41 in the second quarter compared to 4.4 percent in the first quarter following an improvement in the supply of foreign exchange—mostly from foreign portfolio investors and mining companies. On a net basis, foreign financial institutions increased their foreign exchange sales in the market to US$452.3.million from US$13.2 million. In a similar vein, the mining companies supplied a total of US$573.3 .million, of which US$374.9 million was directly remitted to Bank of Zambia as tax payments. To moderate exchange rate pressures, the Bank of Zambia sold US$358.2 million compared to US$259.7 million in the previous quarter.

Recently, the Kwacha has appreciated sharply mainly due to significant inflows from non-resident investors in Government bonds and improved market sentiments. Between July 1 and August 31, 2021, the Kwacha strengthened by 29.6 percent to K15.94 per US dollar.

The MPC Decision

The Committee noted that, over the forecast horizon, inflation is projected to decelerate faster and edge closer to the target range than was envisaged in the May 2021 MPC Meeting. Underlying the decline in

[3] The current account is computed as a percent of quarterly GDP.

inflation is mostly the favourable outlook for the exchange rate and improved prospects for fiscal consolidation. In this regard, t**he MPC decided to maintain the Monetary Policy Rate at 8.50 percent.** In arriving at this decision, the Committee remained mindful of the subdued economic activity and existing vulnerabilities in the financial system.

The Bank remains committed to adjusting the Policy Rate upwards should the disinflationary process be slower than expected.

Decisions on the Policy Rate will continue to be guided by inflation forecasts, outcomes, and identified risks, including those associated with financial stability and the COVID-19 pandemic. Implementation of fiscal adjustment measures premised on fiscal discipline, the dismantling of domestic arrears, enhancement of revenue collections, securing an IMF programme, external debt restructuring and achieving a sustainable budget balance remain critical to restoring macroeconomic stability.

The next MPC Meeting is scheduled for November 15 - 16, 2021.

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September 1, 2021