

Economics

Zambia: Annual economic outlook

Smooth return to pre-crisis trend growth

February 2010

Yvonne Mhango

Projections for 2010:

- Real GDP growth of 6.0% is expected
- Average annual inflation to fall to 8.3%
- Kwacha to appreciate to an annual average rate of ZMK4 728.4/USD
- Trade balance is projected to moderate to 0.5% of GDP
- Fiscal deficit is expected to decrease to 2.4% of GDP

Recent trends

Production

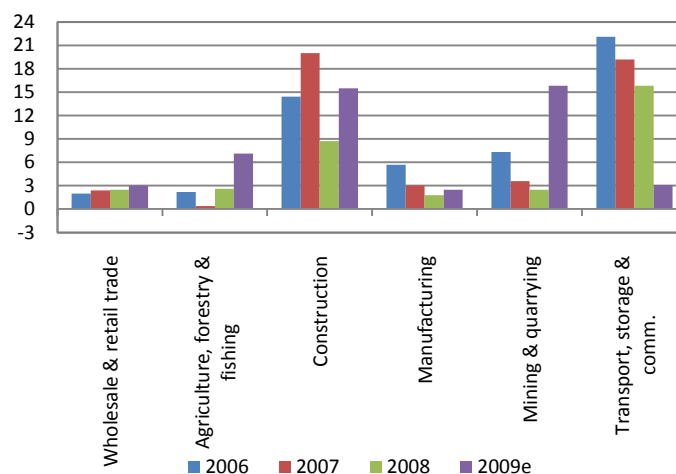
Zambia's economy exhibited greater resilience than expected in 2009, according to the International Monetary Fund's (IMF) preliminary real gross domestic product (GDP) growth estimate of 5.3% compared to 2008 when the economy grew by 5.7%. Zambia's Central Statistical Office's growth estimate for 2009 is actually one percentage higher than that of the IMF at 6.3%, implying economic activity strengthened in 2009 compared to 2008. Given the closure of some mines and supporting businesses, the decline of the transport, storage and communications sector and the sluggishness in the services sector, we are of the view that economic growth slowed in 2009, compared to 2008. Subdued activity in the tertiary sector was offset by the strong performances of the primary and secondary sectors. This buoyancy is largely attributed to an increase in mining production, a sound improvement in agricultural output and a pickup in construction activity. According to the IMF, copper production reached a three-decade high in 2009, and the agricultural harvest was the highest recorded in 10 years.

The mining and quarrying sector is estimated to have grown by a remarkable 15.8% in 2009, following a three-year slowdown in growth to 2.5% in 2008, on the back of a significant increase in copper and cobalt production. Copper output increased by 18.7% y/y to 636 528 metric tonnes in the year to November 2009 owing to the start of production at Equinox Mineral's Lumwana Copper Mine, and higher

output at the Konkola Copper Mines, which is owned by Vendanta Resources and First Quantum Minerals. The production of cobalt was also boosted by the resumption of production at Chambishi Metals, Zambia's largest cobalt smelter, and the commencement of operations at Baluba Mine. As a result, cobalt production increased by a significant 26% y/y in the 12 months to November 2009. These increases in production offset the impact of the closure of mines in early 2009.

Preliminary estimates suggest that Zambia's construction sector posted a recovery in 2009 when it grew by 15.5%, following its sharp slowdown in 2008 to 8.7% from a notable 20% in 2007. The construction sector was one of Zambia's fastest-growing sectors during the first decade of this millennium. The expansion of the construction industry partly reflects the scaling up of public spending on infrastructure projects, particularly following the cancellation of Zambia's public external debt in 2005. The creation of fiscal space, by debt relief, manifested in the building of infrastructure, including power stations, to ease the electricity shortage, and transport infrastructure, particularly roads, rail and bridges. Construction in the mining industry also contributed to the growth of the secondary economic sector.

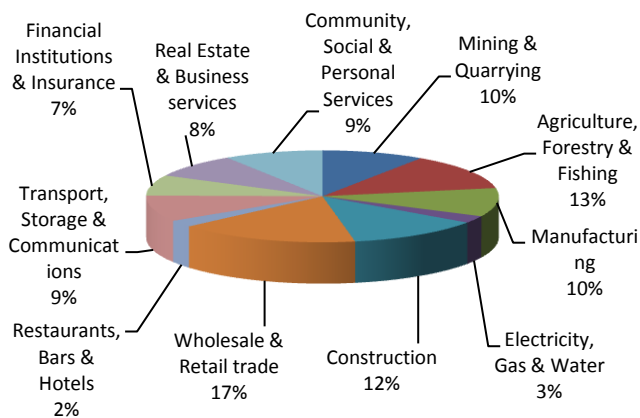
Figure 1: Real growth of largest sectors (%)



Source: Central Statistical Office, Zambia

The country's second-largest economic sector, agriculture, forestry and fishing, which is detached from dynamics of the global economy, partly cushioned the Zambian economy from the worst of the global recession. The sector's strong growth of 7.1% in 2009 was largely due to the agriculture sub-sector, which grew by an exceptional 12.4%. The agriculture sector's strong performance in 2009 is a significant improvement from that of 2007, when it contracted by 2.7%, and 2008 when it grew by a modest 1.9%. Good rains largely explain the stellar expansion of the agriculture sector in 2009.

Figure 2: Gross domestic product by activity (2009 estimates)



Source: Central Statistical Office, Zambia

The worst performer of the economic sectors in 2009 was restaurants, bars and hotels. As the second-smallest economic sector, it is estimated to have contracted by a considerable 14.5% in 2009. Although Zambia is not a significant market in the southern Africa region for international tourists, it is an important destination for business travellers. The collapse in the commodities market, which adversely affected Zambia's mining industry, and the global credit crunch led to a decline in foreign direct investment (FDI). As a significant share of Zambia's business travellers is involved in the mining industry, the slowdown in the global mining industry moderated businesspersons' traffic in 2009, thus negatively impacting the country's small hospitality industry.

The economic sectors that exhibited slower growth than total GDP growth in 2009 were wholesale and retail trade; manufacturing; transport, storage and communications; real estate and business services; and financial institutions and insurance. However, while most of these sectors showed trend growth in 2009, one sector, transport, storage and communications, underperformed compared to its levels of activity in previous years.

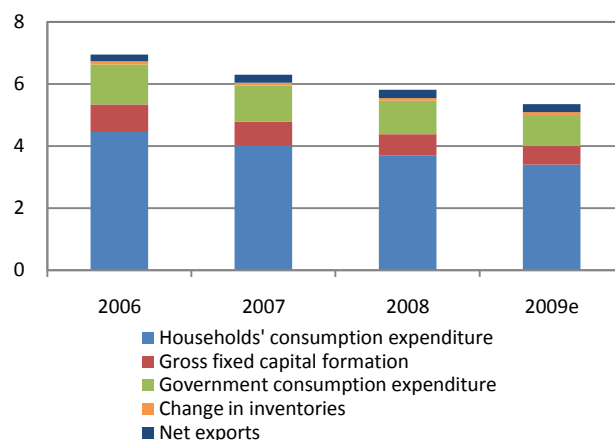
The transport, storage and communications sector stalled in 2009 when it grew by a modest 3.1% following four consecutive years of double-digit growth that averaged 17%. The halt in growth of the sector is attributed to massive contractions in rail transport and air transport by 31.2% and 29.0%, respectively. The collapse in rail and air transport reflects the slowdown in international trade and business travel due to the global recession.

Only the road transport and communications constituent of the transport, storage and communications sector posted positive growth in 2009. Road transport, which conveys most of Zambia's freight, sustained its 2008 momentum in 2009 when it grew by 13.3%. Economic growth in one of Africa's fastest-growing sectors, the communications sub-sector, slowed for a third consecutive year to 12%, from an annual average of 29.6%. The exceptionally high growth of recent years (40.5% in 2006) reflects the initial growth period of the mobile phone industry. The slowdown of the industry in 2009 was largely due to the maturing and stabilisation of the communications, sub-sector as average revenue per subscriber declined, and was less attributable to the global economic recession.

Domestic expenditure

Domestic expenditure is estimated to have slowed in 2009 on the back of a moderation in spending by private households, which spend six out of every 10 units of currency spent in the Zambian economy. However, a strong food harvest in 2009 softened the impact of the loss of wages in affected households. Gross fixed capital formation slowed as some foreign investment programmes were put on ice; however, the slowdown was mitigated by an increase in fixed investment by the public sector. Our estimates show that fixed investment's contribution to GDP decreased slightly in 2009 as a result of the slowdown in investment activity. This decline was countered by an increase in government consumption expenditure, which exhibited the strongest growth in 2009.

Figure 3: GDP growth by type of expenditure (%)



Sources: Standard Bank, IMF

Layoffs in the mining industry, particularly those that ceased production in the first half of 2009, and a tightening in lending placed a damper on households' consumption expenditure in 2009. The fact that fiscal revenue from excise duty, which is a tax on the production or sale of goods, came in 40% below target in 2009 reflects a sharp decline in retail sales and is testimony to the weakening of households' consumption expenditure. The slowdown in credit extension due to a global credit crunch is expected to have had a limited impact on households' spending because of the very low households' debt to GDP ratio of 1.5%. On the other hand, the bumper harvest contained

food prices and provided households the room to spend on non-food items, which was supportive of the country's retail base and domestic spending, particularly during a global recession.

Although the Zambian economy is estimated to have attracted US\$1.4-1.5 billion of FDI in 2009, according to the governor of the Bank of Zambia, Caleb Fundanga, this was a moderation from levels of previous years, particularly during the commodity boom. Gross fixed capital formation was subdued by the global credit crunch and demand slump, which reduced the attractiveness of investment in the mining industry. However, the stepping up of fixed investment by the government, particularly for infrastructure projects, dulled the impact of slower private fixed investment.

The positive net exports balance (equivalent to the trade balance) is estimated to have narrowed in 2009 largely because of a contraction of the import bill, as aggregate demand responded to the change in relative prices that was associated with the sharp depreciation of the exchange rate earlier in the year. Overall, it was government spending and the lift that a bumper agricultural harvest provided for private households' spending that supported domestic expenditure in 2009.

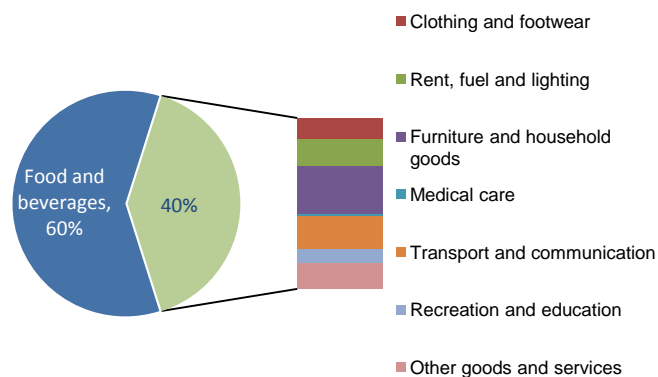
Monetary policy

Tight monetary policy conditions, particularly in the first half of 2009, supported by a bumper harvest enabled the monetary policy authority, the Bank of Zambia, to achieve its objective of bringing inflation down to below 10% in the dusk of 2009, when headline inflation slowed to 9.9% y/y in December. The Bank of Zambia has a reserve money-based monetary programme. When the exogenous factors that influence inflation are stripped out, including food and fuel prices, the remaining 'core' inflation measure is contained by the central bank's control of monetary aggregates' growth rates.

Reserve money, the sum of currency issued by the central bank and commercial banks' deposits, exhibited strong growth in 2009. Reserve money growth accelerated to a monthly average rate of 27.1% y/y in 2009, from 12.1% y/y in 2008. The swell in reserve money was due to a sharp increase in statutory required reserves, particularly of foreign exchange deposits, and a surge in commercial banks' positive current account balances, especially in the second half of 2009. The increase in the growth rate of reserve money, the central bank's operational target, in the second half of 2009 was countered by the disinflationary effect of lower food prices.

Food inflation dropped to 8.0% y/y in December, from 21.3% y/y in January. Conversely, non-food inflation accelerated from 11.2% y/y to 15.1% y/y over the same period. The largest sources of non-food price inflation were furniture and household goods and transport and communication. The price pressures from rent, fuel and lighting, which were strong in 2008, eased in 2009 on the back of a lower international oil price. The strengthening of the kwacha over the course of 2009 also supported a lower inflation rate.

Figure 4: Food's contribution to consumer price inflation in 2009

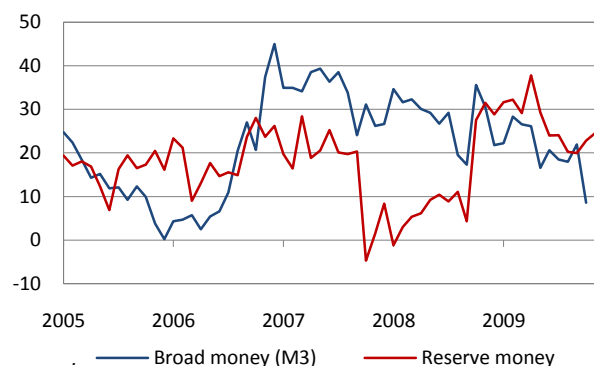


Source: Central Statistical Office

Broad money (M3) is the sum of net domestic and net foreign assets. The significant depreciation of the kwacha, especially in the first half of 2009, implied that there was greater preference for holding foreign assets, so net foreign assets swelled; however, this was at the expense of net domestic assets. The decline in net domestic assets was reflected in a slowdown in growth of its largest constituent, domestic credit.

Contrary to reserve money growth, M3 growth decelerated to a monthly average rate of 20.7% in the first 10 months of 2009, down from 28.2% in 2008. The slowdown in monetary growth in 2009 stemmed from the moderation in economic activity, which was reflected in a significant slowdown in lending, while local currency time and savings deposits and foreign exchange deposits exhibited significant growth. The expansion of longer-term kwacha deposits indicates the market's reluctance to spend and preference to save, owing to the uncertainty in the financial market and slowdown in the real economy. Foreign currency demand and other deposits showed their strongest growth in the first quarter of 2009 when the kwacha depreciated significantly. This expansion led to foreign currency demand and other deposits' contribution to M3 increasing to 38.7% in March 2009, which is the largest it has been in over three years. The sharp fall in the value of the kwacha explains the significant increase in the preference for holding foreign currency.

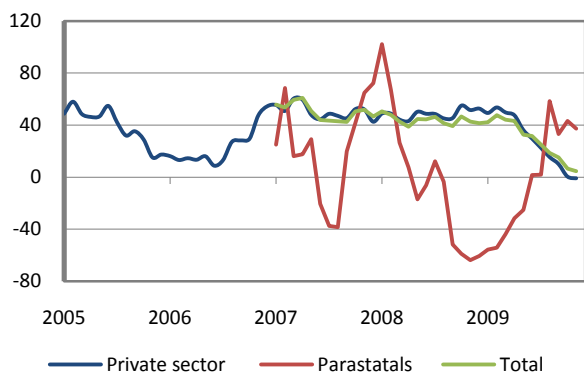
Figure 5: Money supply growth (% y/y)



Source: Bank of Zambia

The aversion to net domestic assets was reflected by the plunge in domestic credit growth to 4.5% y/y in November 2009, from 42.7% y/y 12 months earlier. The deceleration of domestic credit growth in 2009 was due to the decline in private sector credit. The growth rate of credit extended to the private sector, which makes up 90-95% of domestic credit, declined by 1% in the year to December 2009. Conversely, the growth of credit extended to parastatals accelerated in 2009 to 37.2% y/y in November, from a contraction of 63.9% y/y in November 2008. These credit growth rates reveal that as the private sector steered away from kwacha loans, the government began to borrow from commercial banks in mid-2009, following several months of being a net creditor to commercial banks, to counter the slowdown in fiscal revenue collections and suspension of budget support due to governance issues.

Figure 6: Domestic credit growth (% y/y)

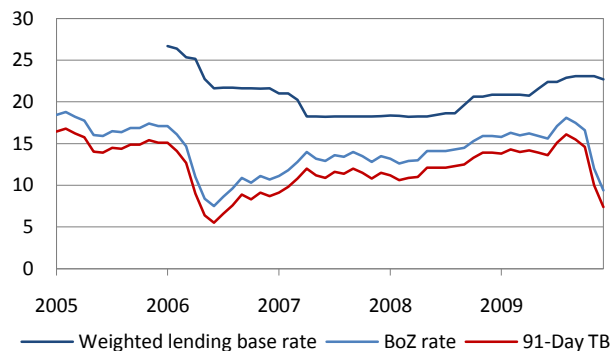


Source: Bank of Zambia

Lending to Zambia's private sector was dampened by the global credit crunch, which compelled domestic commercial banks to tighten their lending requirements, especially as credit quality deteriorated. An increase in non-performing loans in 2009, particularly amongst households and commercial agriculture, also prompted commercial banks to impose more stringent lending requirements. The stepping up of government's domestic borrowing requirement in 2009 also contributed to the crowding out of the private sector. This tightening in lending was reflected by the incline of the weighted lending base rate to 23.1% in September, October and November from 20.9% in January.

Zambia's commercial banks determine their own lending rates without an official reference rate. The increase in the weighted lending base rate to an average of 22.1% in 2009, from 2008's average of 19.1%, reflects the tighter domestic credit environment in 2009. The yields on Treasury bills have in recent years been influenced by foreign interest in government paper. The 91-day Treasury bill yield increased from 13.8% in January to 2009's peak of 16.1% in August on the back of weak appetite for Zambian government paper during the global financial crisis. However, in the period between September and December the yield decreased from 15.2% to 7.0%, as global risk aversion subsided and interest in government paper picked up.

Figure 7: Interest rates (%)



Source: Bank of Zambia

Overall, monetary policy was tight in 2009 as indicated by the slowdown in monetary growth and the increase in the lending rate.

International trade

Global trade bounced back in the second half of 2009, as suggested by the trade figures coming out of China, which showed that it surpassed Germany in the January to October 2009 period to become the world's biggest exporter. Similarly, import growth showed significant improvement when it surged to 55.9% y/y in December, from 26.7% y/y in November. Chinese import growth holds greater significance for exporters around the world as it implies that China's appetite for the rest of the world's goods and services has returned in a big way.

Zambia's biggest export, copper, is mainly employed in highly cyclical industries, including construction and the manufacturing of industrial machinery. As the bulk of the world's largest fiscal stimulus programmes constituted expenditure measures that promoted the stepping up of fiscal spending, particularly on infrastructure development, commodities employed in construction benefitted. The implementation of fiscal stimulus-related infrastructure programmes in the first half of 2009 perked up the demand for commodities such as copper and the onset of a global recovery that emanated mainly from emerging markets further bolstered the revival in demand for copper.

The recovery of the Baltic Dry Index, which tracks the price of shipping raw materials and thus measures the demand for shipping capacity versus the supply of dry bulk carriers, from 774 at the end of 2008 to 3 005 at the end of 2009, is testimony to the revival of the global trade in commodities. The recovery of global trade in 2009 was partly due to the decision G20 leaders made at the London Summit in April 2009 to grease the wheels of trade by providing US\$250 billion of support for trade finance. The rising demand for commodities boosted the international copper price. A 141% increase in the international copper price to US\$7 342 in the 12 months to the end of December 2009, and a remarkable increase in local copper production, largely due to the opening up of the Lumwana copper mine in early 2009, improved Zambia's copper exports and allowed for the return of monthly trade surpluses from June 2009.

Figure 8: Baltic Dry Index (1974=100)



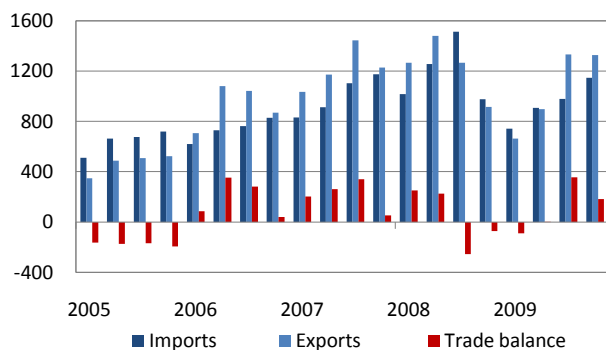
Source: Bloomberg

The improvement in the trade balance from a deficit of 249 202 million Zambian kwacha (approximately US\$50 million) in January 2009 to a surplus of 178 976 million kwacha (approximately US\$38 million) in December was also supported by the lower international oil price that reduced the import bill. The oil price declined by 50%, in annual average terms, in 2009 compared to 2008. The drop in the oil price largely contributed to the 36% decrease in Zambia's monthly import bill in the period January to December 2009.

External sector

Conditions in Zambia's external sector improved considerably in the 12 months to December 2009. The trade deficit reverted to a surplus in mid-2009 on the back of an increase in exports' revenue, which is attributed to both the price and production of copper, and a decrease in the oil import bill owing to a lower international oil price. The return of trade surpluses allowed for the current account deficit to narrow, which was positive for the Zambian kwacha. Preliminary estimates suggest that the trade balance for 2009 surged by a multiple of 17 to about 2.1 billion Zambian kwacha (about US\$414 million) in 2009, from 123 521 million kwacha (US\$33 million) in 2008. This swell in the trade surplus is largely due to the 13.1% increase in exports' revenue in 2009 to 21 031 billion kwacha (US\$4.2 billion) compared to a modest 2.1% increase in the import bill to 18 941 billion kwacha (US\$3.75 billion).

Figure 9: Trade balance (US\$ millions)



Sources: Central Statistics Office, Standard Bank est.

The income account deficit in the country's current account is estimated to have narrowed significantly in 2009, on the back of a decrease in investment income flowing out of Zambia. The slowdown

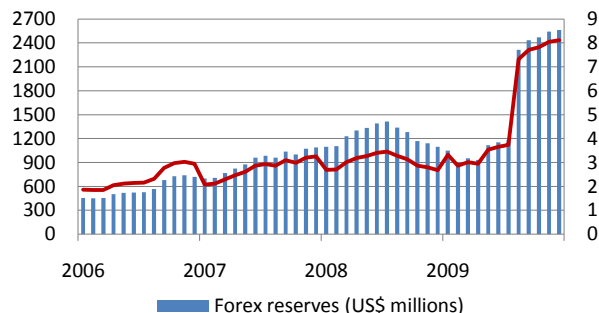
in economic activity led to a decline in the repatriation of branch profits and retained income, and a decrease in dividends and interest that were payable to foreign investors. Zambia's smaller services account deficit also narrowed in 2009 as fewer services, particularly transportation, travel, communications, financial and business, were provided by foreigners to Zambians. Smaller deficits in the income and services accounts contributed to a narrower current account deficit in 2009.

The one sub-account in the current account with a perennial positive balance, the current transfers account, saw a deterioration of its balance in 2009. The decline in transfers was due to a decrease in sector-specific donor financing partly caused by the suspension of aid by one donor on the back of governance concerns in the health sector, and a fall in income remitted by Zambia's diaspora. Nevertheless, the sharp decline in the income account deficit, together with a smaller services account deficit, allowed for the current account deficit to narrow in 2009 to an estimated 1.8% of GDP, from 5.6% in 2008.

On the capital and financial account front, the capital account, which primarily reflects project grants, was relatively unchanged in 2009; however, the financial account deteriorated. Actually, it was Zambia's Special Drawing Right (SDR) allocation of US\$627 million from the IMF that shored up the financial account. Otherwise, the financial account balance decline on the back of a decrease in foreign direct and portfolio investments in 2009, and a significant outflow of other investments. The global credit crisis and the collapse in commodity prices subdued FDI inflows. Portfolio investments were especially weak in the first half of 2009; however, they started picking up in the second half of 2009 as risk aversion subsided.

A narrower current account deficit and relatively smaller capital and financial account balance stemmed and reversed the depreciation of the kwacha from the second quarter of 2009. Large inflows of foreign exchange in the third quarter due to the widening of access under the Poverty Reduction and Growth Facility (PRGF) arrangement and the SDR provision from the IMF boosted the country's foreign exchange position significantly and further supported a stronger kwacha. The kwacha appreciated by 17.4% from its weakest value against the US dollar in April 2009 of ZMK5 663/USD, to an exchange rate of ZMK4 675.48/USD in December 2009.

Figure 10: Gross foreign exchange reserves



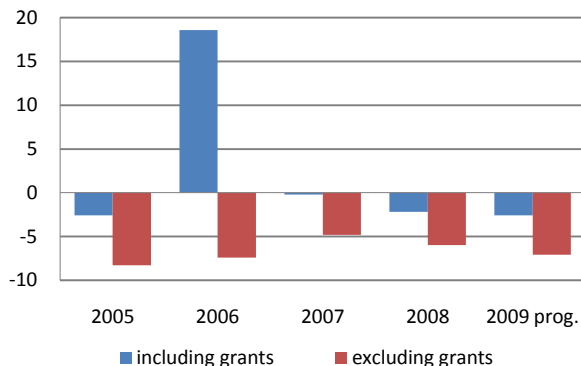
Sources: IMF, Central Statistics Office, Standard Bank est.

Zambia's gross international reserves began to recover in May 2009 from the year's low of US\$931.96 million; however, it was the inflow of Zambia's SDR allocation from the IMF that doubled the country's foreign exchange reserves in August to US\$2 312.46 million, from US\$1 181.80 million in July. As a consequence of this injection of foreign exchange, the country's foreign exchange reserves jumped from 3.74 months of import cover in July 2009 to 7.32 months. By December, foreign exchange reserves had reached 8.1 months of import cover, implying that the economy was well positioned to face a major external shock.

Public and external solvency indicators

The dampening effect of the slowdown in economic activity in 2009 on fiscal revenue and the shortfall of grants led to the widening of the budget deficit, including and excluding grants, causing domestic borrowing's importance as a budget-financing option to increase. The government's revised programme for the 2009 budget suggested that the fiscal deficit excluding grants would widen to 7.1% of GDP, from 6.0% in 2008. As such, the biggest grants-inclusive fiscal deficit, following debt relief, is estimated for 2009 at 2.6% of GDP, which is an increase from 2.2% in 2008.

Figure 11: Budget balance, including grants (% of GDP)



Source: IMF

Preliminary estimates reveal that total government spending for 2009 was almost 10% lower than expected at about 14 000 billion kwacha (US\$3 billion) owing to revenue shortfalls and under execution of the budget. Fiscal revenue came in 13.2% below projections at 11 647 billion kwacha (US\$2.496 billion). The shortfall in fiscal revenue was largely due to the underperformance of grants received, which were only two-thirds of the amount programmed for the year. The grants' shortfall resulted from the suspension of financial assistance to Zambia from donors following allegations of embezzlement at the health ministry.

Budget support and project-related aid gained momentum in the second half of 2009, following the delay of disbursements in the first half of the year. In mid-December 2009, total disbursements for general budget support and sector-specific support came to US\$300 million against the year's commitment of US\$345 million, which equates to a disbursement rate of about 87%. Of the total disbursement, general budget support amounted to US\$153 million,

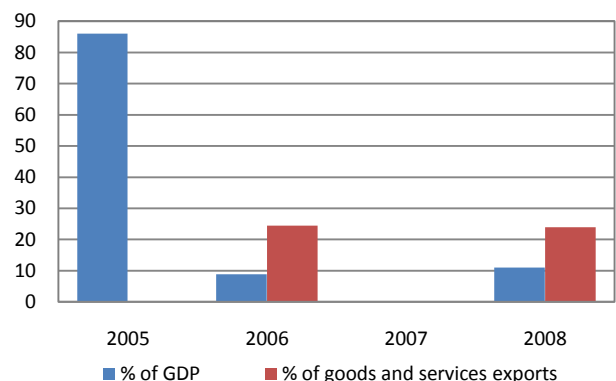
budget support loans came to US\$33 million and sector budget support grants of US\$20 million.

The slowdown in global trade flows adversely affected Zambia's trade tax revenue, which was the worst performer compared to the other types of fiscal revenue. In particular, revenue from import value added tax (VAT) was 30% short of the target and fiscal income from customs duty, which is a tax levied on imported or exported goods, was 23% less than programmed. Revenue from excise duty came in 40% below target, implying that production and retail sales were subdued in 2009.

The shortfall in fiscal resources explains the higher-than-projected domestic borrowing in 2009, which is estimated to have increased to 3% of GDP, from an earlier target of 1.8% of GDP. However, the rise in donor finances and aid in the second half of 2009 may have reduced the domestic borrowing requirement projection. This implies that the government's crowding out effect could have been limited, which is positive for private sector activity, especially in the context of the global economic slump that in itself has subdued economic activity.

Zambia's public debt is estimated to have inched 0.3 percentage points lower to 26.4% of GDP at the end of 2009, from 26.7% at the end of 2008. The central government's domestic debt constitutes 55% of its total debt. As a percentage of GDP, public domestic debt is estimated to have decreased to 14.5% at the end of 2009, from 15.5% a year earlier, which is positive for private sector expansion, while external public debt increased to 11.9%, from 11.2%. Notably, Zambia's public external debt has dropped, from 86% of GDP in 2005 to 11% in 2008. The country's risk of debt distress has thus eased considerably and is low, even when non-concessional borrowing is accounted for. Moreover, public domestic debt now constitutes the largest item in the central government's debt stock, with 60% of total public debt, from about 20% in 2005. Lower exposure to external debt has improved Zambia's external solvency indicators.

Figure 12: Public external debt (%)



Source: IMF

National policy assumptions and the international environment

Implementation of the first of the government's five-year planning instruments, the US\$1.5 billion Fifth National Development Plan

(FNDP), ends in 2010. It is thus apt to briefly assess and review the achievements of the primary objectives of the plan, which is a subset of the authorities' Vision 2030 strategic plan to pull Zambia out of poverty and become a middle-income country by 2030. The focus of the FNDP programme is poverty alleviation and the re-prioritising of government spending towards education, health and infrastructural development.

The FNDP has four main goals. The first one is to spur economic growth rates that will result in wealth creation and poverty reduction. This goal is similar to the first of the United Nations' Millennium Development Goals (MDGs), namely 'Eradicate extreme poverty and hunger'. One of MDG 1's indicators is the prevalence of underweight children (per cent of children under age five). In the four-year period to 2007, the prevalence of underweight children decreased to 19.3%, from 23% in 2004. This indicates that some progress has been made in reducing poverty; however, there is still considerable work to be done if the 2015 target of 11% is to be achieved.

The second of the FNDP objectives is to reduce income inequality through the creation of opportunities in agriculture, education and health. The two percentage points' decline in the percentage share of income or consumption held by the poorest 20% to 4.0% in the two-year period to 2005 is testimony to the disparity of wealth and opportunities in Zambia. There are no recent data on this indicator so it is difficult to say the direction that the percentage share of income or consumption accruing to the poorest 20% has taken post-2005. However, the increasing budget allocations to agriculture, education and health, particularly following debt relief, which created fiscal space, suggests that more opportunities in these sectors were created in the 2005 to 2010 period. Notably, one-fifth of the budget is assigned to education, and one-third of the budget is spent on all three sectors.

Empowering the poor to make a decent living through productive ventures is the third of the FNDP's objectives and probably the most challenging to measure. According to the 2005 Labour Force Survey, most of Zambia's labourforce (43%) is self-employed and half of the labourforce works in the agriculture sector. As agricultural production is largely undertaken by smallholder farmers and is mainly labour intensive, investing in improving the productivity of agriculture would be the most effective way to achieve the third objective. Increasing the use of capital and irrigation in agriculture is a long-term challenge.

The fourth of the FNDP goals is constructing and rehabilitating major transport routes to ensure that agriculture-producing areas are connected to markets. Transport infrastructure received the second-largest slice of the 2010 government budget and over 90% of this allocation is intended for road infrastructure alone. About 40% of the transport allocation is intended for the rehabilitation of roads and routine maintenance. Rural areas, in particular, will benefit from the rehabilitation of feeder roads and river crossings, which is expected to improve access to markets. Evidently, public investment in transport infrastructure is taking place in keeping with the FNDP.

One of the more notable fiscal policy developments in 2009 was the early release of the 2010 budget, through a constitutional amendment, to allow for a longer implementation period. Another development was the abolishment of a 25% mineral windfall tax, in light of the slump in the mining industry.

The fiscal authority seeks to preserve capital spending, particularly on transport infrastructure, as a means of diversifying the economy. Shortfalls in donor financing and aid have firmed the fiscal authority's will to reduce its dependence on budget support for capital spending. Containing current expenses, especially the wage bill, will allow the authority to ensure that the capital expenditure is financed with domestic resources. However, the approaching 2011 elections suggest pressures on fiscal resources will increase over the short term.

Fiscal restraint in recent years has supported the effectiveness of monetary policy and enabled inflation to slow. The monetary authority aims to keep its policy stance firm in 2010 as it seeks to bring down inflation to the single-digit range by the end of 2010, through the control of reserve money growth.

International environment

The close of 2009 signalled the end of the global economic recession. The global economy shrank by 0.8% in 2009, following growth of 3.0% in 2008. The advanced economies were by far the worst affected by the recession; the collective of economies contracted by 3.2% in 2009. Of these economies, Japan, the Euro area and the United Kingdom were the hardest hit by the global financial and economic crisis. Conversely, the emerging and developing economies showed positive growth of 2.1% in 2009, albeit significantly slower than the buoyant 6.1% of 2008.

Table 1: Global economic outlook

	Real GDP growth (year-on-year)			
	2008	2009	2010p*	2011p*
World	3.0	-0.8	3.9	4.3
Advanced economies	0.5	-3.2	2.1	2.4
United States	0.4	-2.5	2.7	2.4
Euro-area	0.6	-3.9	1.0	1.6
United Kingdom	0.5	-4.8	1.3	2.7
Japan	-1.2	-5.3	1.7	2.2
Emerging and developing economies	6.1	2.1	6.0	6.3
China	9.6	8.7	10.0	9.7
India	7.3	5.6	7.7	7.8
Brazil	5.1	-0.4	4.7	3.7
Russia	5.6	-9.0	3.6	3.4
Africa	5.2	1.9	4.3	5.3
Sub-Saharan	5.6	1.6	4.3	5.5
Developing Asia	7.9	6.5	8.4	8.4

* p = projection

Source: IMF

Of the BRIC economies, Russia and Brazil were the laggard performers, with negative growth rates of 9.0% and 0.4% respectively in 2009. China and India's economies were a lot more resilient to the recession than expected. China's economy exhibited growth of 8.7% in 2009, which is less than a percentage point lower than its growth rate for 2008. On the contrary, Africa's real economy was pummeled by the global economic slump and, in particular, the collapse in global trade. As a result, economic growth slowed to 1.9% in 2009, from 5.2% in 2008.

The resilience of the emerging and developing economies partly explains the bounce back in economic performance projected for 2010. The world economy is expected to grow at 3.9% in 2010, which is even stronger than its 2008 growth performance. This strong projection is largely based on an expectation that the advanced economies will exhibit a strong recovery in 2010, with a growth rate of 2.1%. However, increasing concerns about a double-dip recovery, partly due to the rising risk of sovereign debt defaults, could mute the strength of the recovery. Stronger advanced economies are positive for providing a lift to consumer spending, which is supportive of a recovery in export-led emerging economies that will in turn support a recovery in demand for Africa's commodities.

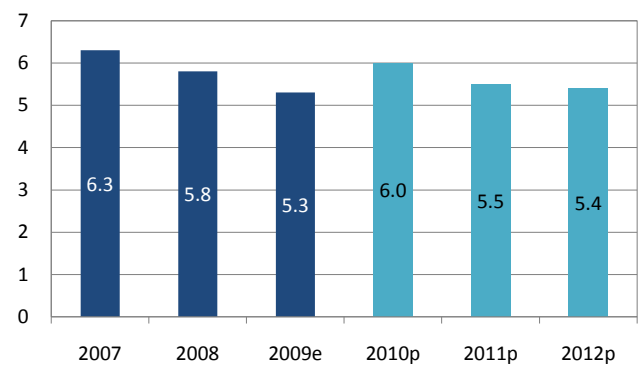
Higher commodity prices and an increase in economic activity are expected to spur an increase in inflation in 2010. Average inflation in the advanced economies is thus projected to increase to 1.3% in 2010, from 0.1% in 2009, while that of the emerging and developing world is expected to increase from 5.2% to 6.2%.

Forecast summary

Growth outlook

A global economic recovery, the scaling up of public spending on infrastructure and expectations of a favourable agriculture harvest are expected to spur economic growth to 6.0% in 2010, from an estimated 5.3% in 2009. The resumption of production at mines that closed during the height of the global crisis in 2009 is expected to stem job losses in the mining industry and thus stabilise household incomes, which is supportive of a recovery in households' consumption expenditure. The Luanshya Copper Mine, for instance, which is Chinese owned, will recommence production in 2010 after shutting down in December 2008. The resumption of mining production will partly reverse the unemployment that was created in 2009 and in turn support job creation in businesses that service the mining industry. Households' spending growth is thus projected to increase to 6.7% in 2010, from 6.4% in 2009.

Figure 13: Real GDP growth (%)



Source: Standard Bank

An increase in economic activity will be buttressed by an increase in gross fixed investment. Gross fixed investment is expected to be supported by a recovery in FDI (the central bank governor's projection for FDI in 2010 is US\$2 billion, up from an estimated US\$1.4-1.5 million in 2009) and the government's maintenance of public investment projects, particularly in electricity generation and transport networks. Investment will also be spurred by the waiving of taxes by the local authorities, including a 25% import duty on imported equipment and 16% value added tax on all companies investing in the economic zones. Zambia's economic zones, shopping mall projects, agriculture sector and infrastructure projects are expected to draw foreign investment. FDI peaked during the commodity boom period, in 2007, at 12% of GDP; however, investment in the mining sector is projected to slow over the medium term due to projected capacity constraints, to a projected 3% of GDP in 2014.

Government consumption expenditure is expected to increase, not least because of the constitutionally required spending on voter and national registration before the 2011 presidential and parliamentary elections, the national census and the constitution-making process. The wage bill continues to be the elephant in the government budget that constrains spending. The downside risk to containing government spending is the upcoming 2011 elections that may make it difficult for the authorities to resist wage demands.

Export revenue is expected to improve significantly in 2010 on the back of the recovery in global trade that is being led by the emerging market economies. The bounce back in China's trade figures is a prelude to the resurgence in commodities' demand that we are likely to witness in 2010. China's export revenue and import bill ceased their contraction in December and November 2009 respectively. More notable is the swiftness of the recovery. China's import bill surged by 85.5% y/y in January 2010, from 55.9% y/y and 26.7% y/y in December and November respectively. The growth in China's imports has accelerated significantly in a three-month period, partly implying a recovery in the Asian economy's appetite for commodities, which is encouraging for Zambia's commodity-heavy exports.

Zambia's import bill is expected to burgeon on the back of a higher international oil price. The international oil price is projected to average

US\$76 per barrel in 2010, up from US\$62 in 2009. As the 36% drop in the average oil price in 2009 largely contributed to the shrinkage of the import bill by one-third, a 20% increase in the oil price in 2010 is expected to increase the import bill significantly.

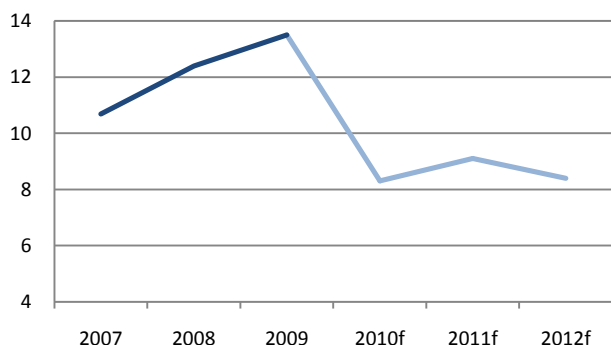
Although both export revenue and the import bill are projected to increase in 2010, the stronger growth is expected of the import bill, partly because of the resumption in mining production, which consumes a significant share of the oil imports. The projection of a smaller trade surplus is negative for Zambia's 2010 GDP growth prospects. The trade surplus, which is essentially the difference between locally produced goods that are consumed abroad and foreign goods consumed locally, constitutes about 15% of GDP. As it decreases, national output is eroded, as it implies that an increasing value of foreign goods was consumed domestically compared to locally produced goods that were consumed abroad.

Infrastructure investment that lags behind aggregate demand is expected to slow Zambia's growth potential over the medium term. The electricity shortage, in particular, will constrain the expansion of the manufacturing industry and may deter FDI.

Monetary policy

The monetary authority will remain firm on its pursuit of single-digit inflation through the control of reserve money growth. The central bank plans to place a cap on reserve money growth at 19% in 2010, down from a monthly average of 26.9% y/y for the January to November 2009 period. This rate of expansion is expected to give room for private sector credit extension to recover in 2010, following its contraction in 2009, even after allowance is made for the government's borrowing plans for 2010. Contained monetary growth and a stronger kwacha are expected to support a softer average inflation rate of 8.3% for 2010, down from 13.5% in 2009. The risk to this favourable outlook is below-average agricultural production due to poor weather and a spike in the international oil price.

Figure 14: Consumer price inflation (% , annual average)

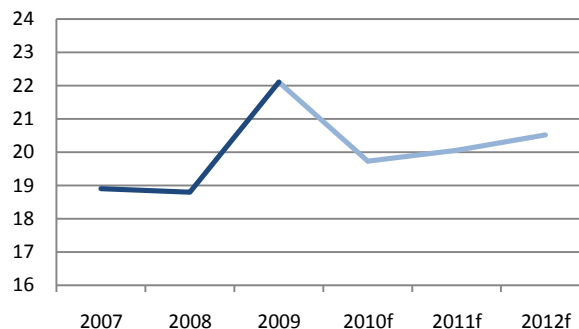


Source: Standard Bank

The fiscal and monetary authorities plan to redeem some domestic debt in 2010 as treasury bills mature, through a limited sale of foreign exchange from the international reserves. The authorities intend for this plan to reduce the supply of treasury bills and, in so doing, place downward pressure on interest rates. Lower interest rates are

expected to reduce the cost of Kwacha credit for the private sector and thus promote greater private sector lending. We thus expect the weighted lending base interest rate to fall to an average of 19.7% in 2010, from 22.1% in 2009. According to the IMF, Zambia's private sector credit as a percentage of GDP inched up to 14.8% of GDP in 2008, from 8.5% in 2000; however, it remains low when compared to its peers.

Figure 15: Lending interest rate (% , annual average)



Source: Standard Bank

The Zambian government's large presence in the country's small financial sector explains commercial banks' dependence on government deposits and their preference for lending to the government at a high interest rate. This practice is expected to ease from 2010 when the government opens a single treasury account and closes most of its accounts at the commercial banks. This is expected to boost liquidity and reduce the spread between lending and deposit rates as commercial banks now compete for deposits and in the lending market.

In the medium term the central bank seeks to develop a fixed benchmark interest rate to support the government's domestic debt policy shift. Presently, Zambia's commercial banks' lending rates do not take their cue from a reference rate. The commercial banks determine their own lending rates. The introduction of a short-term interest rate as a monetary policy anchor, in place of monetary aggregates, would give the authorities the room to respond to unfavourable cyclical conditions by reducing interest rates. The limitations of the current reserve money-targeting framework's as a monetary tool were exposed during the economic slowdown of 2009.

External sector

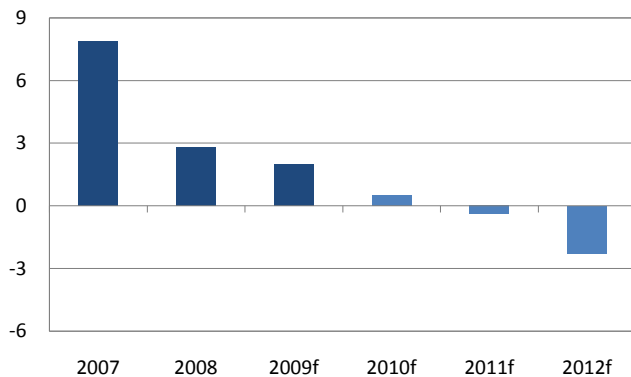
Zambia's external sector, which was harder hit by the global economic recession than the country's real economy was, is expected to bounce back in 2010. Stronger growth in export earnings is expected on the back of a projected 23% increase in the price of Zambia's biggest export, copper, and the new Lumwana mine's output coming on stream and thus boosting annual production.

The projected recovery in commodity prices also implies a stronger international oil price will contribute to an increase in the import bill. Moreover, the resumption of production at mining operations that shutdown during the worst of the crisis, including Luanshya mine, is

expected to push up the demand for petroleum. Other than oil imports, imports of capital equipment intended for large new infrastructure projects, particularly in the energy sector, are expected to increase. Mines are also likely to ramp up production in preparation for the global economic recovery, and, as such, imports of mining-related equipment are likely to increase in 2010.

Although a swift rebound in export revenue is projected for 2010, the import bill is expected to grow at a stronger rate owing to the larger value-added composition of Zambia's imports. The trade surplus is thus projected to decrease in 2010 to 0.5% of GDP, from 2.0%.

Figure 16: Trade balance (% of GDP)



Source: Standard Bank

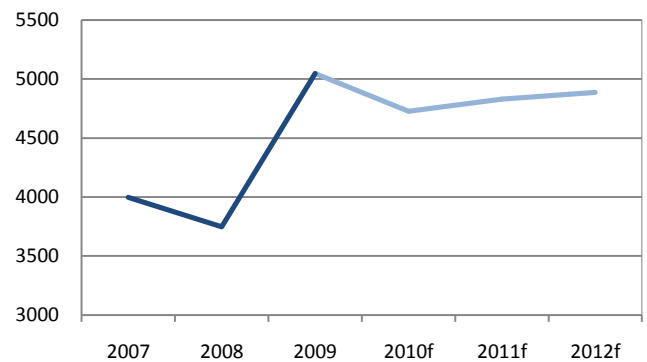
The income account deficit is projected to widen in 2010 as economic activity picks up and investment income recovers, allowing for an increase in repatriated income, compared to that repatriated in 2009. Similarly, an increase in the services account deficit is expected as the increase in economic activity spurs an increase in demand for services provided by foreigners to Zambians. Bigger deficits in the income and services accounts will contribute to a wider current account deficit. This will be partly mitigated by a projected recovery in current transfers. An improvement in private remittances and sector-wide grants is expected to support an increase in current transfers. The current account deficit is thus projected to widen in 2010 on the back of a smaller trade deficit and deterioration in the deficits of the income and services accounts.

The capital and financial balance is expected to remain flat in 2010 as the expected improvement in foreign direct and portfolio investments is likely to be countered by the reversion of other investments, which include loans, currency and deposits, and trade credits, to a negative balance, as the once-off boost provided by the SDR allocation in 2009 falls off.

A wider current account deficit may be kwacha negative; however, we expect a lower inflation environment, a higher copper price and a stronger foreign exchange position to buttress the kwacha in 2010. The copper price, which is highly correlated to the kwacha, is projected to improve by 36% in 2010 to an average of US\$7 000 per metric tonne, from US\$5 150 in 2009. We thus project an appreciation of the kwacha against the US dollar to an average of ZMK4 728.41/USD in 2010, from

ZMK5 047.86/USD in 2009. The kwacha is expected to stabilise in 2010, compared to 2009, and to exhibit appreciation tendencies.

Figure 17: Exchange rate, ZMK/USD (annual average)



Source: Standard Bank

Fiscal policy

The 2010 budget deficit is projected to narrow in 2010 to 2.4% of GDP, from an estimated 2.6% in 2009. The smaller deficit is premised on an increase in revenue collections owing to the projected economic recovery that is expected to boost incomes and administrative efforts to mobilise new streams of revenue. The downside risks to a smaller deficit in 2010 are the expenses related to an upcoming election. Voter registration and the national census are expected to weigh on the budget. Wage demands in the run-up to the elections should also not be ruled out.

The fiscal authority's medium-term policy seeks to sustain investment in infrastructure, particularly in the electricity sector, and human capital, but increasingly through domestically generated income. Transport infrastructure is the government's focus as it seeks to open up the country's trade routes through improved road, rail and bridge projects. The transport infrastructure projects include a US\$420 million road being built by the Chinese, as well as a rail network, including the North-South Corridor.

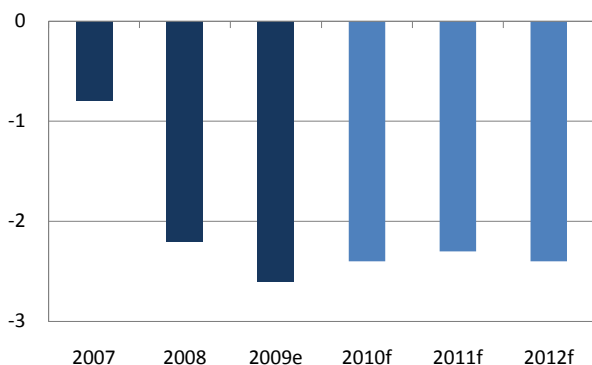
The government plans not to rollover some of the Treasury securities that will mature in 2010. By reducing the supply of Treasury bills in the market, the government will reduce the interest burden on the budget. In the 2010 budget, interest payments on domestic debt account for 7.1% of the total budget. Given the squeeze on fiscal resources due to donor financiers' conditionalities and a tight external credit market, the government is determined to finance its capital projects with domestic resources and reduce spending on non-priority items.

One of the more notable developments in the 2010 national budget was its early release, through a constitutional amendment, to allow for a longer implementation period, and the abolishment of a 25% mineral windfall tax. This abolishment goes against the advice of the international financial institutions, the World Bank and the IMF, which are of the view that this is a revenue-eroding measure that the government cannot afford. However, the government has communicated that it will not be introducing new tax measures nor

increasing tax rates for the mining sector as it seeks to promote investment.

In late 2009, Zambia's nine cooperating partners – the African Development Bank, Finland, Germany, United Kingdom, the Netherlands, Norway, Sweden, the European Union (EU) and the World Bank – provided budget assistance amounting to US\$215 million (6% of the 2010 budget) to the government. The donors at the same time raised concerns about the high levels of corruption and lack of good governance, implying that budget support is unlikely to be scaled up until these concerns are addressed. The health sector, where the embezzlement is alleged to have occurred, is expected to depend more on domestic resources to make up for the shortfall in aid.

Figure 18: Fiscal balance (% of GDP)



Source: Standard Bank

Zambia's large infrastructure requirements, especially in the electricity and transport sectors, in the context of donor financing that may be compromised by bloated fiscal deficits in donor countries suggest that the budget deficit may come under pressure to increase over the medium term. The government is likely to pursue the issuance of an international bond to raise funds for its infrastructure projects as credit markets thaw and the global economy recovers. Over the medium term, the government's debt profile is expected to lean increasingly towards external debt. The public external debt position is expected to remain sustainable, especially given the country's comfortable foreign exchange position and prospects of sustained strong foreign exchange inflows.

Outlook

Zambia's economic activity is expected to pick up in 2010 on the back of a resumption of production at mines that closed in early 2009, strong public spending on infrastructure projects and a recovery in private fixed investment. Real GDP growth is thus expected to accelerate to 6.0% in 2010, from an estimated 5.3% in 2009. The downside risk to this growth prognosis is a poor agricultural harvest due to weather-related shocks.

The Bank of Zambia's monetary policy stance will remain firm as single-digit inflation is sought by the monetary authority. The central bank plans to bring inflation down to 8% by year end. Our expectation is of an average inflation rate of 8.3% in 2010, slowing from 13.5% in

2009. A sharp increase in the international oil price may thwart this low inflation outlook by fuelling an increase in the utilities and transport price sub-indices. Interest rates are also expected to decrease in 2010. Yields on Treasury bills will continue to ease as global risk aversion subsides. The government's decision to retire domestic debt as it matures in 2010 will also support a decline in interest rates. Lending rates are thus expected to take their cue from falling yields. We expect the weighted lending base rate to ease to an average of 19.7% in 2010, from 22.1% in 2009.

The fiscal authority plans to sustain its infrastructure spending drive and investing in the priority sectors of health and education by mobilising additional domestic revenue. The main constraint in the budget is the large wage bill; however, this year the budget will face further pressure from spending related to the 2011 elections, the national census and the constitutional review. The economic recovery and revival in global trade are expected to improve fiscal revenue and thus contain the budget deficit at 2.4% of GDP, from an estimated 2.6% in 2009. However, the downside risk is expenditure overruns related to the 2011 elections that may widen the deficit.

The external sector, which was ravaged by the global economic recession, is expected to post a recovery in 2010, based on stronger commodity prices and improvement in capital inflows. The kwacha is thus expected to stabilise on the back of a stronger foreign reserves' position, higher copper price and lower inflation environment. We thus expect the kwacha to US dollar exchange rate to average at a stronger level of ZMK4 728/USD in 2010, compared to ZMK5 048 in 2009.

Zambia

Standard Bank forecasts of selected indicators

	2007	2008	2009	2010p	2011p	2012p
National Accounts						
Gross Domestic Product (LCU billions, constant 1995 prices)	4 392.2	4 647.0	4 893.2	5 187.3	5 486.7	5 783.4
% change	6.3	5.8	5.3	6.0	5.5	5.4
Final consumption expenditure of:						
Households (LCU billions, constant 1995 prices)	2 794.8	2 977.7	3 168.6	3 382.4	3 627.4	3 894.5
% change	6.4	6.5	6.4	6.7	7.2	7.4
Gross fixed capital formation (LCU billions, constant 1995 prices)	519.5	531.2	543.9	558.1	574.1	591.2
% change	2.6	2.3	2.4	2.6	2.9	2.8
Agricultural production (% of GDP)	11.5	10.6	9.9	9.4	9.0	8.8
Prices						
Inflation (annual average, %)	10.7	12.4	13.5	8.2	9.1	8.4
Monetary sector						
Weighted lending base interest rate (annual average, %)	18.9	18.8	22.1	19.7	20.1	20.5
Exchange rate, annual average (LCU/USD)	3996.8	3 748.5	5 047.9	4 728.4	4 831.5	4 887.4
External sector						
Trade balance (% of GDP)	7.9	2.8	2.0	0.5	-0.4	-2.3
Public and external solvency indicators						
Fiscal balance, including grants (% of GDP)	-0.8	-2.2	-2.6	-2.4	-2.3	-2.4
Public sector debt (% of GDP)	23.7	26.7	26.4	25.2	23.8	22.6

Group Economics

Goolam Ballim – Group Economist

+27-11-636-2910 goolam.ballim@standardbank.co.za

International

Jeremy Stevens

+27-11-631-7855

Jeremy.Stevens@standardbank.co.za

South Africa

Johan Botha

+27-11-636-2463

Johan.botha@standardbank.co.za

Shireen Darmalingam

+27-11-636-2905

Shireen.darmalingam@standardbank.co.za

Danelee van Dyk

+27-11-636-6242

Danelee.vanDyk@standardbank.co.za

Rest of Africa

Yvette Babb

+27-11-631-1279

Yvette.Babb@standardbank.co.za

Jan Duvenage

+27-11-636-4557

Jan.duvenage@standardbank.co.za

Anita Last

+27-11-631-5990

Anita.last@standardbank.co.za

Yvonne Mhango

+27-11-631-2190

Yvonne.Mhango@standardbank.co.za

Kenya

Tanzania

Uganda

Zimbabwe

Botswana

Lesotho

Namibia

Swaziland

Malawi

Mauritius

Mozambique

Angola

DRC

Ghana

Nigeria

Zambia

Simon Freemantle

+254 (20) 3269 027

Freemantles@stanbic.com

Kenya

Uganda

Tanzania

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