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## ZAMBIA: Political pay-offs limit economic pragmatism

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### Abstract (summary)

The Bank of Zambia announced yesterday that it would increase the overnight lending rate for commercial banks to 10.0% (from 6.0%).

Despite robust GDP growth forecasts, the economy features weaknesses that will probably temper its medium-term growth prospects. Its relative lack of sectoral diversification leaves the country exposed to variable global copper prices, which are on a downward trend. Meanwhile, populist pressure continues to exert state influence on the mining sector, such as heightened taxes. Current rising inflation, exacerbated by the currency devaluation, is also raising the chances that the Central Bank will further increase borrowing costs. The scope for pragmatic policy-making is likely to narrow: factionalism within the ruling party is mounting ahead of the 2016 general election.

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### Full Text

**EVENT:**The Bank of Zambia announced yesterday that it would increase the overnight lending rate for commercial banks to 10.0% (from 6.0%).

**SIGNIFICANCE:**Despite robust GDP growth forecasts, the economy features weaknesses that will probably temper its medium-term growth prospects. Its relative lack of sectoral diversification leaves the country exposed to variable global copper prices, which are on a downward trend. Meanwhile, populist pressure continues to exert state influence on the mining sector, such as heightened taxes. Current rising inflation, exacerbated by the currency devaluation, is also raising the chances that the Central Bank will further increase borrowing costs. The scope for pragmatic policy-making is likely to narrow: factionalism within the ruling party is mounting ahead of the 2016 general election.

**ANALYSIS: Impacts.**

Robust GDP growth is unlikely to alter Zambia's high unemployment rate (15%) given the poorly diversified economy.

Food price inflation (7.6% year-on-year in April 2014) will undermine household incomes, exacerbating the 60.5% poverty rate.

Without significant investments in social infrastructure, improvements to water and sanitation access will be limited.

With two years to go until elections, Sata's PF faces mounting opposition:

*Grand Coalition.* Frustrated with the slow pace of constitutional reform, the newly-formed 'Grand Coalition' brings together 16 political parties, non-governmental organisations (NGOs) and church organisations, including the influential Catholic Church. It is pushing for a new constitution before 2016. Though the chances of success appear remote, so far this movement is uniting a usually fractured opposition ( *see ZAMBIA: Wrangling over constitution damages government - November 27, 2013*).

*Bemba chieftaincy.* Sata is embroiled in a personal dispute with the powerful Bemba chieftaincy over the his refusal to recognise the new paramount chief. The stand-off provoked Sata's strong ally, Geoffrey Mwamba, to resign as defence minister. This places PF at an electoral disadvantage in an area that it must retain in 2016 to stand any chance of re-election, exacerbated by the gradual erosion of urban support revealed in by-election losses in Lusaka and Copperbelt provinces.

PF's prospects for the elections are likely to weaken further by factionalism within the party on whether Sata step down owing to health concerns, which may happen before the end of the year (*see ZAMBIA: Ruling party woes cloud 2014 policy outlook - October 23, 2013*). One faction is led by Finance Minister Alexander Chikwanda, with strong support in the tribes of the north; the other by Justice Minister Wynter Kabimba with strong support from the tabloid Post newspaper. Indeed, Sata's health appears to be deteriorating; his rare but choreographed public appearances reveal a frail figure.

### **Economic context.**

However, Zambia's economic growth looks robust, supported by a favourable performance in mining production and strong infrastructure spending, especially on energy and transport. However, it will likely be undercut by other factors:

*Growth.* The government projects that real GDP will grow up to 7.0% in 2014. This is more optimistic than 2013's 6.0%.

*Inflation.* After relative stability last year, inflationary fears have resurfaced after the annualised rate reached 7.8% in May -- 1.2% over the government's 6.5% target for 2014. Zambia has consistently failed to achieve its annual inflation targets. The latest inflationary pressures have been fuelled by last year's public wage hike, in which salaries rose by more than 50%.

*Currency depreciation.* Inflationary pressure has been exacerbated by the sharp depreciation of the kwacha, which has lost 30% in value against the US dollar over the last 12 months. The Central Bank has responded by raising the overnight lending facility rate (OLF), restricting automatic access to OLF and revoking exchange controls (in a bid to reassure investors).

### **Fiscal outlook.**

The government is currently targeting a fiscal deficit of 6.6% of GDP for 2014. This is lower than the 8.5% deficit in 2013, which eventually exceeded the initial 4.3% target, despite the removal of subsidies on maize and fuel (worth more than one billion dollars annually) ( *see ZAMBIA: Government bets on new taxes to raise revenues - February 7, 2008*).

The Sata administration now plans to limit the fiscal deficit through a combination of pay and recruitment freezes, widening the tax base and additional domestic and foreign borrowing. It secured a one billion dollar eurobond in April 2014 and borrowed around 250 million dollars in a syndicated loan from commercial banks. Notably, these deficit targets were set before the recent GDP re-base, which now estimates the economy to be 25% larger. This may give the government some flexibility as it seeks to live within its means.

#### *Expansionary pressures.*

The government's plan to limit the fiscal deficit is likely to be compromised by upward spending pressures from important political constituencies:

If current agricultural projections are correct, Zambia is on course to record a large 3.4 million tonne maize harvest. The government will come under pressure to buy up maize in order to support small-scale farmers -- an important PF constituency -- despite commitments to reduce such spending ( *see AFRICA: Growth has only modest effect on smallholders - February 17, 2014*).

The public sector wage bill continues to rise, despite the proposed freeze.

External borrowing costs are also rising and the state's budget plans assume a highly optimistic domestic revenue collection outlook, which may explain support for increasing mining royalties.

#### **Mining sector.**

The government estimates that annual copper production will double from current levels to around 1.5 million tonnes by 2016. However, copper revenue prospects are vulnerable to shifts in global demand and supply ( *see ZAMBIA: High prices will blunt rising copper royalties - August 2, 2006*):

New and expanded mines in Chile, Mongolia and Indonesia are growing global supply and depressing prices.

Moderating GDP growth in China -- Zambia's primary market -- is resulting in declining demand.

On the policy side, while the PF has resisted public demands for increased state ownership and the reintroduction of windfall taxation, it imposed a 10% export tax on unprocessed minerals. This has led to increased stockpiling of unprocessed copper concentrates due to limited domestic refinery capacity.

Renewed public pressure to revise the mining taxation revenue has followed recent allegations that Konkola Copper Mines may be under-declaring profits. This has triggered an audit by the revenue authorities, as well public suggestions from the mining ministry that royalties may have to be increased from 6.0% to 10.0% in the next budget.

**CONCLUSION:** Support for the ruling Patriotic Front (PF) is likely to come under pressure during the run-up to the 2016 national election: it is losing support in key constituencies, while experiencing internal instability regarding who might replace the ailing President Michael Sata. Strong GDP growth will continue in the short term and is unlikely to be affected by government plans for fiscal consolidation -- which will face resistance given the current political cycle.

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