

Caleb M Fundanga: Review of Zambia's economy

Remarks by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the Zambia Association of Manufacturer's Annual General Meeting, Lusaka, 16 April 2010.

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***The President of ZAM – Mr Chance Kabaghe
The Vice Presidents (North and South) – Mr Sebastian Kopulande and Mr Eugen Appel
The ZAM Executive Committee
Captains of Industry
Ladies and Gentlemen***

I feel greatly honoured to officiate at this Annual General Meeting for the Zambia Association of Manufacturers (ZAM). The Bank of Zambia and the Zambia Association of Manufacturers have a long standing relationship which is intertwined in more ways than one. I am sure that without making appropriate policies to support key sectors such as manufacturing, we would be robbing the country of the development that it deserves. I am reliably informed that ZAM has been going through restructuring in the last two years and has achieved a lot in terms of the establishment and making itself relevant not only to its members but to the Government and other stakeholders. It therefore gives me pleasure to stand before you to discuss issues that are pertinent to manufacturing. I am hopeful we will be able to understand the challenges and identify plausible ways of overcoming them for the sector to forge ahead and make a meaningful contribution to the economy.

Mr President, the performance of the Zambian economy in 2009 was favourable. Although projections of GDP growth for 2009 had been revised downwards to 4.3% on account of the effects of the global financial and economic melt-down, preliminary data indicates that the economy posted a real GDP growth rate of 6.3% compared with the 5.7% recorded in 2008. Almost all key sectors of the economy recorded positive growth except for restaurants and hotels which saw negative growth due to lower tourist and business travel arrivals during the financial crisis.

Annual overall inflation slowed down, reverting to single digit level of 9.9% in December 2009 from the 16.6% recorded in December 2008, and was in line with the original end-year target¹ of no more than 10%. This outturn was attributed to the decline in both annual food and non-food inflation.

In the external sector, Zambia's external position showed remarkable improvement as reflected in the build-up of gross international reserves to 5.1 months of import cover in 2009 from 2.1 months of import cover in 2008.

Zambia's overall balance of payment position is expected to remain favourable in 2010 due to the rebound of copper prices on the international market as well as the expected increase in copper production as some mines increase production to full capacity and the resumption of production at some mines.

The rebound in the international price of copper in the second half of 2009 and the return of foreign portfolio flows resulted in an appreciation of the exchange rate of the Kwacha by 4% at the end of the year.

However, fiscal performance in 2009 was weak, mainly due to the global economic crisis, which reduced domestic revenues. Despite this, Government remained within the programmed domestic financing for the year.

¹ December-2009 inflation revised to 12.0% in the Budget Speech for 2010 presented to Parliament on October 9, 2009.

Distinguished Members, the financial sector has remained resilient despite the effects of the recent global financial crisis. Currently, the Zambian financial sector is characterized by high liquidity levels, reflecting tighter lending standards in the wake of the lessons from the global financial crisis leading to marked decline in private sector lending. As a result, the demand for the relatively risk free Government securities has increased causing a decline in yield rates on Government securities. The decline in Government securities yield rates and relatively low inflation experienced since the beginning of the year should contribute to a decline in banks lending rates and thus stimulate borrowing by the private sector.

I am aware that the high interest rates in the country pose a very big challenge for our manufacturers to borrow for recapitalisation and expansion of their businesses. Access to finance is essential for the economy to grow and therefore it is necessary that we find ways that could reduce the cost of borrowing to allow key sectors to expand.

Ladies and Gentlemen, I wish to reiterate that the economic fundamentals point to a reduction in lending rates. In a liberalised financial market environment, the central bank contributes to the reduction in lending rates by reducing inflation. The Government also contributes by implementing prudent fiscal policy, thus limiting the incidence of crowding out of the private sector by the Government. As a result, yield rates on Government securities fall. As inflation and yield rates on Government securities decline, lending rates are also expected to decline in the medium to long term as the two provide the relevant opportunity cost of lending to the private sector.

Another factor that commercial banks take into consideration in determining lending rates is the default risk arising from the poor credit culture in the economy in general. In resolving the problem of poor credit culture, the Central Bank through the Financial Sector Development Plan, facilitated the establishment of a credit reference bureau which collects information on borrowers to be used by credit providers.

Furthermore, in order to increase competition in the financial sector the Bank of Zambia has registered a number of commercial banks and other financial institutions to operate in Zambia. In 2009, the number of registered banks increased from 14 to 17.

In addition, the Bank of Zambia is developing a framework to migrate from the use of monetary aggregates as the anchor of inflation expectations to the use of interest rates. Inflation expectations are fundamental to the process of interest rate determination and low inflation expectations are entrenched not only by the implementation of appropriate monetary and fiscal policies at any given time, but also by past inflation developments. Low inflation expectations were becoming entrenched in 2008 following two consecutive years of single digit inflation in 2006 and 2007. However, towards the end of 2008, the increase in food prices and the impact of the global financial crisis caused inflation to increase to a double digit figure of 16.6%. In spite of this, the prospects for low inflation, now look positive, creating an appropriate environment for interest rate reduction.

Mr President, as you may have noticed from the newspapers in the recent days, a number of banks have reduced their lending base rates though not as much as we would like to see. We hope that this is just a start, and that banks will continue adjusting their rates downwards consistent with developments in other macroeconomic indicators.

Distinguished Members, allow me to comment on the statutory instrument regarding the US\$5000 over the counter limit on deposits. These regulations are meant to encourage the use of the banking system in order to assist in curbing money laundering. Doing away with this would deprive the Central Bank of a mechanism for detecting fraudulent activities and create a healthy environment for money to be laundered in our financial system.

Ladies and Gentlemen, the Bank of Zambia recognises the importance of long term finance for growth. We are also aware of the important role that the Development Bank of Zambia and others institutions that provide long term finance can play in this process. It is for this reason that the Bank of Zambia monitors the performance of these institutions to ensure that

they are financially viable to be able to play this important role. Rather than thinking of Government recapitalising these institutions, we should think more in terms of developing the capital markets to enable these institutions raise resources for long term financing from the private sector.

On the issue of the foreign exchange market, I wish to emphasise that we have a flexible exchange rate regime that has served us well after doing away with exchange controls in the early 90s. The exchange rate of the Kwacha against other international currencies has enjoyed relative stability since 2003 when the interbank foreign exchange market system (IFEM) was introduced. With this system, the Bank of Zambia intervenes in the market mainly to smoothen fluctuations and to build international reserves. The exchange rate is expected to be driven by economic fundamentals such as the terms of trade. An attempt to fix the exchange rate would have disastrous effects especially when the fundamentals suggest that the rate should depreciate as this would wipe out all the reserves we have struggled to build over the recent past. In such circumstances, the Bank intervenes to moderate short term volatility of the exchange rate but not to change the direction dictated by the fundamentals. On the other hand, an improvement in the terms of trade provides an opportunity for the Bank of Zambia to build reserves as it smoothen the rate of appreciation.

Finally, **Mr President**, I wish to congratulate you on the contribution made by manufacturing sector to the GDP growth in 2009. The performance of the sector was favourable, recording a real growth of 2.5% compared with 1.8% in 2008. I am confident that as the economic fundamentals continue to improve, banks are expected to increase lending to the private sector at reduced rates. We therefore expect the sector's contribution to growth in 2010 to increase. In order to assist the country's diversification process away from copper, I wish to implore you to seek ways of enhancing productivity in your various sectors as a means improving competitiveness of your products for exports.

Mr. President, one way by which your members can contribute to increased GDP is through participation in the Multi-Facility Economic Zones (MFEZs) for which the Government has approved establishment of three. You may wish to note that the construction of the Chambishi MFEZ on the Copperbelt has reached an advanced stage while work on the Lusaka South MFEZ is underway. Several enterprises with significant investments are already being established at the Chambishi MFEZ. There is also a proposal for the establishment of the Lumwana MFEZ in North-western province. These zones are expected to enhance the country's efforts of promoting value addition to raw materials which will in turn boost the manufacturing sector. They are also consistent with the budget themes for 2009 and 2010 of "**Enhancing Growth through Competitiveness and Diversification**". In collaboration with the development partners, Government will provide the necessary support institutions, infrastructure and services conducive to efficient and competitive manufacturing. I would like to strongly encourage Zambian firms particularly members of ZAM to take advantage of the opportunities created under this initiative.

Mr President, as I conclude my remarks, I wish you and your members a prosperous 2010.

I thank you for your attention.