Caleb M Fundanga: Global financial and economic crisis and its effect on the Zambian economy

Speech by Dr Caleb M Fundanga, Governor of the Bank of Zambia, to the SADC Group of High Commissioners and Ambassadors Meeting, Lusaka, 9 July 2009.

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Chairperson
Your Excellencies High Commissioners and Ambassadors from SADC Resident in Zambia
Distinguished Guests
Ladies and Gentlemen

It is a great honour and privilege to be invited this afternoon to share Zambia's experiences given the unfolding global financial and economic crisis. In discussing this topic, I will begin by highlighting, albeit briefly, the origins of the current global economic crisis. I will then underscore the effect of the crisis on the Zambian economy before I look at the policy responses, the challenges and then conclude.

Origins of the crisis

As Your Excellencies are already aware, the genesis of the current global economic crisis has been traced to the collapse of the sub-prime mortgage market which started between 2002 and 2006. This was when lending to the household sector in the United States of America (USA) was growing at a rate far beyond that of the broader economy (i.e. growth in GDP). The rising delinquencies in the subprime mortgage market triggered turbulences in the subprime mortgage – backed securities market leading to a financial crisis which quickly spread to other advanced economies.

Subsequently, the financial crisis created a recessionary economic environment in which global trade, stock market indices, and commodity prices, such as copper and cobalt, declined significantly. The global financial and economic crises thus negatively impacted on economies around the world by adversely affecting trade and investment flows and the price of key export commodities.

To respond to this crisis, several actions are being taken at global level by the major economies to address the root causes and the effects of the global financial and economic crises. These are fiscal and monetary policy stimulus measures aimed at boosting global consumption and investment demand in an effort to avoid a significantly sharper global contraction than that which has already occurred. Measures typically entailed reduction of interest rates, tax cuts and increased Government spending in form of bail-outs of strategic institutions and in some cases virtual nationalisation. Concrete steps are also now being taken to reform the regulatory and supervisory frameworks governing the financial sector. Further, increased resources have been provided to key multi-lateral institutions such as the IMF and the World Bank. These institutions have also been mandated to play a central role in leading the global response to the crisis and evaluating the efficacy of the various measures that are being implemented.

Impact of the global economic crisis on Zambia

The Zambian financial sector has so far not been directly adversely affected by the credit crunch as reflected in the continued stability of the banking sector with most banks being adequately capitalized and the inter-bank market operating as before. This is mainly due to the sector's limited integration into the international financial markets. Further, our financial sector had no exposure to toxic assets, which led to the credit crunch in most developed markets. However, the current global financial crisis, with the subsequent global economic recession, has adversely affected Zambia, like most global economies, mainly through: reduced revenue earnings from mineral resources; job losses, particularly in the extractive industry; lower foreign capital inflow (both foreign portfolio investment (FPI) and foreign direct investment (FDI)); rising domestic inflation driven by pass-through effects of the depreciation in the exchange rate of the Kwacha against major currencies; and declining number of foreign tourists.

Revenue earnings from mineral resources

As you may know, Your Excellencies, Zambia, like many African countries, relies heavily on commodity exports. This has made the country more vulnerable to the global downturn. The global financial crisis and the plummeting commodity prices on the international market have negatively affected Government revenue. The global economic recession has resulted in a reduction in world demand for copper, which in turn, has led to the precipitous fall in copper prices. Copper prices at the London Metal Exchange (LME) fell from highs of US$8,980 per tonne in July 2008 to as low as US $2,812 per tonne in December, 2008. The dramatic decline in the price of copper has entailed reduced earnings from copper exports by mining companies and subsequently reduced earnings for the Government from mineral royalties and corporate taxes from this source as well as falling income taxes from employees in the mining and related sectors.

The reduced earnings for the mining sector may translate into lower investments and production. Further, some mining companies, which were carrying out exploration works, have suspended these activities. Ultimately, all this lead to job losses in the country's extractive industry, leading to lower income tax revenue. In addition, the downturn will reduce Government's capacity to develop the much needed infrastructure as it may have to scale-down its capital expenditure in line with lower realized revenue.

Loss of employment

In the real sector of the economy, the impact of the crisis has been reflected in the scaling down of production or the closing down of some mining operations due to low copper prices. This has had the inevitable consequence of loss of jobs. However, following the reopening of some mines, the situation has slightly improved.

External position

The declining earnings from copper exports adversely affected Zambia's balance of payments position. For instance, during the fourth quarter of 2008, the overall balance of payments deficit widened to US $177.6 million from US $120.6 million recorded the previous quarter. Merchandise export earnings declined to US $909.8 million from US $1,206.7 million realised in the third quarter of 2008 following a sharp reduction in metal export earnings. Metal export earnings declined by 23.1% to US $711.7 million in the fourth quarter of 2008 from US $925.6 million the previous quarter. Metal export earnings at US $575.8 million in the first quarter of 2009 were 49.8% lower than the US $1,147.2 million recorded in the similar period last year. A slide in both copper and cobalt export earnings owing to lower prices accounted for this outturn. Nonetheless, it should be noted that commodity prices on the international markets recently have been edging upwards. If this trend is sustained, Zambia's external position may improve accordingly.

Foreign capital inflow

Your Excellencies, the global financial crisis has led to the decline in the foreign portfolio investment inflows as investors reduced their exposure to emerging market instruments. The risk aversion towards emerging markets has led to a reduction in foreign portfolio inflows and holdings in Zambia's Government securities. This has resulted in a net outflow of foreign portfolio investment since funds that mature are not being rolled over and funds coming in have be en scaled down. For example, the foreign investor's total holding of Government securities has reduced from K1,054.7 billion in the third quarter of 2008 to K446.2 billion by the second quarter of 2009. Similarly, the flow of foreign investments at the Lusaka Stock Exchange has switched from a net inflow of US$2.5 million during the period January to May 2008 to a net outflow of US$8.5 million in the same period this year.

Exchange rate volatility and domestic inflation

The global financial meltdown has caused a contagion effect to our foreign exchange market and has led to volatility in the exchange rate of the Kwacha against major currencies. This unfavourable development is partly a consequence of reduced earnings from copper exports arising from the fall in copper prices as reflected in the lower supply of foreign exchange on the market by mining companies. For instance, the supply of foreign exchange to the market by mining companies has declined by 35.7% to a monthly average of US $62.4 million in the first half of this year from an average of US $97.0 million in the last half of 2008.

Further, the weakness of the local currency is a consequence of increased risk aversion to emerging and developing economy financial assets, as stated earlier, attributed to the deepening global financial crisis. In this regard, the supply of foreign exchange by foreign portfolio investors for the purchases of Kwacha financial assets, such as Government securities and domestic company equities, has significantly declined, with most non-residents preferring to liquidate their investments and externalising the foreign exchange. The result of this is the volatility in the exchange rate of the Kwacha against major foreign currencies. In the last quarter of 2008, the Kwacha depreciated by 26.9% to trade at an average of K4,394.76/US$ (BoZ mid-rate) from an average of K3,462.00/US$ in the third quarter.

It should also be noted that the depreciation of the Kwacha against major currencies partly contributed to higher inflation, particularly as Zambia remains dependent on imports for a wide variety of consumer goods as well as inputs for domestic production. Further, this unfavourable development has a strong role in shaping inflation expectations.

Tourism

Apart from mining and related companies that are affected by the effects of the global recession, tourism has also been negatively impacted. The number of foreign tourists is anticipated to decline owing to financial problems and credit crunch their countries of origin are facing.

Availability of credit

Perhaps the most challenging effect of the global financial crisis, especially for developing countries like Zambia, is its impact on private sector investment. Between 2006 and 2008 credit to the private sector grew strongly (at an average of 45.6% per annum), largely driven by the expansion of consumer credit and the strong growth in the domestic economy. An immediate consequence of the financial and economic crisis has been a curtailment of credit lines and a slow-down in FDI flows. In 2009, domestic credit is expected to slow down as financial institutions adopt more conservative lending practices and tighten their lending standards. In addition, the deterioration in corporate and household balance sheets is now being translated into higher non-performing loans (NPLs) as a percentage of total assets in the banking sector (from 6% in mid-2008 to 10% in May, 2009 – an increase of 67%.). The deterioration in NPLs is now across all the past due loan categories.

Policy response

In responding to the crisis, the Government is taking steps to maintain macroeconomic stability and continue encouraging investments that will lead to diversification of the economy and safeguard vital social services. Further, the Government is actively engaging new investors to take over the running of the closed mining operations as well as negotiating with the owners of the bigger mines on modalities of continuing with operations at the mines to forestall further job losses. The 2009 Budget has prioritised infrastructure development with the view to opening investment opportunities for diversification, particularly in agriculture, tourism, and manufacturing sectors. Some specific measures include the following:

Agricultural sector:

Increased allocation of funds to the sector for livestock development and creation of at least one disease-free livestock zone, Farm Block infrastructural development and irrigation projects. Further, the value added tax on selected agricultural equipment and spares, has been zero rated as incentive to increase agricultural production and productivity.

Tourism sector:

In order to diversify the economy and attain broad based economic growth, Government has increased the allocation to the sector to improve access to the Northern Tourism Circuit (infrastructural development in Mbala and Kasaba Bay). Further, Government will embark on the development of a new world class tourism area in Livingstone, and step-up the development of road infrastructure in key national parks namely, Luangwa and Kafue.

Manufacturing:

In order to expand the manufacturing base, Government is promoting the establishment of Multi-Facility Economic Zones (MFEZ) on the Copperbelt (Chambishi), and Lusaka (Lusaka south and east) provinces by providing for fiscal incentives and quality infrastructure development in the budget. The construction of the Chambishi MFEZ has already commenced. Further, the budget reclassified and re-categorised certain manufacturing materials with the aim of lowering customs duty rates.

Mining sector:

In light of the adverse impact of the global economic crisis on the mining sector and with the view of easing these effects, the Zambian Government introduced tax concessions, which included removal of the windfall tax, increasing capital allowance to 100 percent as an investment incentive, and reduction of customs duty on Heavy Fuel Oils.

As the Central Bank, we have continued to monitor and review developments in the foreign exchange market and provide prudent support when necessary in order to dampen excessive volatility in the exchange rate and safeguard the recently achieved macroeconomic stability. To this end, the Bank has been a net seller of foreign exchange to banks. However, the Bank’s interventions are limited given the global extent and magnitude of the crisis.

In addition, the Bank has enhanced its vigilance and interaction with the domestic financial system to ensure adherence to its supervisory guidelines and to enhance information flows between banks and itself. Accordingly, the Bank also introduced measures to ensure that financial market players under its supervision provide detailed information on their foreign exchange transactions.

Further, the Bank has continued to reinforce the regulation and supervision of the financial sector. Effective surveillance of the financial market entails adopting appropriate risk management policies and procedures that will ensure that financial institutions do not undertake excessive risks that may increase the vulnerability of the country to external shocks.

Challenges

Maintaining macroeconomic stability is critical to sustaining economic growth in Zambia. The challenge is how to sustain stability and mitigate falling domestic demand within the constraints posed by increasingly scarcer external financial inflows. This has to be done in the context of implementing policies consistent with medium-term stability and development goals.

The second challenge relates to **mitigation of the vulnerability of the Zambian economy to the adverse external shocks.** We will have to closely monitor capital flows and adopt supervisory policies that will ensure a sound and stable financial system. The pursuit of policies that promote macroeconomic stability is also important to ensure that the domestic economy remains attractive to both domestic and foreign investors for the long-term growth and development of the economy.

One of the unfolding lessons of the current crisis is the need for **greater transparency** in the transactions players in the financial markets undertake, particularly, with respect to off-balance sheet transactions. We will therefore be acting to ensure that market players provide us with detailed information on their transactions. In addition, we will continue to work towards strengthening and developing our financial markets as well as encouraging competition and efficiency.

Prospects for 2009 and beyond

Your Excellencies, going forward, it remains important to accelerate diversification of the economy as a way to mitigate the effects of a prolonged global financial crisis. Currently, there are enormous business opportunities which still lie unexploited in Zambia in virtually all sectors of the economy. It is important that we continue reducing the cost of doing business, in conjunction with the private sector, in order to improve investments in various sectors of the economy. The agriculture sector, for instance, remains underdeveloped despite the country possessing large tracts of arable land, adequate water and relatively good weather. This is one sector where the country can easily take advantage of its comparative advantage.

The achievement and maintenance of a low and stable inflation rate, preferably single digit, therefore remains key to promoting investment, enhancing business planning and confidence in the economy, maintaining external competitiveness and stabilising people's incomes. In the medium-term, Government continues to pursue market and structural reforms in partnership with the private sector with the view of consolidating the gains so far attained for sustained economic growth and development.

Despite the adverse effects of the global economic meltdown, there are still prospects for appreciable economic growth in 2009 and the years ahead. GDP growth is expected to be led by growth in agriculture; construction; financial services; manufacturing; transport and communication; and wholesale and retail trade.

Conclusion

In conclusion, we all agree that Zambia remains vulnerable to effects arising from the on-going global financial crisis, particularly if it is prolonged. We hope that the actions that most affected countries, led by the US and the EU, have taken would help cool down the financial crisis and bring back the much needed confidence in the financial systems.

For its part, the Bank of Zambia continues to closely monitor global developments and always stands ready to intervene in the local financial market with a view to prevent any systemic risks that may have negative effects on macroeconomic gains achieved thus far.

Once again, **Your Excellencies** let me thank you most sincerely for this opportunity to discuss the challenges Zambia is facing in view of the current global economic crisis.

I thank you.