

Caleb M Fundanga: Future of the Zambian economy – a balanced look

Paper presented by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at a discussion sponsored by the LSA Group, Ndola, 30 June 2006.

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- Mr. Chairperson
- Distinguished Guests
- Ladies and Gentlemen

On behalf of the Bank of Zambia and indeed on my own behalf, I wish to express my sincere gratitude to Lawrence Sikutwa Associates for inviting me to this very important discussion. Our interaction with the corporate world on the subject "**The Future of the Zambian Economy – A Balanced Look**" is indeed appreciated and very important. This subject, as you rightly pointed out in your letter of invitation to us, is vital considering that Zambia, in general, and Ndola, in particular, are in dire need of investment. It is this investment, Mr. Chairman, which would create employment and accelerate economic growth, a necessary condition to combating extreme poverty among the Zambian people.

Ladies and Gentlemen, the future of the Zambian economy can only be known, if one understands the past and the present. Therefore, with your permission, I would like to begin by giving an account of the macroeconomic developments in Zambia in the recent past. I am certain that many of you have been following the economic trends and have seen that the economy has performed relatively well in recent years. Inflation and interest rates have been coming down, while the exchange rate has relatively stabilized, following a steep appreciation towards the end of 2005.

Distinguished Ladies and Gentlemen, during the period 2001-2005 growth in real Gross Domestic Product (GDP) averaged 4.7 percent per annum. This growth has been broad-based - extending beyond the recovery of the mining sector. In 2005, the economy registered growth of about 5.0% in real terms, marking the seventh consecutive year of positive growth in real output. This growth was largely due to the expansion in construction, driven by a robust demand for housing as well as largescale investment, which led to a marked pick-up in mineral production, particularly of copper. Other sectors, such as, tourism and transport, storage and communications also contributed to the overall economic growth.

Mr Chairman, inflation declined to 15.9% at the end of December 2005 from 17.5% at the end of December 2004 despite several setbacks. These included the partial drought that significantly reduced food supply and high prices of oil and petroleum products. Attainment of single digit inflation has been Government's goal for a long time. It is, therefore, encouraging to see inflation coming down in recent months, reaching a single digit level of 9.4% in April 2006 and dropping further to 8.6% in May and 8.5% in June 2006. This inflation out-turn has been largely due to the conduct of appropriate monetary policy aided by prudent fiscal policy and relative strengthening of the Kwacha. The bumper maize harvest this season has helped to ease pressure on food prices and to keep food inflation and thus overall inflation low.

Distinguished Ladies and Gentlemen, with respect to developments in the money market, commercial banks lending interest rates have also been coming down, though not as fast as the decline in inflation and yield rates on Treasury bills. Commercial banks nominal weighted average lending base rate declined from 29.8% in 2004 to 27.6 % in 2005. As at June 21, 2006, the weighted average lending base rate stood at 21.6%. Clearly, there is an urgent need for commercial banks to do more to reduce lending rates in order to influence a substantial expansion of private sector credit. Lower lending rates will contribute to the reduction in the cost of doing business in Zambia. In the current environment of low inflation, sustainable lowering of lending rates by commercial banks should be a logical course of action.

The next issue I would like to address is that of the appreciation of the Kwacha against major currencies. The appreciation has occurred mainly due to the higher supply of foreign exchange on the market than demand. The key factors underlying the increased foreign exchange supply include:

1. Increased copper output and exports as well as record high prices of the commodity. The volume of copper exports has in recent years registered sustained growth, increasing from 353,000 metric tons in 2003 to 423,000 metric tons in 2005. The price of copper rose to US

- \$4,572.0 per metric tons in December 2005 from US \$3,134.79 per metric tons in December 2004. The price of copper has since increased sharply and by May 2006 it had risen to over US \$8,000 per metric ton;
2. Increased non-traditional export earnings, from US \$410 million in 2003 to US \$576.7 million in 2005;
 3. Improved economic confidence following the attainment of the enhanced Highly Indebted Poor Countries(HIPC) Initiative Completion Point in April 2005, which resulted in reduced external debt service and obligations; and
 4. Increased foreign direct and portfolio investments, reflecting increased market confidence in the economy, occasioned by the greatly improved prospects for the copper sector, the cancellation of the bulk of Zambia's external debt, and anticipated continued commitment to implementation of prudent fiscal and monetary policies.

Mr. Chairman, from this, it is clear that the current strengthening of the Kwacha has been caused mostly by changes in economic fundamentals. I recognise the concerns by some of our exporters of non-traditional commodities that they are losing external competitiveness. I wish to point out that not all has been lost as a result of the appreciation of the Kwacha. Some non-traditional exporters have benefited through, among other things, the reduction in the cost of capital goods and imported raw materials. In addition, may I mention the fact that the exchange rate alone does not determine external competitiveness of exports. Exporters should look at those areas in their production processes where they can attain efficiency gains and improve productivity. These efforts need to be complemented by Government through directing investment in infrastructure and structural reforms, including labour laws, so as to reduce the cost of doing business in Zambia. On its part, the Bank of Zambia will carry out its function of smoothing the movements in the exchange rate in a way that would not compromise the low inflation objective.

Ladies and Gentlemen, these achievements will have been impossible without the financial sector reforms. In the early 1990s, Zambia embarked on economic liberalisation, of which reforming the financial sector was a major part. Specific measures which were undertaken included, among others, the removal of all restrictions on interest rates and, elimination of controls on foreign exchange rates and transactions. Interest and exchange rates are now market determined, that is they are being driven by underlying demand and supply factors.

To enhance the role of the market in the determination of exchange rates, the Interbank Foreign Exchange Market (IFEM) trading system was introduced in July 2003. The entrenchment of the IFEM trading system has been characterised by increased interbank foreign exchange liquidity flows, particularly from mineral exporters.

With the liberalisation of the financial sector, several bank and non-bank financial institutions were established. The financial sector has expanded remarkably over time and the services provided have been improved.

- The number of commercial banks has more than doubled to 13 from 4 banks prior to 1990. Currently, the banking system is made up of the Bank of Zambia, which is the central bank, and 13 commercial banks, with a branch network of 159 as at end-December 2005 compared to 123 in 1990.
- Commercial banks have improved the range of products offered to customers, in line with global innovations. These include Automated Teller Machines (ATMs), foreign exchange accounts, Visa debit cards, mortgages, and leasing services. In 2005, 4 commercial banks launched the E-switch facility to allow their customers to share their ATMs and other payment delivery channels, like point of sale terminals. These services were unheard of before the reforms and were supported by the international community.
- Commercial banks have also embarked on other initiatives including expansion programmes based on the community banking concept. This is consistent with the rural banking concept and is intended to provide financial services to those sectors of the community that are not currently serviced by the banking sector.

Ladies and Gentlemen, to meet the challenges which come with an expanded banking sector and in our desire to continue modernising the overall financial sector, it has been imperative for the prudential and supervisory mandate of the Bank of Zambia to be strengthened. In this regard, the key initiatives

that have been effected, with an ultimate goal of promoting safe, sound and efficient operations have included:

- The enactment and amendment of the Banking and Financial Services Acts in 1994 and 2000, respectively.
- The implementation of the Banking Supervision Application Project, aimed at supporting banking supervision and providing a framework for supervision with the view of having a safer financial sector.

Distinguished Ladies and Gentlemen, in order to promote greater access by the population to banking and financial services, the following have been implemented:

- Establishment of an automated electronic clearing house in 1999 (to speed up processing cheques from 4-10 days for local and country checks to 2-5 days, respectively), enhancing the security of cheques and introducing machine-readable cheques.
- Establishment of a direct debt and credit clearing system (DDACC) and a realtime gross settlement system (RTGS) called Zambian Interbank Payment and Settlement System (ZIPSS) in October 2001 and June 2004, respectively. The DDACC system has facilitated the transfer of money by electronic means for payment of bills and salaries while RTGS allows a speedy, safer and large value clearing facility. Commercial banks have also set up a foreign currency cheque clearing system.
- The adoption of the Financial Sector Development Plan (FSDP). This is a framework which aims to promote the development of a stable, sound and market-based financial system that would support efficient resource mobilisation necessary for economic diversification, sustainable growth and poverty reduction. Currently, key recommendations of the FSDP are under implementation. For example, the creation of a Credit Reference Bureau will improve the information available to credit providers in order to enable them to make better credit decisions.

Ladies and Gentlemen, at this juncture, I would like to mention that the macroeconomic gains attained in the recent past will need consolidating in 2006 and onwards. You will agree with me that the macroeconomic gains attained have set the stage for sustained future growth of our economy, employment creation and poverty reduction. In this regard, allow me now turn to the future growth focus of our economy.

Mr. Chairman, Zambia has articulated its long-term development objectives in the National Long Term Vision 2030. Part of this vision is enshrined in the Fifth National Development Plan (FNDP); 2006-2010 whose theme is: "Broad Based Wealth and Job Creation through Citizenry Participation and Technological Advancement". This calls for policies that accelerate and sustain economic growth, and which enable the poor to participate in, and benefit from the growth process. In this respect the broad macroeconomic objectives for the Plan period 2006-2010 are as follows:

- To accelerate pro-poor economic growth;
- To reduce and stabilise inflation; and
- To sustain a viable balance of payments and external and domestic debt position.

What then do we see as the sources of economic growth and employment creation in future? **Ladies and Gentlemen**, we see the growth of the Zambia economy being driven by increased activities in agriculture, mining, export-led manufacturing, tourism and energy.

Agriculture

Mr Chairman, this sector possesses great potential to make higher contributions to the country's growth and employment aspirations given the abundant arable land and water supply. Water supply is abundant, accounting for 45 percent of the total water resources of the Southern African region, thus providing investment opportunities for the supply of water for irrigation, home and industrial use. Investment in agriculture is important because the majority of our people in rural areas depend on agriculture for their livelihood and income.

Thus, investment in agriculture will help reduce poverty, especially if it is directed at bringing into the fore small scale farmers in the production of cash crops, such as, tobacco, sugar and cotton.

In addition to increased production among small scale farmers, it will be of paramount importance to put in place strategies that will increase productivity among small scale farmers.

Mining

Mr. Chairman, the ongoing activities in mining suggest that the sector is poised to be, once again, one of the major contributors to the future growth of our country. It is expected that copper output in particular will soon reach and probably even exceed the mid-1970s levels. Increased output is expected from the existing mines and those under establishment such as Lumwana in North-Western Province and Konkola Deep on the Copperbelt. Exploration for other mining ventures has continued with high prospects for nickel mining in Southern Province. Although in the early stages increased employment will be created, the ability to absorb more labour in future will reduce as some mines employ more efficient and less labour intensive techniques in the production processes.

I should mention here that though copper mining has again become prominent in terms of exports and to some extent employment, Government strategies and policies are focusing on reducing the country's dependence on copper mining through economic diversification as articulated in the FNDP (2006-2010). In our diversification efforts, due attention will be paid to those that have high potential for creating employment. This will make our economy resilient to future external shocks and ensure sustained development, and have a required impact on the quality of life of the Zambian people.

Manufacturing

Ladies and Gentlemen, the Zambian Government has demonstrated its commitment to the development of a vibrant but competitive manufacturing sector in this year's national budget. This is in line with its commitment to facilitate increased value addition which is one of the key ingredients in achieving sustainable development in the country. To this effect, several measures and incentives aimed at enhancing the competitiveness of the sector will be provided in conformity with the future growth objectives. One such example is the Government's move to implement a new initiative called the Multi-Facility Economic Zone (MFEZ). This will replace the Export Processing Zones (EPZ), as special industrial zones for both export-oriented and domestic-oriented industries. The zones will have all the necessary infrastructure for the easy commencement and conduct of manufacturing activities. In addition, several concessions will be provided for those companies that will operate in the MFEZ.

Ladies and Gentlemen, we see the growth in manufacturing emanating from increased investment in agro-processing whose potential has not yet been fully exploited. It is in this respect that current and future initiatives emphasise forging of stronger linkages between agriculture and manufacturing, particularly through upstream linkages to agro-related processing.

The other aspect of manufacturing that we see as stimulating growth in future is increased processing of minerals, key being copper (given the rapid expansion in copper output) and precious stones. **Distinguished guests**, the processing of copper into various high products at ZAMEFA is commendable. However, there is still a lot of room for other investors to invest in the processing of copper and indeed gemstones and precious stones that are mined in the country and exported as rough stones. Investing in downstream processing of gemstones and other minerals will not only enhance our export earnings but create employment for our people. Government on its part will among other things facilitate improved access to capital and equipment, enhance skills, rehabilitate support infrastructure and facilitate linkages for marketing of processed gemstones and other minerals.

Mr. Chairman, it is worth noting that the construction of Zambia's third cement company by Zambezi Portland Cement and the planned establishment of an assembly plant by Tata Ltd of India, here in Ndola are all welcome developments following improved confidence in our economy, which should boost growth and create employment. I would like to urge the business community to invest in similar ventures. I am positive that with improved macroeconomic stability there will be more investment in such productive activities.

Tourism

Distinguished guests, tourism is another of Government's priority sectors from which growth and employment are expected to be generated. One of the key aspects of Zambian tourism is the

increasing participation of locals in the sector through among other activities establishment of lodges that are complimenting the traditional hotels and offering services with a Zambian touch. It is worth mentioning that tourism, more than any other sector, is labour intensive and provides jobs for local people in both rural and urban areas. In order to stimulate the potential of this sector, there will be need to facilitate access to affordable and sufficient credit, entrepreneurship (private sector capacity building) training, improved marketing and provision of the necessary support infrastructure. Access to most of these tenets will enable the local small scale investors to provide competitive tourist services.

Ladies and Gentlemen, may I also add that tourism should not be based on wild life (visiting national game parks) alone. Here on the Copperbelt, you have a unique opportunity to develop a tourism industry based on copper mining - e.g. going underground. Collectively, we can also encourage and promote eco-tourism in much of rural Zambia.

Energy sector

Mr. Chairman, a growing economy needs sufficient, stable and affordable energy supply. I have here in mind the electricity sector. Given abundance of water resources in the country, as earlier alluded to, the potential for development of hydro-power for both domestic and exports is quite high. Current estimates show that the country's hydropower resource potential stands at 6,000 mega watts (MW) while the installed capacity is somewhere around 1,715.5 MW. These estimates are a testimony to the great potential this sector has. I am aware of several investment plans that ZESCO has put in place and which are aimed at exploiting this potential.

Ladies and Gentlemen, the opportunities identified above do not just happen. Zambians must make a conscious effort to exploit the opportunities identified. We must not view Government efforts of promoting investments opportunities as meant for foreigners only.

To facilitate long-term planning for the productive sector, the Bank of Zambia will continue with measures that would achieve and maintain low and stable inflation and interest rates as well as a relatively stable exchange rate. This would provide a foundation for *value addition* in industries such as agro-processing, manufacturing, construction, and tourism, which is key to sustainable development. It is imperative that as a country, we move from being raw materials producers only to value addition in a stable macroeconomic environment. Apart from appropriate monetary policy and prudent fiscal policy, the stability in the foreign exchange market is important in achieving low and stable inflation. The objective of the Bank in this respect would be to achieve a non-volatile but competitive exchange rate.

Ladies and Gentlemen, in order to achieve efficient allocation of resources and to promote savings and investment, there is need to achieve and sustain low and stable interest rates. As earlier indicated, it is worth noting that lending interest rates have trended downwards in the recent past owing to the reduction in inflation. Low and stable interest rates would create conducive credit conditions, which would improve accessibility and availability of credit to the productive sectors. This would result in expansion in investment, increased production as well as enhanced *value addition*. This ultimately leads to sustainable economic growth required to accelerate poverty reduction in our country.

Mr. Chairman, another aspect of the Bank of Zambia mission is that of ensuring financial system stability. As you may be aware, financial system stability is very critical to the maintenance of macroeconomic stability. As a matter of fact, monetary policy would not be effective in pursuing the inflation objective if the financial system were not stable, as monetary policy actions are transmitted through financial institutions.

In this regard, the Bank of Zambia will continue with its efforts of ensuring stability in the financial sector. A stable financial system plays a catalytic role for financial institutions to provide the financial products that will contribute to the development of the insurance business. In this instance, the Bank will continue to support local financial institutions in their efforts to mobilise increased savings particularly domestic, which should go towards sustained financing of the future productive activities in our economy. This calls for increased innovation on the part of the financial sector in developing products to support a growing economy.

Ladies and Gentlemen, in conclusion, may I simply state that as we consolidate macro-economic stability, we are committed to achieving the necessary economic growth that will have a bearing on poverty levels in the country. In this regard, we see the future of the Zambian economy as one which

is highly diversified through resuscitating the industrial base to enable increased value addition and employment creation. We strongly believe that increased value addition is key to sustained development. I would like to urge you all and those in the private sector that are not with us to take advantage of the immense investment opportunities in our country.

Let me once again thank you for inviting me to share my thoughts on this important topic.

I thank you for your attention.