Zambia Country Brief

December 2018

Introduction

The Republic of Zambia is a land-locked country located in south-central Africa. It shares borders with the Democratic Republic of Congo to the north, Tanzania to the north-east, Malawi to the east, Mozambique to the southeast, Zimbabwe and Botswana to the south, Namibia to the south-west, and Angola to the west. The capital and largest city of Zambia is Lusaka.

Zambia has an area size of roughly 752,618 square kilometers, making it the 17th largest country in the continent. With a population of about 16.4 million, it is the 22nd most populous nation in Africa. Like most countries in the region several different languages are spoken in Zambia. The official language is English, while the main local languages, include Nyanja (Chewa), followed by Bemba. Other languages that are commonly spoken include Lozi, Kaonde, Tonga, Lunda and Luvale.

Zambia's economy is predominantly driven by the mining sector, especially copper. Mining and its supporting activities contribute about 12 percent of the gross domestic product (GDP), and more than 70 percent of country's export earnings. Other exports include tobacco, gemstones, maize and cotton. Agriculture provides the main livelihood for most of the people, followed by the services sector.

Political Environment

The country is administered under a presidential system of governance, whereby the President is both head of state and head of government. The government exercises executive power, while legislative power is vested in both the government and parliament.

briefly held the office after the passing of Michael Chiluyfa Sata. General elections held on 11 August 2016, re-elected President Edgar Lungu for a full five-year term. Presidents serve terms of five years and are limited to two terms. The next general election is scheduled to take place in 2021.

Economic Overview

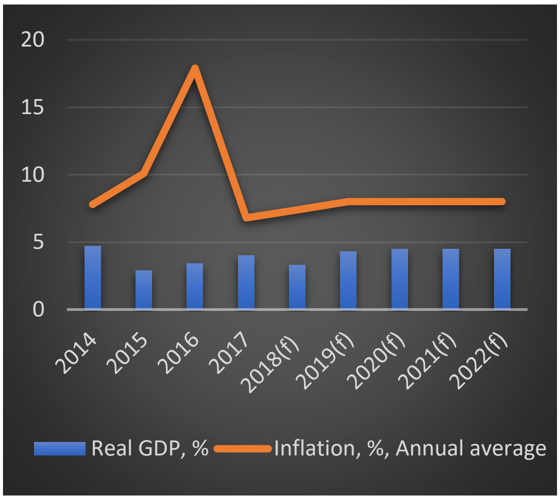
GDP: Output which picked up in 2017, expanding by 3.8% in a context of recovery in copper prices, strengthening industrial production and favorable agro-climatic conditions is set to decelerate in 2018. According to the World Bank, GDP growth in 2018 is expected at 3.3% down from a previous forecast of 4.3%.

The deceleration is largely due to increased volatility in agricultural output, lower copper prices and the adverse impact of rising government debt on the private sector. GDP is expected to improve moderately in 2019. However, officially forecast at 4.3%—partly due to rising copper production but also on the continued expansion in the manufacturing and services sectors.

Sustaining robust growth rates will largely depend on implementation of economic reforms to boost productivity and enhance competitiveness, especially in the small and medium size enterprise sector. Some of the risks to the economic outlook include weak commitment to and ownership of economic reforms, adverse weather conditions and commodity price shocks.

Prepared by the Research and International Cooperation Department.

Figure 1: Zambia GDP Growth and Inflation



Source: IMF Article IV (2017),. World Bank

Inflation: After returning to single-digit levels at the end of 2016, inflation remained low and stable in the first ten months of 2017 and within the Bank of Zambia's medium-term target of 6-8 percent. The sharp depreciation of the kwacha in H2-2018, once again, stoked price pressures with inflation reaching 8.3 percent in October 2018, its highest since November 2016. According to Bank of Zambia's projections, inflation is likely to exceed its target in 2019.

The exchange rate is a major driver of inflationary pressures. While the appreciation of the kwacha in 2016 helped in containing inflation during that period, higher fuel and electricity prices put upward pressure on prices in 2017. However, this was compensated for by lower food prices following a bumper harvest in 2017—food and non-alcoholic beverages account for over 53% of the inflation basket.

Exchange Rate: The Zambian kwacha has come under renewed pressure in 2018, depreciating by over 22 percent compared with its level at the start of the year. The currency has been pressured by weaker copper prices and production as well as poor harvests which have widened the trade deficit and tightened foreign liquidity. Relatively subdued policy rates, in response to falling inflation in 2017 have compounded pressure on the kwacha. Moreover, capital flows have been constrained by the perception of higher country risk especially after the ratings agency Moody's downgraded Zambia to Caa1 from B3 in July 2018. The kwacha averaged around ZMK11,927 against the US dollar compared with ZMK9,828 in January 2018.

Fiscal Balance: Zambia's overall fiscal balance improved from a deficit of 12.1 percent of GDP in 2015 to an estimated deficit of 5.6 percent of GDP in 2017 due in part to fiscal reforms which included a reduction in fuel subsidies and the introduction of a tax amnesty to boost revenue, though half of the estimated proceeds is expected to be collected in 2018.

Fiscal performance in 2018 is likely to have undershot initial targets partly on account of a weaker harvest which will undermine efforts to reduce agricultural subsidies, coupled with weaker copper prices which dent government royalties on production. As a result, the government is implementing policies aimed at cutting down on public expenditure and borrowing and accelerating domestic resource mobilization.

Part of these measures were unveiled in the 2019 Budget and include an increase in copper royalties and a 15 percent export duty for precious metals and gemstones. Whilst these reforms are decisive, fiscal sustainability may remain a challenge into 2019, partly due to the substantial contribution of the mining sector to fiscal receipts as well as substantial outlays on external debt servicing.

Overview of trade, reserves and financial sector

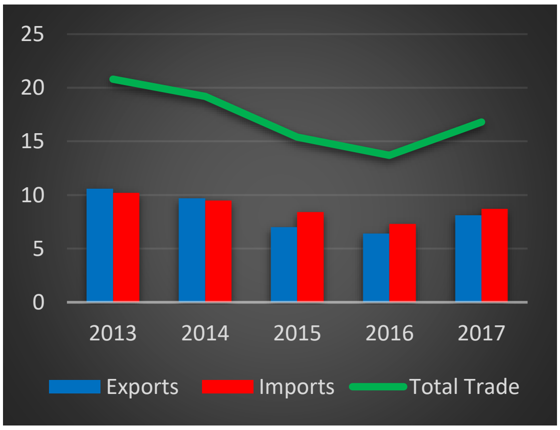
Total Trade: Zambia is the 101st largest export economy in the world and was the 13th largest export economy in Africa in 2017. Zambia exported US$8.13 billion and imported U$8.71 billion worth of goods, resulting in a trade deficit of U$580 million, down from US$900 million in 2017. The narrowing of the trade deficit is largely on account of the recovery in copper prices in 2017.

Zambia mainly exports raw copper, refined copper, precious stones, raw tobacco and maize. Its top export destinations are Switzerland, China, DRC, South Africa, Singapore and United Arab Emirates which together accounted for more than 82 percent of total exports in 2017. Zambia's top imports include refined petroleum, other cast iron products, excavation machinery, delivery trucks and pharmaceuticals. Its top import origins are South Africa, China, DRC, Kuwait, the United Arab Emirates, and India which together accounted for around 75 percent of total imports in 2017.

Intra-African Trade: Zambia's total intra-African trade amounted to approximately U$6.65 billion in 2017, accounting for around 39.6 percent of its total trade, significantly above the regional average of 15 percent. The DRC and South Africa are the top destinations for Zambia's exports within the region, accounting for 64 percent of Zambia's total intra-African exports. Other export markets include Zimbabwe, Malawi and Tanzania. The main intra-African exports include sugar, copper, maize, gold, and cobalt.

Zambia's largest African import partners are South Africa, DRC, Mauritius, Mozambique and Tanzania, which together accounted for 94 percent of Zambia's total intra-African imports. It imports mainly refined petroleum, fertilizers and motor vehicles from South Africa and copper ore from the DRC.

Figure 2: Zambia's total trade, US$ billion



Source: ITC Trademap, Afreximbank Research

Reserves: Zambia's reserve position has been trending down and reached US$2.18 billion at the end of December 2017 – equivalent to around 2.5 months of imports—down from US$3.08 billion (4.5 months of import cover) in the lead up to the end of the commodity super-cycle in the second half of 2014. The country remains heavily dependent on natural resources which accounts for over 90 percent of total export earnings. Export earnings have fallen markedly reflecting declining global commodity prices, while import compression has been tempered by the need to import additional fuel and electricity.

At 2.5 months of import cover, International reserves are below the IMF's recommended threshold of 3 months and well below the Southern Africa Development Community (SADC) convergence target of six-months for imports of goods and services. The devaluation of the kwacha and a recovery in copper prices should help in easing pressure on demand for foreign reserves.

Current and Capital Account Balances:

Since the end of the commodity super-cycle in 2014, Zambia's current account position has slipped into deficits, peaking at 4.2 percent of GDP in 2016 before narrowing to 3.4 percent of GDP in 2017, supported by improved terms of trade. Current-account prospects will continue to be determined largely by the copper-dominated mining industry. Higher copper prices and ongoing efforts by the Government to accelerate the process of structural transformation and diversification of sources of growth will support growth in earnings with the current account deficit forecast to narrow to 2.6 percent of GDP in 2018 and further to 1.2 percent in 2019. The shortfalls in will be covered by a combination of external borrowings and FDI, allowing international reserves to recover gradually from their current levels.

The capital account also came under pressure as foreign direct investment (FDI) continued to be adversely affected by lower copper prices and declining terms of trade. Increased participation of foreign investors in government securities markets has eased the government's financing constraint but has made the economy more vulnerable to swings in market sentiments and capital flow reversals.

Financial Sector: The IMF notes that despite deterioration in asset quality and declining profitability, financial soundness suggests that most banks remain well capitalized. Authorities have started implementing recommendations emanating from an IMF Financial Sector Assessment Programme. This includes measures to address financial sector weaknesses, ensure financial stability, and support financial development and inclusion.

The Banking and Financial Services Act (BFSA) has been approved. It addresses issues related to operational independence of the Bank of Zambia (BoZ), Basel II/III standards, and licensing. The BoZ is also strengthening its supervisory capacity and enhancing its collaboration with other financial services regulators. Furthermore, the Government of Zambia is finalizing the financial sector development policy aimed at promoting a well-developed, competitive, and inclusive financial system. The authorities are also strengthening their Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework.

In order to grow and transform the financial sector, Government developed the Financial Sector Development Policy in November 2017. The five-year Policy provides a holistic approach for Government to offer strategic guidance and coordinate overall financial sector development initiatives in the country, with the aim of having a well-developed and inclusive financial system that supports efficient resource mobilization and investment for sustainable economic development.

The commercial banking sector in Zambia comprises 19 international and local banks. According to PwC's 2017 Zambia Banking Industry Survey, domestic banks in Zambia expressed reduced optimism in the short-to -medium-term, due to concerns about the stability of monetary policy, fiscal discipline, growth prospects and uncertainty surrounding the IMF's economic program.

Debt Sustainability

Zambia scores 3.3 in the 2017 World Bank Country and Policy Institutional Assessment (CPIA) score[1]—unchanged from 2016. This is slightly above the IDA[2] borrowers average of 3.2 and is indicative of moderate quality in policy management for the country. However, among the four components that make up the CPIA, the quality of economic management is seen as weak and below the peer average, including monetary and exchange rate, fiscal and debt policy with an average score of 2.8, below the overall IDA mean of 3.2. The overall CPIA score of 3.3 is indicative of the following thresholds for debt burden indicators: Present value (PV) of external debt to GDP at 40%; PV of total debt to GDP of 55%; PV of external debt service to exports at 15%; PV of external debt/exports at 140%; PV of external debt service/revenue at 18%. Zambia's debt sustainability is assessed against the aforementioned benchmarks.

Zambia's debt profile has changed substantially since 2011 when the composition of debt was largely multilateral and on concessional terms. This has now evolved towards private non-concessional debt, largely reflecting three Eurobond issuances in 2012, 2014 and 2015 for an aggregate amount of US$3 billion. Total external debt is currently estimated at US$9.4 billion.

The share of concessional government debt has fallen to around 20 percent of total external debt. At end 2016, outstanding public and publicly guaranteed external debt stood at around US$8 billion compared with US$1.9 billion at the end of 2011.

[1] (1=lowest, 6=highest); Debt thresholds corresponding to strong performers are highest, indicating that countries with good macroeconomic performance and policies, can generally handle greater debt accumulation.

[2] There are currently 75 borrowing IDA countries spread across Africa, Asia, Latin America and the Middle East

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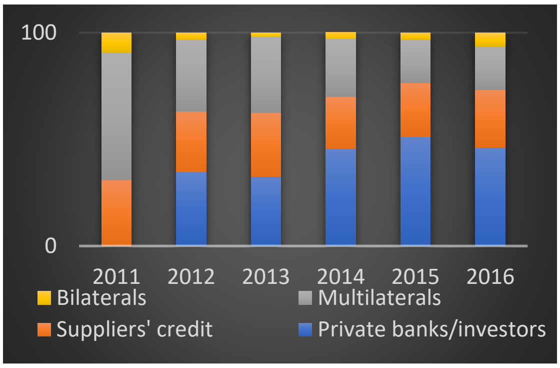
Figure 3: Evolution of Zambia's debt composition



Source: IMF Article IV (2017)

(i) PV of external debt/GDP

Expressed as a share of GDP, the present value (PV) of public and publicly guaranteed external debt which rose from 8.4 percent of GDP in 2011 to 34.5 percent in 2017, is forecast to increase further, reaching to 44.3 percent of GDP in 2020 (see Table 1). After crossing the maximum threshold of 40 percent, forecasts point to further deterioration of PV of external debt/GDP ratios which could reach 44.2 percent by 2021.

(ii) PV of total debt/GDP

The trend in the PV of total debt/GDP is consistent with the PV of external debt/GDP. At 55.6 percent in 2017, the ratio of PV of total debt/GDP had already breached the maximum threshold of 55 percent and is set to rise even further to 64 percent by 2021.

(iii) PV of external debt/exports

Official figures forecast the PV of external debt to exports at 209% in 2018 (up from 224.7% in 2016), and above the debt sustainability threshold of 180%. Although this ratio is forecast to moderate in the medium term, it remains above the debt sustainability threshold through to 2021 and remains highly sensitive to copper prices. Overall, the dynamics in external debt-to-exports ratio are consistent with a high risk of debt distress and also underscore Zambia's vulnerability to commodity terms of trade, especially copper prices and the impact of weather shocks on its agricultural exports.

(iv) External debt service/Government revenue

At 14% in 2017, the ratio of external debt service to revenue is below the DSF threshold of 18 percent. However, this ratio is expected to increase in 2019 and could breach the threshold if the kwacha remains volatile as has been the case in 2018, if growth volatility undermines prospects for domestic resource mobilisation. While the government is implementing reforms to expand the tax base and raise more revenue in the medium term, the continued reliance on external financing to close the current account deficit point to further risks of deterioration of debt sustainability indicators. Longer term projections suggest that the debt-service-to-revenue ratio will breach its threshold in 2022 and 2024 when Zambia's Eurobonds mature.

On balance, and considering the debt indicators discussed above, the risk of debt distress in Zambia is deemed to be high.

Table 1: Debt Sustainability Indicators

DSF & (threshold)	2017	2018F	2019F	2020F	2021F
PV external debt/GDP (40%)	34.5	39.1	42.6	44.3	44.2
PV total debt/GDP (55%)	55.6	60.0	62.4	63.3	64.0
PV of external debt/exports (180%)	209.7	209	202.6	198.3	187.4
External debt service/revenue (18%)	14	13	17	14	14

Opportunities for Bank Support

Zambia faces several challenges linked to its reliance on the copper sector and agricultural output where price and weather volatility have adverse knock-on effects on its growth and export earnings. This is denting the government's quality of economic management, impacting it ability to service its foreign debt and further weakening the kwacha. As a result, the economy has become increasingly dependent on private financial inflows. The Bank could support Zambia with a Programme that incorporates several components (i) CENDEP and COTRALF—to ensure sufficient external liquidity to finance essential imports within a context of falling external reserves; (ii) FECONTRAF—in view of Zambia's vulnerability to weather induced food emergencies – this product can be put to good use as a financial substitute for physical grain reserves; (iii) ADVISORY—on government bonds in view of plans to restructure their bonds to achieve lower costs and longer maturities.

The Bank could also support Zambia in developing its potential in the energy, manufacturing, agriculture and tourism sectors. According to the government Development Agency, Zambia received investment pledges of US$2.77 billion in the nine months through September 2018, up from US$765 million a year earlier. This support will also help diversify Zambia's sources of growth and make it less vulnerable to exogenous shocks.

Table 1. Zambia: Selected Macroeconomic and Financial Indicators

	2014	2015	2016	2017	2018(f)	2019(f)	2020(f)	2021(f)	2022(f)
Real GDP, %	**4.7**	**2.9**	**3.4**	**4.0**	**3.3**	4.3	**4.5**	**4.5**	**4.5**
Inflation, %, Annual average	**7.8**	**10.1**	**17.9**	**6.8**	**7.4**	8.0	**8.0**	**8.0**	**8.0**
Revenue, ex-grants, % GDP	**18.9**	**18.8**	**18.2**	**17.3**	**18.4**	18.4	**18.9**	**19.4**	**19.6**
Current Account (% of GDP)	**2.8**	**-3.5**	**-4.2**	**-3.4**	**-2.6**	-1.2	**0.2**	**0.1**	**-0.2**
Total Reserves (US$ billion)	3.08	2.98	2.37	2.18	2.63	2.99	3.23	3.71	4.3
Gross Reserves (months of imports)	**4.2**	**4.5**	**3.1**	**2.5**	**2.8**	3.1	**3.0**	**3.2**	**3.3**

Sources: World Bank, IMF

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