CREDIT RATING AGENCY LIMITED

2015 Economic Review and Outlook

CRA is licensed by the Securities and Exchange Commission of Zambia as an authorised provider of credit rating services.

Introduction

2015 will be remembered as a turbulent year economically for Zambia. It was a year characterized by shocks to economic sectors that resulted in significant deterioration in economic metrics and ultimately living conditions of Zambians. This review recounts the developments in the economic sectors and examines the underlying factors and policy implications going forward. Due consideration is made to distinguish external from internal factors and how both weigh-in on policy.

Economic Growth and Output

Zambia's economic growth slowed down significantly in 2015. After posting real growth in Gross Development Product (GDP) averaging 6.4% in the period 2010 to 2014, consistently higher than the average growth for Sub-Saharan Africa, Zambia's economic growth in 2015 is expected to slow down to below 4%. Most industry analysts are agreed on the 2015 projection, with the World Bank's 6th Economic Brief on Zambia, released in December 2015, projecting 2015 growth at between 3 to 3.5%. The reduced growth in 2015 will not only be the lowest for Zambia since 1998, but also the lowest relative to Sub –Saharan Africa during the same period. According to World Bank projections, Sub-Saharan Africa's economic growth will continue to slow in 2015 to 3.7% from 4.6% in 2014. What has caused Zambia's growth to deteriorate disproportionally more than Sub-Saharan Africa? The cause is due to both external and domestic factors.

External Factors:

Zambia is over dependent on commodity exports with copper accounting for 77% of all exports. This renders the economy vulnerable to the external demand and pricing of copper. Most of Sub-Sharan African countries are commodity dependent, albeit to a lesser extent than Zambia. The World Bank's *Africa Pulse* published in October 2015 highlights that continued dependency on oil and commodity exports has left the Sub-Saharan Africa (SSA) region vulnerable to periodic shocks from the prices of international commodities. The region remains a net exporter of oil, minerals, and agricultural commodities. Specifically, energy (oil and gas) and minerals comprise two-thirds of SSA's exports. In August 2015, oil prices reached their lowest level since the end of the financial crisis. Similarly, copper prices fell to their lowest level since August 2009. The slowdown and economic transition in China has been a driver of weakening international commodity prices. China is SSA's largest trading partner and its slowdown and economic transition has direct spillover effects, especially to the oil-exporting and mineral-rich SSA countries such as Angola, Democratic Republic of the Congo, Mauritania, Republic of Congo, Sierra Leone, the Gambia and Zambia. **However, the Gambia, and Zambia have been the most affected given that 40% of their exports go to China**. Central Africa Republic, Eritrea, Mali, South Africa, and Zimbabwe have also been affected as their exports to China are above 20% of total exports. Consequently, the growth of SSA is expected to slow to 3.7% in 2015 on the back of poor growth performance in the oil-exporting and mineral-rich economies.

The World Bank report notes that nevertheless, in the majority of oil-importing countries, particularly those that are non-mineral rich, growth is expected to remain robust. Notable examples include Coted'Ivoire, Ethiopia, Mozambique, Rwanda, and Tanzania, where growth will not only be driven by low oil costs, but also by government investment in infrastructure, and an expanding services sector.

The reduced copper prices in 2015 have caused mines in Zambia to scale down operations. The copper price has fallen from an average of US$6,829 per tonne in 2014 to US$5,030 per tonne in 2015, with the downward trend (record low of $4,672 on 23 December 2015) making it economically unviable for some mines to operate. Output is expected to reduce by 15% from 708,000 metric tonnes in 2014 to 600,000 metric tonnes in 2015.

Domestic Factors:

The dominant domestic factors in 2015 that constrained output were the power generation deficits and poor agricultural yields due to low rainfall.

For over 40 years, Zambia has not had any major investment in power generation. Total generation capacity has stood at 2,200 megawatts while demand is in the range of 1,750 to 1,950 megawatts. Actual power output in 2015 fell significantly below the installed capacity due to low water levels in Kariba Dam, which is Zambia's main source of power at 1,080 megawatts. By August 2015, the low water levels resulted into a national power deficit of about 663 megawatts. In September 2015, ZESCO entered into contracts with Southern African Power Pool (SAPP) utilities and emergency power suppliers for about 172 megawatts. For the period September to December 2015, the deficit has accordingly been reduced to about 591 megawatts or 34% of demand. Accordingly, load shedding for commercial and residential users, typically averages eight hours a day (out of 24hrs). In November 2015 electricity tariffs were increased by as much as 200% from K0.51 per kilowatt hour to K1.54 for some domestic users and the knock-on effect on the cost of living and productivity is yet to be fully felt.

In response to the power deficit, a number of public and private power projects have been initiated. The medium-term measures being taken by Government include rehabilitating old power stations, such as Kafue Gorge (900 to 990 megawatts), Victoria Falls (108 to 180 megawatts) and the Kariba North Bank (600 to 720 megawatts). On 28 November 2015, President Lungu commissioned the construction works for the *Kafue Gorge Lower Hydro power plant*, which upon completion will generate 750 megawatts of electricity. Government through the Industrial Development Corporation is implementing a solar energy projects that will add 600 Megawatts in the medium to long term to the National grid. Government will by mid-2016 also commission the coal power station at Maamba Collieries and the Itezhi-Tezhi hydro power station. The two projects will generate 420 megawatts to the national grid.

Poor rainfall in the 2014/2015 season did not only affect power generation; the agriculture sector was equally not spared. The 2014 -15 agricultural (October-March) season was characterized by below-average rainfall resulting in reduced agricultural production for 2015 and increased food prices. Low rainfall has harmed the agricultural incomes of 62% of the population living in poverty (less than $1.99 per day). The recent drier weather has been largely attributed to the El Niño, which has been active since March 2015 and expected to last into the first quarter of 2016.

<u>Employment</u>

The last release of the unemployment rate for Zambia was by the World Bank which estimated it at 13.3% for 2013. The vast majority of Zambia's work force is in informal employment with the latest Labour Force Survey conducted by the Central Statistical Office (CSO) putting it at 89% in 2008.

While latest employment statistics on Zambia are not available, it is seemingly obvious that formal employment decreased in 2015. Outside Government, the largest employer, the mining sector has been scaling down operations and delaying new investments, due to low global copper prices and the high-cost environment. Substantial job losses have been reported from the major mining companies. It was reported in April 2015 that Lubambe Copper Mine (LCM) had terminated the contract of Murray and Roberts Zambia resulting in the loss of 500 jobs. In August 2015, 1,480 construction jobs were lost at First Quantum Mines owned Kalumbila Mines at its Trident project. Mopani Copper Mines announced in September 2015 the suspension of copper production for 18 months, resulting in about 4,300 direct job losses. The same month, Baluba Mine in Luanshya was put on care and maintenance causing 1,600 employees to be sent on forced leave. In November, 2015, Konkola Mines suspended operations at Nchanga underground mine with a total of 2,503 contract workers to be laid off in the ensuing months. In December 2015, Chibuluma mines announced it would be retrenching 263 workers as part of its restructuring. Total estimated job losses in the mining sector in 2015 are at about 10,700 jobs. According to Bloomberg News, it is estimated that the Zambian Copper Mining Industry provides 62,236 jobs, about half of whom are contract workers. As a conservative estimate, about 17% of the mining labour force could have lost their jobs in 2015.

Inflation Rate

The Central Statistical Office has recorded the annual year-end inflation for 2015 at 21.1%. This is a sharp increase from the 2014 inflation figure of 7.9% and the consistent single digit inflation recorded since 2008.

The 2015 inflation rate is attributable to food inflation at 24.8% and non-food inflation at 17.1%. For food inflation, the main drivers were price increases in maize grain (34.54%), cooking oil (47.27%), dried beans (48.52%), eggs (33.33%) and frozen chicken (25.94%). For non-food inflation the main drivers were the Furnishings, Household Equipment, Routine Household and Maintenance category (27.9 %) followed by the Recreation and Culture category (26.2%). Notable non-food increases were the prices for a Toyota Corolla (70.53%), Lifebouy soap (41.74%) and hammer mill charge (20.23%). The most notable price reduction in the basket was a 50kg bag of cement which reduced by 18.49%.

Exchange Rate

The Zambian Kwacha depreciated from K6.39 to US$1.00 at 31 December 2014 to K10.98 to US$1.00 at close of business on 31 December 2015, representing 71.82% depreciation. At its worst level on 10 November 2015 the Kwacha traded at K14.41 to US$1.00

Industry analyst Bloomberg News reported in September 2015 that the Kwacha was the world's worst performing currency in 2015. The reasons for this are akin to the reasons advanced above for the slower growth in GDP compared to other Sub-Saharan Countries, thereby widening the deficit on the balance of payments (trade and capital accounts, below). In addition speculative pressure on the Kwacha in the second half of 2015 exacerbated the depreciation.

Balance of Payments

Information from the Central Statistical Office (CSO) shows that the trade balance is expected to swing from positive in 2014 to negative in 2015. In 2014 the trade surplus for the year reported by CSO was K0.9 billion. Meanwhile, the CSO December 2015 bulletin recorded a cumulative trade deficit of K12.4 billion for the 11 months period January to November 2015. The projected trade deficit in 2015 is due to reduced exports and increased import costs. As explained above, copper exports reduced in terms of both volume and price. By end of September 2015 copper exports were valued at US$4.1 billion, compared to US$5.7 billion for the same period the previous year, representing a decline of about 28%. Non-traditional exports too in 2015 show a declining trend of about 30%. Meanwhile, the cost of merchandise imports in 2015 is expected to increase by about 23% largely due to the depreciation of the Kwacha.

Information on the capital account is less clear. According to the Zambia Development Agency, there has been a downward trend since 2013. Foreign private capital flows in 2013 were $2.4 billion and in 2014 declined by 17.2% to $2 billion. Of the 2014 figure, 72.7% comprised Foreign Direct Investment (FDI). 2015 figures remain unreported, but indications are that they are lower than 2014. The ZDA observed in July 2015 that investment pledges for the first half of 2015 were $1.1 billion compared to $3.6 billion for the same period in 2014. Mining sector FDI ostensibly scaled down in 2015 due to the lower global copper price. The ZDA further reported in December 2015 that, from experience, it expected low investor flows in 2016 because of the scheduled presidential elections.

The World Bank notes that weakening oil and mineral prices have propagated a deterioration of the terms of trade of oil-exporting and mineral-rich economies. This has led to weakened current account positions for most of these economies such as Nigeria and Zambia.

Corruption Perception Index

Corruption is specifically included in this commentary because it is an inhibitor of economic performance. The author, being a rating agency, score corruption when evaluating the economy of a country and arriving at a sovereign rating. Perceptions of corruption not only affect FDI flows but also domestic economic activity including government revenue collection.

Transparency International notes that despite several steps taken by the Government in order to fight corruption in Zambia, there has not been a dramatic improvement in the public perception of anti-corruption efforts over the past years. Corruption still remains pervasive in the country yet the situation is considered relatively better when compared to other countries in the region.

Out of 174 countries tracked the 2014, the Corruption Perception Index released in early December 2015, placed Zambia at 85 with 34 points. In 2013 Zambia ranked 83 out of 175 countries tracked with still 34 points.

Fiscal Performance

In the year 2015, fiscal pressures were manifest on both revenue and expenditure. Total revenue and grants as a percentage of GDP is projected to reduce to 17.8% from 19.3% in 2014. Most significant reduction is the tax revenue (15.8% to 13.8%). Conversely, fiscal expenditure is expected to increase from 24.8% to 25.8% of GDP. Main expenditure drivers are capital projects (5.4% to 6.0%) and external debt financing (2.9% to 6.6%). The fiscal deficit in 2015 is expected to increase from the budgeted 4.6% to 8.0% of GDP.

Zambia's greatest challenge to revenue in 2015 was the mining tax impasse between Government and mining companies. The 2015 fiscal budget had upped mineral royalty taxes to 20% and 12% for open cast and underground mines, respectively, from six percent in 2014 much to the discontent of the mining companies. Sustained representations culminated in Government on 20 April 2015 reducing mineral royalty taxes to nine percent and six percent for open cast and underground mines, respectively. Consequently, the reduced tax rates, compounded with the low copper output and price, resulted in the treasury foregoing K2.3 billion in expected revenue.

The World Bank in its 6th Economic Brief on Zambia, notes that in 2015 commodity dependent countries such as Angola, Nigeria, and Zambia, where oil and mineral exports contribute to part of the government revenue, the fiscal deficit has widened. However, in other cases, fiscal imbalances have been worsened by recurring domestic factors, among others, which include rising wage bills, large expenditure on infrastructure and high expenditure on subsides. In countries such as Ghana and Zambia, these fiscal deficits have been financed by borrowing in the international debt markets, resulting in substantial increases in the debt to GDP ratios.

Public Debt

In June 2015 the Honourable Minister of Finance, Mr. Alexander Chikwanda, reported to Parliament that total public debt stood at 32.7% of GDP. This was composed of external debt of $US4.8 billion or 18.5% of GDP and domestic debt at K20.5 billion or 14.2% of GDP. Government's benchmark is to limit debt to internationally accepted standard of 40% of GDP.

The International Monetary Fund's (IMF) Article IV Report completed on 5th May 2015 had projected the 2015 year-end public debt at 39.6% of GDP, comprising external debt at 25.3% and domestic debt at 14.3%. As an appendage to the Article IV report, the IMF had conducted a Debt Sustainability Analysis (DSA) dated 5 May 2015. The analysis noted the steep increase in total public debt from 25.5% of GDP in 2012 but concluded that the level was overall sustainable, albeit the debt service-to-revenue ratio breaching the threshold under a number of shock scenarios. The analysis accordingly underscored the need for an improved fiscal position. It noted "sound macroeconomic policies, strong debt management, greater diversification of the export base, and improved project appraisal are needed to maintain debt sustainability in the face of a projected rise in non-concessional borrowing and potential external shocks".

Post June 2015, more foreign and domestic debt has been contracted . A $1.25billion Eurobond was issued by Government in July 2015, to bring the total of three Eurobonds issued to date to $3 billion ($0.75 billion in 2012 and $1.0 billion in 2014). Additional contractions of loans from China and Europe have been reported in the media in the region of $400million. In his Budget address to Parliament on 9 October 2015, the Honourable Minister of

Finance, reported that the latest Eurobond issue brought Government's external debt up to US$6.3 billion as at end of August 2015. Domestic debt, meanwhile, stood at K26.5 billion as at the end of September 2015. Furthermore, CRA notes that the Kwacha depreciated from K7.4 to US$ as at the time of the IMF's DSA to K11.0 to the US$ at 31 December 2015. The drastic depreciation ostensibly represents a "shock" to the DSA. This, together with the increased loan position at the 31 December 2015, is likely to result in the public debt to GDP ratio having significantly exceeded the 40% threshold.

Monetary Developments and Interest Rates

The central bank in 2015 grappled with the daunting task of containing inflationary pressures. Pressure on the value of the Kwacha emanated from both the private sector, via weakened balance of payments, and Government's expansionary fiscal spending. Monetary policy was, therefore, contractionary - seeking to tighten liquidity and arrest the depreciation of Kwacha. Pursuant to this the Bank of Zambia raised the statutory reserve ratio from 14% to 18% in March 2015 but maintained the policy rate constant at 12.5% until November 2015 when it was increased to 15.5% mainly on account of inflation that had increased to 14.5%. BoZ also introduced stringent regulations in the foreign currency market in November 2015 to abate speculative dealings. By and large, the central bank measures managed to hold the exchange rate at between K10.80 to K11 by third week of November to the end of 2015. Reinforcing this too was the boost in market confidence following the press conference on the economy by His Excellency the Republican President on 26 November 2015.

Following the central bank hikes in statutory reserve ratio and policy rates, general market interest rates increased in 2015. Commercial bank lending rates increased from around 22 to 25% to between 25% and 28%. Lending rates of microfinance institutions continued to be higher. The higher interest rates have been a deterrent to borrowers and, moreover, consequent to central bank measures, commercial bank liquidity has been tight to facilitate credit expansion.

Income Distribution

The last measure of income inequality was the 2010 Living Conditions Monitoring Survey (LCMS), released in March 2012 by the Central Statistical Office (CSO). The 2015 LCMS is expected to be released in 2016. The 2010 LCMS showed that income distribution had worsened in Zambia with the Gini Coefficient, increasing to 0.65 in 2010 from 0.60 in 2006. In 2010, the top 20 percent in terms of earnings accounted for 69.7 percent of the per capita income, while the bottom 50 percent had only 9.1 percent of the per capita income. In 2006, the top 20 percent amassed 68.7 percent of the per capita income, whereas the bottom 50 percent accounted for 7.8 percent of the income (Central Statistical Office, 2012).

The World Bank in its 6th Economic Brief on Zambia, released in December 2015, estimates Zambia's Gini Coefficient at 57.5 and notes that Zambia has one of the most unequal distributions of income in Sub Saharan Africa. The report further notes that many of the gainful economic activities in the country are concentrated primarily along the rail line in the highly urbanized Copperbelt and Lusaka regions. The rest of the country is fairly underdeveloped, and its labor depends primarily on subsistence agriculture.

It is apparent, therefore, that income distribution remains an important issue to Government policy going forward.

The Way Forward

2015 marked the close of the Sixth National Development Plan (SNDP) 2011–2015, aimed at actualising the aspirations of the Vision 2030 of becoming "a prosperous middle-income nation by 2030". By and large, 2015 was a tough year and the least performing under the SNDP. Government is aiming for GDP growth of 5% in its 2016 budget. This is much lower than the initial 7% projected in 2015 and represents a strong acknowledgement of the hard times confronting the nation. Economic headwinds and domestic pressures are generally expected to remain strong in 2016. At the foundation of macroeconomic instability are the twin deficits of 2015 – balance of payments and fiscal.

In the medium to long term, Zambia's economic future remains bright with the greatest potential for sustainable economic recovery lying with the private sector. Zambia's vast resource endowments still present viable investment opportunities in mining and quarrying, agriculture, manufacturing, tourism, infrastructure and energy. Key in 2016 and beyond shall be the ability of Government to leverage on these opportunities through private sector investment and Public Private Partnerships (PPPs). Government's role shall continue to be the provision of an investor friendly environment that boosts confidence through policy consistency, export diversification/promotion, reduced bureaucracy and reduced corruption, inter-alia. Noteworthy are efforts to promote non-traditional exports and incentives for investment in the energy sector. Government's overarching role should be operationalised through the Ministry of Commerce and appropriate performance metrics set and monitored at the highest level. The quasi-Government organs, such as the Zambia Development Agency, the Industrial Development Corporation and the Development Bank of Zambia should all feed into this mechanism. The private sector holds the greatest promise for sustainable economic recovery and can overtime reverse the balance of payments and fiscal deficits, while sparing the use of public funds.

However, private sector development even if embarked on vigorously in 2016 will take time to bear fruit. Effects are likely to be significantly felt in the early part of 2017. For 2016 the strongest influences on economic performance are likely to be:

(i) Low global copper price:
This will continue to have an adverse effect on GDP, the fiscal budget, the balance of payments and strength of the Kwacha.

(ii) The power deficit:
2016 will continue to endure a power deficit that will primarily impact GDP and the fiscal budget.

(iii) Market anxiety due to the 2016 Presidential elections:
From experience, this has inhibited private capital flows, including FDI, into Zambia. Low capital flows will have immediate impact on the balance of payments and strength of the Kwacha.

(iv) Below average rainfall and crop harvests:

The El Niño expected to last into the first quarter of 2016 will primarily impact GDP, food inflation and maize exports.

The fiscal space is expected to remain very tight in 2016. The 2016 fiscal budget will grapple with diminished tax revenue prospects due to the constrained copper industry and other influences highlighted above. The expenditure side will deal with pressures from the unions for increased civil servants wages following expiry of the wage freeze in 2015, and considerably expanded debt servicing costs due to additional contracted loans and the depreciation of the Kwacha.

Government is resolved to institute austerity measures in its fiscal management. The 2016 Budget, with its theme of *"Fiscal Consolidation to Safeguard our Past Achievements and Secure a Prosperous Future for All",* amply underscores this. Capital spending should be scrutinized for economic viability and elimination of excesses through by the Zambia Public Procurement Authority. Some capital projects not yet started should be postponed into 2017 when fortunes are projected to improve. Some recurrent expenditure items will, however, not be easy to cut back on. Other than the contracted personnel emoluments and debt servicing costs, energy subsidies on fuel and electricity present a dilemma. Government needs to strike a balance between reducing fiscal expenditure and mitigating the cost of living for an already strained population.

The year 2016 will require strong coordination between fiscal and monetary policy. The latter will continue to be contractionary and market interest rates will most likely remain high. It will be imperative for both the Ministry of Finance and the central bank to maintain confidence through their policy pronouncements and actions.

All in all, 2016 is unlikely to be much easier year than 2015. The best prospects are for stability rather than overall economic recovery. The latter may start taking root in the last quarter of 2016 after the presidential elections. CRA, however, is confident that Zambia will weather the storm. But the constraints of low copper price, energy deficits, election fever and rainfall will inhibit economic growth to between 3.5 to 4% in 2016 before returning to above 5% growth in 2017.

Queries can be emailed to:

info@creditratingagency.net

More information on CRA is available on its corporate website at:

www.creditratingagency.net