Caleb M Fundanga: The global economic crisis – Zambia's strategy to maintain stability

Remarks by Mr Caleb M Fundanga, Governor of the Bank of Zambia, at the 4th Eastern and Southern African Management Institute (ESAMI) Summer School Event, Arusha, 29–30 November 2009.

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I. Introduction

It is a great honour and privilege to be invited by ESAMI to discuss Zambia's experiences in the global economic crisis and the strategies that have been chosen to deal with its effects and to bring economic recovery. In discussing this topic, I will begin by highlighting the effects of the crisis on the Zambian economy. I will also highlight the strategies used to maintain stability, indicate the current state of the economy, the challenges and then conclude.

II. Origins of the crisis

As you may already be aware, the beginning of the 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 in October 2008, first, in the USA, and which later quickly spread to financial institutions in Europe. 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 through falling export demand and tourist receipts, declining commodity prices, reductions in the availability of credit and trade finance, and less inflow of remittances, foreign portfolio, direct investment and other capital flows.

In response to this crisis, several actions were taken at global level by the major economies to address the root causes and the effects of the global financial and economic crises. These were fiscal and monetary policy stimulus measures aimed at boosting global consumption and investment demand in an effort to avoid a much sharper global contraction than that which has already occurred. Measures typically ranged from 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 were also taken to reform the regulatory and supervisory frameworks governing the financial sector. Further, increased resources were provided to key multi-lateral institutions such as the IMF and the World Bank. These institutions were also given the mandate to play a central role in leading the global response to the crisis and evaluating the efficacy of the various measures that had been implemented.

III. Impact of the global economic crisis on Zambia

The Zambian financial sector did not immediately or directly become adversely affected by the credit crunch as was reflected in the continued stability of the banking sector, with most banks being adequately capitalised and the inter-bank market operating normally. This was 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 ensuing global financial crisis, with the global economic recession that followed, 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)); loss of foreign exchange reserves; 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.

Reduced revenue earnings from mineral resources

As you may already know, Zambia, like many African countries, relies heavily on commodity exports. This made the country more vulnerable to the global downturn. The global financial crisis and the plummeting commodity prices on the international market negatively affected Government revenue. The global economic recession resulted in a reduction in world demand for copper, which in turn, 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 led to 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 export earnings for the mining sector also translated into lower investments and production. Further, some mining companies, which were carrying out exploration works, discontinued these activities. Ultimately, all this led to job losses in the country's extractive industry, leading to lower income tax revenue. In addition, the downturn caused a reduction in the Government's capacity to develop the much needed infrastructure as it had to scale-down its capital expenditure in line with lower revenue.

Loss of employment

In the real sector of the economy, the impact of the crisis was reflected in the scaling down of production or the closing down of some mining operations due to low copper prices. This had the inevitable consequence of loss of jobs. However, the reopening of some closed mines which has followed the recovery in metal prices has since led to a slight improvement in the situation.

External position weakened

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 $910.0 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 $712.0 million in the fourth quarter of 2008 from US $925.6 million the previous quarter. Metal export earnings at US $543.5 million in the first quarter of 2009 were 52.6% 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 have since recovered considerably and have thus started to bring improvement in Zambia's external position.

Foreign capital inflow reduced

Ladies and Gentlemen, the global financial crisis led to a decline in the foreign portfolio investment inflows as investors generally reduced their exposure to financial instruments from emerging markets. The risk aversion towards emerging markets thus led to a reduction in foreign portfolio inflows and holdings in Zambia's Government securities. This resulted in a net outflow of foreign portfolio investment since funds that matured were not rolled over and new funds coming in were being scaled down. For example, the foreign investor's total holding of Government securities 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 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 similar period this year.

Exchange rate volatility and domestic inflation

The global financial meltdown caused a contagion effect to our foreign exchange market and led to volatility in the exchange rate of the Kwacha against major currencies. This unfavourable development was 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 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.

In addition, the weakness of the local currency was 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, declined significantly, 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 had a strong role in shaping inflation expectations.

In Q4, 2008 BoZ made net sales of foreign exchange to the market of US $127.6 million, whilst in Q1, 2009 BoZ made net sales of US $208.5 million, in a continued effort to minimize exchange rate volatility. This meant utilizing international reserves to calm the foreign exchange market.

Tourism sector contracted

Apart from mining and related companies that were affected by the effects of the global recession, tourism was also negatively impacted. The number of foreign tourists visiting Zambia declined owing to financial problems and the credit crunch in their countries of origin.

Availability of credit

Perhaps the most challenging effect of the global financial crisis, especially for developing countries like Zambia, was 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 was limitation 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 has now been translated into higher non-performing loans (NPLs) as a percentage of total assets in the banking sector (from 6% in mid-2008 to 13.1% in September 2009). The deterioration in NPLs entails more vigilance for the bank supervision function of the Bank of Zambia.

IV. Strategies to maintain stability

In responding to the crisis, the Government has taken 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 found new investors to take over the running of the closed mining operations and negotiated with the owners of the bigger mines on modalities of continuing with operations at the mines to forestall further job losses. The 2009 Budget 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:

(i) ***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, was zero rated as incentive to increase agricultural production and productivity.

(ii) ***Tourism sector:*** – In order to diversify the economy and attain broad based economic growth, Government 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.

(iii) ***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. Operations at the Chambishi MFEZ have already commenced. Further, the budget reclassified and re-categorised certain manufacturing materials with the aim of lowering customs duty rates.

(iv) ***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 were limited, given the global extent and magnitude of the crisis.

Some of the specific measures the Bank of Zambia implemented include the following:

- *Improving information flows:* The Bank of Zambia has enhanced its vigilance and interaction with the domestic financial system to ensure adherence to its supervisory guidelines and to enhance information flows. The BOZ is continuously interacting with banks to ensure that detailed information regarding foreign exchange transactions is provided and has also engaged major business entities to understand their expected foreign exchange requirements. This is necessary to ensure market constraints are addressed expeditiously.

- *Sale of foreign exchange:* Increased the supply of foreign exchange to the market with the primary purpose of smoothening short-term volatility in the exchange rate and the foreign exchange market generally. Since September 2008 to date, the Bank has sold US $364.5 million to the market against purchases of US $9.5 million;

- *Issuance of directives:* On March 2, 2009, the Bank of Zambia issued directives to commercial banks prohibiting the extension of loans and/or credits and providing other sources of Kwacha funding to non-residents for any maturity period of less than one year. The Government is in the process of issuing a statutory instrument, which will clarify this position, in order to protect the integrity of the financial market.
- *Collaboration with regulators:* Engaged other regulatory authorities regarding measures to stem the growing trend of dollarisation, including some consideration to legislate and provide stringent regulations against this practice, which erodes the effectiveness of domestic monetary policy. In this regard, the Government is in the process of issuing a Statutory Instrument to ban quoting, invoicing and settling in foreign currency of domestic transactions for goods and services in Zambia.

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 the Central Bank. 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 has entailed adoption of appropriate risk management policies and procedures meant to ensure that financial institutions do not undertake excessive risks that may increase the vulnerability of the country to external shocks.

V. Current state of the economy

Mainly due to the policies pursued the Zambian Authorities, the economy has shown appreciable resilience in the wake of the global economic crisis. Positive economic recovery trends have already started to be witnessed within 2009.

(i) According to the Central Statistical Office, GDP growth is now forecast at 6.3% for 2009, up from 5.7% recorded on 2008, primarily driven by increased output in the mining, construction and agriculture sectors:

  - Mining growing by 21.4%
  - Construction by 15.5%
  - Agriculture by 7.1%

(ii) Although inflation rose to 16.6% at end-December 2008 from 8.9% in 2007, much of this increase was driven by the rise in food and energy prices. By October 2009, annual inflation had fallen to 12.3%.

(iii) The exchange rate has also stabilised with the weighted inter-bank rate moving within a range of K4,600 and K4,750 per US dollar in the third quarter of 2009.

(iv) The external sector adjusted strongly with the strong rebound in copper prices, to above US $6,400 per metric tonne, and increased output (primarily through a new mine, Lumwana Copper Mine). The merchandise trade balance recorded a surplus of US $415.0 million (f.o.b.) in the third quarter 2009 compared to a deficit of US $183.9 million in 2008. Similarly, owing to favourable performance of the external sector, international reserves have increased to US $1,788.9 million in 2009 (end-Sept) from US $247.7 million in December 2003.

(v) Equity markets have begun to reverse their large losses and FDI and portfolio flows are returning to Zambia’s financial sector.

(vi) Zambia's financial sector remains strong and stable largely due to banks being adequately capitalised, as confirmed by a recent Financial Sector Assessment Programme (FSAP) Survey by the IMF and World Bank.

VI. Challenges

The unfavourable effects arising from the recent global financial and economic crises are huge but surmountable. To this end, we need to do more than what we have done in the past. One of the key challenges relates to need to maintain macroeconomic stability. Macroeconomic managers in less developed countries have to be careful not to use the global economic crisis as a reason to slip back to unsustainable macroeconomic policies of the past.

In addition, the crisis has brought to the fore, once again, the ever important challenge of accelerating the diversification process. Our reliance on export of primary commodities, copper in the case of Zambia, exposes our countries to external risks such as the ones we are currently experiencing.

VII. Conclusion

The Bank of Zambia and the Government will continue with efforts to deal with challenges from the global economic and financial crisis, which still remain significant and continue to threaten macroeconomic stability and the long term growth path of the economy. In this regard, focus will be on attainment of the following objectives:

- Maintaining macroeconomic stability;
- Maintaining fiscal prudence to ensure that it does not become the source of instability;
- Increasing or consolidating public and private sector investment in infrastructure that builds the long term productive capacity of the economy and helps to diversify the economic base;
- Improving the business climate by lowering the cost of doing business; and
- Harnessing regional markets as an alternative source of demand for exports as well as source of supply for goods and services, including energy.