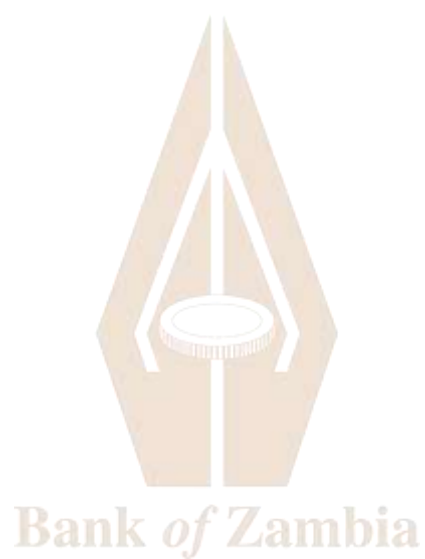


Monetary Policy Framework

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Bank of Zambia



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Foreword

This Monetary Policy Framework outlines how the Bank of Zambia (the Bank or BoZ) formulates and implements monetary policy to achieve its primary objective of keeping inflation low and stable.

Monetary policy frameworks evolve over time in response to changing economic conditions and developments in financial markets. Prior to April 2012, the Bank conducted monetary policy under a *monetary aggregate targeting* (MAT) framework, which focused on influencing money supply growth by controlling reserve money growth to achieve its primary objective of price stability. However, as financial markets developed and the relationship between money supply and inflation weakened, the effectiveness of this framework declined. This prompted the Bank to transition to an *inflation targeting lite* (ITL) framework in April 2012. This marked a shift from monetary aggregates to interest rates and inflation forecasts to guide monetary policy decisions. The transition was also intended to strengthen this new forward-looking approach to monetary policy, enhance transparency, and improve the effectiveness of monetary policy transmission.

Under the current monetary policy framework, policy decisions are made by the Monetary Policy Committee (MPC or Committee), which assesses economic and financial developments, including risks to the inflation outlook. Based on this assessment, the Committee takes appropriate action to steer inflation towards the target band and/or keep it within there over the medium-term.

Clear and timely communication plays a key role in supporting the effectiveness of monetary policy. Effective communication helps to support transparency, strengthen policy credibility, anchor inflation expectations, and enhance the understanding of monetary policy decisions. The Bank communicates its monetary policy decisions through media briefings and publication of the monetary policy statement after each MPC Meeting and the Monetary Policy Report on its website, www.boz.zm. Stakeholder engagements are also undertaken across the country to explain monetary policy decisions as well as the outlook for inflation and economic activity.

The Monetary Policy Framework is reviewed periodically so that it remains effective and responsive to changes in the economy and broader developments in monetary policy practice.



Denny H. Kalyalya (Dr)
Governor

1.0 Introduction

- 1.1 To meet their objectives, central banks adopt different monetary policy frameworks depending on their policy priorities, institutional settings, and economic conditions. A monetary policy framework (the framework) is a coherent and structured system that a central bank uses to formulate, implement, and communicate monetary policy (**Cottarelli and Gianninni, 1997; Kalyalya, 2001**). The framework clearly defines elements that guide policy decisions and anchor expectations, including clear guidelines, accountability of the central bank, and communication with the public. Central banks periodically review their respective frameworks to respond to changing economic conditions to improve the effectiveness of monetary policy.
- 1.2 Between 1964 and March 2012, the Bank used a monetary aggregate targeting (MAT) framework, which focused on influencing the growth in money supply by controlling the growth of reserve money as the primary means of achieving price stability. Prior to March 1995, monetary policy implementation relied mostly on direct instruments, that included the core liquid asset ratio, statutory reserve requirements, administratively determined interest rates, and selective credit allocation (Kalyalya, 2001). In 1995, with the introduction of market-based instruments, notably open market operations (OMOs), the framework shifted towards market-based instruments.
- 1.3 To further strengthen its monetary policy framework, in April 2012, the Bank transitioned to the current inflation targeting lite¹(ITL) framework. This involved shifting from monetary aggregates to price-based signals in its conduct of monetary policy. Subsequent studies supported this transition by revealing that the influence of broad money on inflation had waned over time (Simpasa, et al., 2014; Zgambo & Chileshe, 2014).
- 1.4 The ITL is also intended to improve the public understanding of the monetary policy stance as interest rates are generally easier for markets and the public to interpret than monetary aggregates. In addition, it supports a more forward-looking approach to monetary policy aimed at improving policy efficiency. Above all, the ITL framework was adopted to strengthen the monetary transmission mechanism, particularly through the interest rate channel, reduce volatility in short-term interest rates (especially in the interbank market), and anchor inflation expectations (Chipili & Zgambo, 2024). By making the monetary policy interest rate (Policy Rate) a credible and stable anchor to financial market participants in setting their own interest rates, the ITL also enhances transparency in credit pricing.

¹ **Inflation targeting lite** is a transitional monetary policy framework in which the central bank uses an announced inflation objective to guide policy decisions but does not operate under the full discipline of a formal inflation targeting regime.

- 1.5 Institutional changes have been made to enhance analytical and forecasting capabilities under the ITL. These changes include the development of macroeconomic models to forecast inflation and other key variables.
- 1.6 The rest of the document is structured as follows. Section 2 highlights the monetary policy mandate of the Bank while Section 3 provides a brief description of the Monetary Policy Committee that is responsible for formulating monetary policy. Section 4 discusses the implementation of monetary policy. Section 5 outlines transparency, accountability, and communication of the MPC process. Section 6 concludes with the timeline for the review of the monetary policy framework.

2.0 Mandate of the Bank of Zambia

- 2.1 The **Constitution of Zambia (Amendment) Act, 2016**, sets out the primary functions of the Bank. Article 213(2)(b) and (c) mandates the Bank to determine monetary policy, regulate banking and financial services, banks, financial and non-banking institutions, as well as issue the currency of the Republic. This Constitutional provision, along with Article 215, are operationalised through the **Bank of Zambia Act, 2022 (the Act)**, which outlines additional functions and responsibilities of the Bank in Section 5(3).
- 2.2 Under Part II, Section 5(1) of the Bank of Zambia Act, 2022, the Bank is mandated to formulate and implement monetary and supervisory policies to achieve and maintain price stability and financial system stability. In pursuing these dual objectives, the Act clarifies, under Section 5(2), that price stability shall take precedence when the two objectives conflict.
- 2.3 To operationalise this mandate, the Government, in consultation with the Bank, sets an annual or medium-term inflation target, which is publicly announced in the National Budget Speech presented to the National Assembly. The current target band is 6–8 percent². Monetary policy decisions are, therefore, directed towards achieving and maintaining overall or headline inflation within the prevailing target band over the medium-term. When inflation falls outside this target band, and if deemed appropriate, it may be allowed to gradually return to it to avoid adverse consequences on the economy.
- 2.4 To support this process, the Act establishes a Monetary Policy Committee under Part IV, Section 27(1).

3.0 Monetary Policy Committee

- 3.1 The Monetary Policy Committee of the Bank formulates monetary policy of the Republic of Zambia on behalf of the Bank in line with Section 27(2) of the Bank of Zambia Act,

² The target band of 6-8 percent was introduced in January 2018 as announced in the **2018 National Budget Speech**. In 2022, the target was temporarily changed to a *single digit* in view of persistent macroeconomic imbalances, such as, low growth, unsustainable debt levels, and escalating cost-of-living.

2022. The implementation of monetary policy is the responsibility of the Bank under Section 27(3) of the Act. The Committee regulates its own procedures in line with Section 27(5) of the Act. Further, the formulation and implementation of monetary policy is conducted autonomously without any external influence³.

The Committee comprises:

- a) The Governor, who is also the Chairperson;
- b) Deputy Governor responsible for monetary policy, who also serves as Vice Chairperson;
- c) Deputy Governor responsible for administration;
- d) One person appointed by the Minister responsible for finance;
- e) Two persons appointed by the Board; and
- f) Three members of staff of the Bank in senior management appointed by the Governor. The appointed staff members are those responsible for research or economic policy, monetary policy operations, and financial stability.

- 3.2 External members are selected based on their technical expertise and professional experience relevant to the functions of the MPC. Their inclusion strengthens the independence of the Committee, promotes diversity of views, and enhances monetary policy deliberations.
- 3.3 The MPC normally meets every second month of the quarter in February, May, August, and November to decide on the appropriate stance of monetary policy. These meetings are preceded by Pre-MPC Meetings during which staff engage the Committee on areas that may require further analysis, including on growth, fiscal developments, inflation outlook, and risks to the projections. Typically, MPC Members offer guidance informed by their judgment, experience, and additional information available to them. The main meetings are held over a two-day period. On the first day, the Committee reviews macroeconomic developments in the previous quarter, including survey-based information, and prospects for inflation over the forecast horizon, currently eight quarters. On the second day, the Committee deliberates on the appropriate monetary policy stance. Finally, a media briefing is held on the third day to communicate the decision of the MPC. The Committee may also convene extraordinary meetings at any time if economic, financial conditions or other circumstances warrant.
- 3.4 The meetings are physical, virtual or hybrid as Members may determine. To enhance transparency and predictability, the schedule of MPC meetings for each calendar year is published on the Bank of Zambia website.
- 3.5 At its Meetings, staff make presentations on economic, financial, and other pertinent developments, inflation forecasts, and alternative inflation scenarios that include key risks and uncertainties in general and those related to financial stability, which the MPC assesses. The Committee also considers staff recommendations on the appropriate

³ **Section 27 (4) of the Act and Article 213 (5) of the Constitution.**

monetary policy stance. This assessment constitutes the first stage of the decision-making process and provides the analytical basis for policy deliberations.

- 3.6 In the second stage, the Committee decides on the Policy Rate⁴, which it arrives at through consensus. The Policy Rate may be adjusted upwards if inflation is forecast to persistently rise above the target or lowered if inflation is projected to persistently decline. It may also be left unchanged if projections and assessment of risks show a temporary rise or fall in inflation or for other policy considerations, such as, financial stability. Above all, expert judgement is used in arriving at the interest rate decision besides inflation and growth considerations.

4.0 Monetary Policy Implementation

- 4.1 Under the current framework, the Policy Rate serves as the main benchmark while the overnight interbank rate is the operational target the Bank seeks to influence within the set band in its quest to manage inflation. Movements in the overnight interbank rate are expected to impact broader market interest rates and in turn affect the credit conditions, exchange rate, and expectations. Through this transmission process, the Bank seeks to influence borrowing and lending decisions in the economy and ultimately inflation by affecting the spending behaviour of households and firms.
- 4.2 To keep the overnight interbank rate within the set band, currently defined as a corridor of plus/minus one percentage point around the Policy Rate⁵, liquidity management operations are undertaken through **open market operations** (OMOs)⁶, a market-based instrument of monetary policy. The corridor system determines the trigger for deploying OMO activities. This should not be mixed with the existence of standing deposit and lending facilities. When banks are short of liquidity, they can access central bank funds at zero interest rate against collateral or have intraday recourse to their statutory reserves. Should banks require funds beyond the day, they can access the **Overnight Lending Facility** (OLF—refer to section 4.7 for details). The exclusion of standing facilities is intended to encourage interbank trading by removing the incentive for commercial banks to hold excess reserves at the central bank's standing deposit facility. Currently, excess reserves at the central bank are not remunerated. Interbank market activity has been constrained by perceived counterparty credit risk, which has contributed to market segmentation and limited the redistribution of liquidity among banks (Chipili et al, 2019).

⁴ A chronology of monetary policy decisions since April 2012 is contained in the appendix of the **Monetary Policy Report**.

⁵ **In 2017, the Bank narrowed the Policy Rate Corridor to +/-1 percentage points from +/-2 percentage points to strengthen the monetary policy framework by providing clarity to the stance of monetary policy.**

⁶ OMOs have been in use since March 1995 as an indirect monetary policy tool to influence liquidity conditions. Typically, OMOs involve the buying and selling of eligible financial instruments to influence liquidity conditions. The Bank operationalises OMO by supplying or withdrawing liquidity from the banking system in volumes required to keep the overnight interbank rate within the Corridor of +/- 1 percentage points around the Policy Rate.

- 4.3 The 5-day weighted moving average overnight interbank rate⁷ is used to guide the conduct of OMOs. Through OMOs, the Bank injects or withdraws liquidity from the banking system or money market to keep the interbank rate aligned with the Policy Rate in reference to the prescribed corridor. The interbank rate may, however, be deliberately allowed to drift outside the Policy Rate corridor when deemed appropriate.
- 4.4 Decisions to intervene or stay out of the money market are guided by the behavior of the 5-day weighted moving average of the overnight interbank rate. When the interbank rate moves towards the lower bound of the corridor, contractionary OMOs are undertaken to absorb excess liquidity and push it back toward the Policy Rate. Conversely, expansionary OMOs are conducted to inject liquidity in the money market when the interbank rate moves toward the upper bound to steer it back to the Policy Rate. The Bank may stay out of the market when market conditions are stable and the interbank rate is at or as close as possible to the Policy Rate.
- 4.5 OMO activities are also guided by the assessment of developments in the foreign exchange and Government securities markets that may have adverse implications on inflation and broader financial stability. Based on the assessment, the Bank may or may not intervene regardless of where the interbank rate is in relation to the corridor.
- 4.6 Term deposits, repurchase agreements, foreign exchange swaps, and outright sales of Government securities or foreign exchange are used to absorb excess liquidity from the banking system. On the other hand, secured loans, reverse repurchase agreements, reverse foreign exchange swaps, as well as outright purchases of Government securities and foreign exchange inject liquidity to align the interbank rate with the Policy Rate. This in turn provides short-term funding to commercial banks to ease liquidity pressures. The diversified toolkit provides flexibility in responding to changing liquidity conditions.
- 4.7 In addition to liquidity injected through OMOs at the instance of the Bank, banks may have recourse to central bank funds through the **Overnight Lending Facility** (OLF). This standing facility provides short-term liquidity support to commercial banks facing immediate funding needs. Access to the OLF is limited to commercial banks with clearing or settlement accounts at the Bank. Liquidity under the OLF is provided on a collateralised repo basis using eligible securities, such as, Treasury bills, Government bonds, and term deposits issued under OMOs. Commercial banks may access the OLF directly through the Central Securities Depository (CSD) via overnight repo transactions or indirectly through the automatic OLF under which unpaid intraday liquidity is

⁷ A weighted average overnight interbank rate is exponentially calculated by assigning a large weight to the latest observation and decays thereafter. The current 5-day weighted average interbank rate allocates a third of the weight to the latest observation with the last observation receiving the least importance. This helps to smooth short-term volatility in the overnight interbank rate to appropriately guide policy interventions.

converted into an overnight loan. A haircut margin is applied to securities pledged as collateral under the OLF. The OLF rate is determined by adding a margin on the prevailing Policy Rate. Adjustments to the OLF rate are communicated to market participants through the “**CB Circular**” whenever the Policy Rate or margin changes. The operating rules and guidelines for the OLF are regularly reviewed for continued effectiveness.

- 4.8 Besides OMOs, statutory reserve requirements (direct instrument) are employed to support liquidity management. In this way, commercial banks are required to hold a prescribed proportion of their deposits as reserves with the Bank⁸. In addition, the Bank determines the reserve maintenance period depending on market conditions.

5.0 Transparency, Accountability, and Communication of the Monetary Policy Committee Process

- 5.1 The Bank promotes transparency and accountability to help anchor inflation expectations within the target band, strengthen public understanding of monetary policy, and enhance the effectiveness of monetary policy transmission. To support these objectives, the MPC announces its decision on the Policy Rate through a Monetary Policy Committee Statement, which is issued following the MPC Meeting. The Committee also conducts a media briefing where the Governor communicates the decision of the Committee, explains the key considerations behind it, and responds to questions from the media. The briefing is broadcast live on national television and streamed live on official Bank of Zambia digital platforms and other media channels, such as, television and radio stations.
- 5.2 Under Part IV, Section 29 (2) of the Act, the Bank is required to publish the Monetary Policy Report (MPR) at least once a year. Currently, the Report is published within 14 calendar days after each meeting. The MPR provides detailed analysis and context for the policy decision. In addition, the MPC may publish minutes of each meeting in line with Section 30 of the Act.
- 5.3 Press briefings are complemented by outreach engagements with a wider range of stakeholders. In particular, the Bank conducts post-MPC stakeholder meetings across the country to deepen understanding of monetary policy and encourage informed dialogue. These engagements bring together representatives of mainly the business community, public officials, and academia. These engagements serve as avenues for the Bank to strengthen transparency and accountability as well as engender policy credibility.
- 5.4 MPC Members observe a communication blackout period of **two** weeks prior to the meetings until the public announcement of the policy decision. During this time, MPC

⁸ A chronology of decisions on reserve requirements and maintenance period since April 2012 is contained in the appendix of the **Monetary Policy Report**.

Members and Bank Management refrain from engaging with the public, media or external stakeholders on matters that could influence or be perceived to influence monetary policy decisions. The blackout period helps to contain sensitive information, reduce speculation and market uncertainty, and safeguard the integrity and credibility of the monetary policy process.

6.0 Review of the Monetary Policy Framework

The monetary policy framework will be reviewed every three years or earlier when need arises to reflect institutional changes and evolution in macroeconomic conditions.



Bank of Zambia