Bank of Zambia

Curriculum Vitae

Denny H. Kalyalya

Dr Denny H. Kalyalya joined the Bank of Zambia (BoZ) in 1996 as Adviser - Economics. During 1997/1998 he was seconded to the IMF as a Special Appointee, Monetary and Exchange Affairs and African departments. In addition he served as economics lecturer (1983-1995), Assistant Dean (Postgraduate), School of Humanities and Social Sciences (1994/95), and Head of the Economics Department (1995) at the University of Zambia (UNZA). Since 1998 he has been the Director of the Economics Department, BoZ.

Dr Kalyalya was born in 1957 in Monze, Zambia. He holds a PhD (Economics) from the University of Massachusetts, Amherst, USA (UMASS, 1993), obtained on a Fulbright Hays scholarship, an MA (Economics) from UMASS (1989) and UNZA (1983), and a BA (Economics), UNZA (1980). Dr Kalyalya has undertaken extensive research on socio-economic issues in Zambia. Published works include *Aid and development in Southern Africa: evaluating a participatory learning process*, Africa World Press: Trenton, New Jersey, 1988. He serves on various Government committees, including those for the IMF, World Bank and the Paris Club negotiations, the Donors Consultative Group meetings, and ESAF/PRGF monitoring committees.

E-mail: DKalyaly@boz.zm

MONETARY POLICY FRAMEWORK AND IMPLEMENTATION IN ZAMBIA

Denny H Kalyalya[1], Ph. D (Econ)
DIRECTOR – ECONOMICS

Bank of Zambia
P O Box 30080, Lusaka. ZAMBIA
E-mail:dkalyaly@boz.zm

Abstract
This paper reviews the monetary policy framework and implementation in Zambia since 1992. The paper argues that the thrust and orientation of monetary policy after 1992 has been towards market-based instruments of monetary control. In the process, it has been possible to reduce inflation from three-digit figures to an average of about 23 per cent over the past three years. However, formidable challenges, in terms of reducing inflation further and establishing a stable and sustainable macroeconomic environment, still lie ahead.

1. INTRODUCTION

A monetary framework, defined as "the announced basic principles and institutional rules guiding the execution of monetary policy," underpins the efficacy of monetary policy for any country (Cottarelli and Giannini, 1997). Over the past ten years or so, many countries in Africa and Eastern Europe have joined industrialized countries and their counterparts in the Pacific Basin and Latin America in quickening the pace of financial sector reforms and innovations (Mehran, et al., 1998). A major thrust of these reforms has been the liberalization of the financial markets underpinned by a shift towards market-based instruments of monetary policy. These reforms have in the main been induced by the observation that by the mid-1980s the economies of most of the non-reforming countries exhibited severe weakness and vulnerability. Deteriorating macroeconomic conditions had become commonplace in these countries largely due to political interference in the operations of financial institutions, negative real interest rates and directed credit policies, and structural weaknesses (Mehran, et al., 1998). Zambia is no exception in this regard.

The major aim of this paper therefore is to review Zambia's monetary framework against the background of the financial sector reforms that the country has undertaken over the past decade. Apart from providing insights into the financial reforms and the monetary framework, the review should offer an opportunity for sharing information and experiences as well as a basis for making comparisons among other countries.

The paper is organized as follows. We begin, in Section Two, with a presentation of major highlights of the financial sector reforms in Zambia. This is followed, in Section Three, by a discussion of the monetary policy framework. In Section Four we outline the major challenges of monetary policy in Zambia and provide some concluding remarks in Section Five.

2. FINANCIAL SECTOR REFORMS IN ZAMBIA

Soon after gaining political independence in 1964, the incoming Zambian Government embarked on, among other programmes, a rigorous programme of nationalization of what were considered the 'commanding heights' of the economy. By the 1980s about 80 per cent of the country's economic and financial activities were in the hands of the State. Over 150 parastatal firms had been established, ranging in size from the giant mining company, the Zambia Consolidated Copper Mines (ZCCM) to breweries and to small bakeries (Profit, 1992).

The world oil price shocks of the mid- and late-1970s dealt a severe blow to the Zambian economy. This, along with the severe decline in terms of trade, arising from a precipitous decline in world prices of Zambia's single most important commodity, copper, pushed the economy into what would prove to be a long-term stagflation. As the economic situation in the country continued to deteriorate, towards the end of the 1980s the Government, with the support of co-operating partners, in particular the Bretton Woods institutions, undertook to carry out some economic and structural reforms. The re-emergence of plural politics[2] in 1990 and the consequent change of Government in October 1991 provided additional stimuli to the reform process. More important, unlike the pre-

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[2] At independence Zambia had multi-party politics, but these gave way to the so-called One Party Participatory Democracy in 1973.

vious Government the newly elected Government embraced fully the structural adjustment programme introduced in June 1989 (UNZA, 1993). The core of these reforms was the liberalization of the economy. Henceforth, the Government undertook to

- liberalise the economy so that price, rather than state intervention, became the basis on which economic resources were allocated. This would ultimately ensure that resources were efficiently allocated through a market mechanism;

- re-establish the private sector, through privatization, as the fulcrum of economic development rather than the State;

- improve the efficiency of the public sector through appropriate reforms in order to ensure efficiency in the delivery of services to the public; and

- ensure economic stabilization through the use of appropriate monetary and policy instruments.

All these measures required that all players in the management of the economy, including the Bank of Zambia, (here after the Bank or BoZ), played effective roles in the transformation process. Facilitating the effective implementation of the market-based monetary policy instruments required extensive financial reforms (Mehran, H., et al., 1998). In this regard, considerable progress has been made in the reform and liberalisation of the financial sector, and several measures were implemented between 1992 and 2000. The developments that have taken place as a direct consequence of the financial reform process in Zambia, and that deserve special mention, include the following:

(a)   Interest rates

The decontrol of interest rates in 1993 was the cornerstone of the liberalization of the Zambian financial system as ceilings were eliminated to improve real interest rates, which had been negative for many years. Since then financial institutions have been free to compete and determine the savings as well as lending rates.

(b)   Foreign exchange rate

Following the cessation of the Exchange Control Act in 1994, the exchange rate became fully liberalized. Apart from eliminating the rent-seeking behaviour characteristic of exchange controls, liberalization was aimed at maintaining the competitiveness of the domestic currency *vis-à-vis* foreign currencies, promoting an efficient external payments system, and the attainment of a sustainable external balance.

(c)   Government securities market

Another important development in 1993 was the introduction of the Treasury bill tender system in that year's Budget, with the primary aim of supporting the cash budget[3], which had also been introduced, to finance maturing Treasury bills and Government bonds. The introduction of the tender system marked a significant shift from a fixed to a market-determined pricing of Treasury bills and Government bonds.

The Treasury bill tender system also provided the central bank with an additional and powerful instrument for monetary policy. In the first instance, the central bank could, depending on the circumstances, use the instrument to withdraw or inject liquidity in the economy. Secondly, commercial banks could also use the system to manage their cash balances through rediscounting the bills at the central bank and/or trading them amongst themselves. Fairly soon, commercial banks began to use Treasury bill yield rates as benchmarks for interest rates in the market.

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[3]   The cash budget was introduced as one of the tools for tightening fiscal policy with a view to complementing monetary policy in controlling inflation.

(d)   The interbank market

The emergence of an active interbank market is another important feature of the Zambian money market associated with financial reform. Previously, this type of activity had been the preserve of the central bank. This market has given banks greater flexibility in their daily liquidity management.

(e)   Establishment of a stock exchange

The Zambian financial system was also changed when the first ever, formal capital market, the Lusaka Stock Exchange (LuSE) was established in February 1994. This has provided an opportunity to business houses to broaden their sources of financing and at relatively cheaper cost than through commercial banks.

(f)   Modernization of the national payments system

Sustainable economic growth requires a well-functioning, efficient and reliable clearing and payments system to lubricate local and international business transactions by providing liquidity in the financial system. In this respect, the Bank of Zambia, in conjunction with the Banker's Association of Zambia, introduced an automated electronic clearing system. This became formalized on November 1,1999 with the establishment of the Zambia Electronic Clearing House (ZECH).

(g)   Strengthening of the financial sector legal framework

The enactment of an appropriate legal framework for the banking sector is essential for the establishment of a well-functioning financial system and the effective implementation of monetary policy. In this regard, and in recognition of the changed environment, the existing banking legislation was strengthened with the enactment of the Banking and Financial Services Act in December 1994. Substantial amendments were further made to the Act in 2000. Notably, to

- enhance the supervisory and regulatory powers of the Bank of Zambia in relation to banking and financial services;

- bring existing legislation in line with best practice and internationally accepted standards for licensing, prudential regulation and supervision; and

- establish higher standards of responsibility, accountability, professional competence and integrity on the part of directors, senior officers and employees of banks and financial institutions.

3.   MONETARY POLICY FRAMEWORK IN ZAMBIA

It should be stated from the outset that Zambia, as a member of the International Monetary Fund (IMF) since 1965, has over the years undertaken quite a number of Fund-supported programmes. This, as Cottarelli and Giannini (1997) rightly argue, is important as it has a critical bearing on Zambia's current monetary framework and helps to put the discussion into a proper context. However, a discussion of these programmes goes beyond the scope of this paper. For the interested reader, a variety of IMF and World Bank documents can be consulted, as well as scholarly papers including Allast, et al. (1992), UNZA (1993), Kalyalya (1995), Cottarelli and Giannini (1997), and Mehran, et al. (1998).

As we go into the discussion of Zambia's current monetary framework we deem it useful to have an account, albeit brief, of monetary policy in the immediately preceding period. Firstly, as a way of providing a contrast, and secondly, to further underscore the rationale for the change in the design and implementation of monetary policy.

3.1   Monetary policy before 1992

Prior to 1992 monetary policy had multiple objectives. Targets had also not been well defined and the implementation of monetary policy relied mainly on direct instruments which included fixed inter-

est rates and credit allocation, core liquid assets and statutory reserve requirements. Equally important, the financing of the Government fiscal budget relied heavily on central bank borrowing.

As it turned out, real interest rates were for the most part negative which resulted in high levels of disintermediation, as economic agents shunned the banking system in preference for other forms of assets that could under the circumstances provide a hedge against loss of value. Moreover, more often than not the monetary policy was loose, mainly as a way of providing relatively cheap credit to state-owned enterprises, resulting in high growth rates in domestic credit and consequently in the money supply.

Fundamental internal and external imbalances were accompanied by structural and institutional deficiencies. On the domestic front, widespread price controls (largely of consumer items) and the wholesale system of subsidies made the fiscal budget unsustainable. Large fiscal deficits became prevalent (see Table 2). These were accompanied by a widening in the gap between domestic savings and investment.

The external sector was also a source of concern, as the balance of payments position became unsustainable following the loss of international reserves due to high debt service payments coupled with capital flight and the poor performance of exports.

The combined effects of the above factors as well as structural rigidities in the economy, such as heavy dependence on the production and export of copper, an inefficient and hence inappropriate industrial strategy of import substitution and an inefficient public sector, were to push the economy into a state of stagflation. Clearly, monetary policy and other government policies had failed to deliver.

3.2   Monetary policy since 1992

On October 31, 1991, Zambia held its first and successful multiparty democratic elections in more than 20 years and ushered in a new government. Against the backdrop of a difficult inherited macroeconomic situation, the new government immediately took bold decisions to revamp the economy, including moving swiftly to liberalize the economy and hence re-establishing the private sector as the prime mover of economic growth and development.

In early 1992 Zambia reached agreement with the IMF for a shadow programme through the first half of the year to be monitored informally by the Fund staff[4]. In July of the same year, the Fund approved Zambia's Rights Accumulation Programme (RAP) for the next 3½ years, with a maximum amount of SDR 836,9 million or 309,6 per cent of quota[5]. Zambia managed to graduate successfully from RAP to SAF/ESAF (Structural Adjustment Facility/Enhanced to Structural Adjustment Facility) in December 1995. Since then she has been on ESAF, which was transformed into the Poverty Reduction and Growth Facility (PRGF) in 1999. As could be expected, being on a Fund programme and given the amount of resources Zambia has accessed as a result (SDR 898,37 million or 183,7 per cent of quota), she has observed and continues to observe a number of performance criteria and benchmarks (or in short, conditionalities).

Consistent with the government policy of liberalization, the Bank of Zambia, which has the primary responsibility of formulating and implementing monetary and financial system policies, has had to have its principal Act amended to better focus its objectives. Accordingly, the amended Bank of Zambia Act No. 43 of 1996 narrows the central bank's objective to price and financial system stability.

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[4]   On May 1, 1987 Zambia broke off relations with the Bretton Woods Institutions. Following this, on September 30 1987, the IMF declared Zambia ineligible to use its general resources.

[5]   In April 1991, the IMF had approved rights accumulation for Zambia, but due to elections and other difficulties the programme went substantially off track and therefore it had to be cancelled when the new Government came into office.

In its conduct of monetary policy, the Bank is increasingly placing greater reliance on indirect than on direct instruments. That is, the Bank now tries to influence the behaviour of the financial institutions and other market players through the operations of the market mechanism rather than through administrative controls, as had been the case previously. Apart from being in line with the Government policy of economic liberalization, indirect instruments offer greater scope for efficient resource allocation than direct instruments. They also enhance the effectiveness of monetary policy in reducing and stabilizing the growth of money supply and subsequently inflation in the short and long run. Equally important, they promote the emergence of efficient financial intermediation, which enhances the efficiency of money and capital markets (Alexander, et al., 1995). It is should therefore not be surprising that the conduct of monetary policy worldwide is increasingly relying on such instruments.

By contrast, direct instruments are only effective in the short run as commercial banks in the long run devise ways to circumvent regulation, such as creating non-bank subsidiaries through which to channel credit, and transactions with financial institutions that are not subjected to direct controls. Furthermore, direct instruments prevent banks from making optimal decisions about the structure of interest rates and balance sheets and thus discourage competition. This, in turn, results in inefficient money and capital markets.

In Zambia, indirect and market-based instruments have included open market-type operations, namely primary auctions of Treasury bills and Government bonds and auctions of short-term credit and term deposits to and from commercial banks. The Bank also auctions foreign exchange, either in its own right or on behalf of large players in the market (currently defined as suppliers of foreign exchange in excess of US$100 000 a week). However, due to the still underdeveloped nature of the country's financial markets, it has not been possible so far to abolish direct instruments completely. In this regard, until late last year the Bank has been using direct instruments sparingly[6]. Reserve ratios on core liquid assets and deposits are the two instruments that the Bank has been using.

As in other countries following a Fund programme, in Zambia financial programming forms the core of the monetary framework. This means that, as Cottarelli and Giannini (1997) argue, Zambia falls in the category of countries following a discretionary-cum-external agency delegation (or constrained-discretion) monetary framework. In other words, while the country enjoys a significant degree of instrument flexibility, its performance is subjected to strict oversight by the Fund through a number of agreed-upon performance criteria and benchmarks. I must point out here that while it may have been the case when Cottarelli and Giannini wrote their paper that there was hardly any disclosure to the public of the details of a Fund-supported programme, good progress has been made in this area. There are now quite a large number of countries, including Zambia, that have allowed the publication of their programmes (e.g. the authorities' Letter of Intent to the IMF Managing Director) on the IMF's website on the Internet. Some countries have gone as far as allowing the Fund to publish the accompanying Fund staff report. This means that the public is also now an important factor in terms of monitoring policy performance and thereby affecting policy credibility in an essential way. The only question one might ask is, how many people have access to this information, let alone the Internet?

As is well known, any breach of performance criteria results in the cancellation of a Fund-supported programme, unless waivers are granted. A waiver is not easily granted, it will only be granted if the Fund Board is satisfied that the breach can be remedied within a reasonable period of time or if the breach was due to unforeseen circumstances beyond the control of the authorities. Another important element which has gained currency in recent years, is that external financial support, particularly balance of payments support, is increasingly being tied to getting a nod or a "no-objection" indication from the Fund. As could be expected, conditionality in Fund-World Bank supported pro
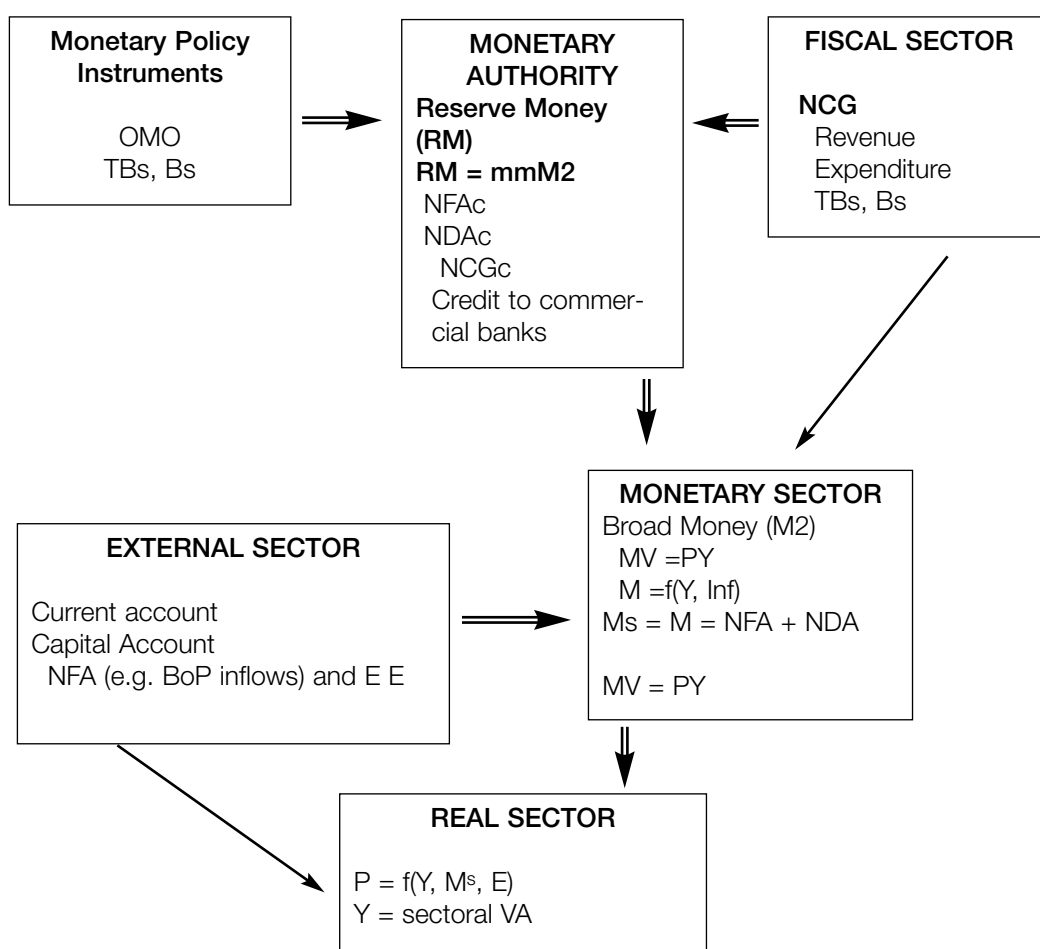
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6   Last year, particularly in the fourth quarter, the Kwacha experienced severe pressure arising mainly from excess liquidity due to unprogrammed fiscal expansion and fiscal behaviour.

grammes is one of the reasons, apart from the issue of the ownership of programmes, that causes concern among members of the IMF (particularly those from the developing world). However, from a policy performance angle it is quite tempting to argue that it is a good thing and even desirable. One possible downside of this argument is that it calls into question the issue of sustainability once the external stimulus has ceased.

I wish, at this point, to give a brief outline of the financial programming framework that Zambia currently uses. May I hasten to add that the description of financial programming that follows is extracted from the work of Bolnik (1994), which was later turned into an internal Manual at the Bank by Kuosmanen, Nkalamo, and Mtonga (1996), to whom I shall remain indebted. Note should also be taken that credit for the schematic model itself (Financial Model) is due to Kalyalya and Mutoti (1999). With a few exceptions here and there, mainly of emphasis and detail, the financial programming framework being presented is a typical exercise countries following Fund-supported programmes engage in.

Financial Model (BOZFM)

Monetary Policy Instruments	MONETARY AUTHORITY	FISCAL SECTOR
OMO TBs, Bs	Reserve Money (RM) RM = mmM2 NFAc NDAc NCGc Credit to commercial banks	NCG Revenue Expenditure TBs, Bs

MONETARY SECTOR
Broad Money (M2)
MV = PY
M = f(Y, Inf)
Ms = M = NFA + NDA

MV = PY

EXTERNAL SECTOR

Current account
Capital Account
  NFA (e.g. BoP inflows) and E E

REAL SECTOR

P = f(Y, Ms, E)
Y = sectoral VA

OMO = open market operations; mm = money multiplier; NFAc = net foreign assets of BoZ; NDAc = net domestic assets of BoZ; NCGc = BoZ's net claims on Government; NCG = total banking net claims on Government; TBs = GRZ Treasury bills; Bs = GRZ Bonds; NFA = total net foreign assets; BoP = balance of payments support; E = exchange rate; M = money demand, V = velocity; P = price level; Y = output; Inf = inflation rate, Ms = money supply; NDA = total net domestic assets; VA = value added

Financial programming refers to the forecasting of major macroeconomic variables over a period of time, and deriving quantitative policy targets from a set of objectives and assumptions. The exercise is pretty much like a normal projection model run in reverse. One starts out by setting the objectives and then applying basic macroeconomic relationships to generate targets for monetary and fiscal policy. The derived quantitative targets become policy targets and constitute the programme.

Accounting framework

The framework itself is based on macroeconomic accounts transformed into an accounting framework to ensure that the projections are consistent, at least to some extent. This does not necessarily mean that they are good. Rather, the projections are only as good as the available data or assumptions underlying the behavioural relationships. Indeed, if the data or the assumptions do not reflect reality, neither will the forecast. Nonetheless, engaging in the exercise forces its user to think about the basic relationships between the different economic variables from which a fully fledged macro-model can be built.

The framework is mainly built around four macroeconomic systems of accounts: National Accounts, particularly the GDP at current and constant prices; balance of payments; government finances; and monetary accounts, i.e. the monetary survey. The relationships between various accounting systems can be illustrated with simple equations familiar from any basic macroeconomics textbook.

National accounts identity:

$$Y + M = C + I + X$$

  Total   Total
 supply   demand
       where

Y =   value of total output
M =   value of imports of goods and services
C =   value of private and public sector consumption
I =   value of total investment, both private and public
X =   value of exports of goods and services

Rearranged:
$$C + I - Y = M - X$$
This equation basically tells us that any excess expenditure in the economy must be covered by an equal deficit in the trade balance.
Current account:

$$CA = X - M + YF + TR$$

In other words, the current account equals the trade balance plus net factor income from abroad (YF) plus net transfer payments (TR).
The current account can, in turn, be divided into sectoral accounts:

$$CA = S_p - I_p + S_g - S_g$$

Where $S_p - I_p$ means the difference between savings and investment in the private sector, and $S_g - S_g$ means the same in the government sector. It can also be interpreted as the overall resource gap or surplus (OBAL). This is a good target variable as it has a direct link to the current account.

Sometimes the banking sector is separated from the rest of the private sector as well, if, for example, there is a revenue shortfall that must be financed. The financing can take place either through the banking sector or through the non-bank private sector. In the former case, the financing requirement will show as an increase in net claims on Government by the banking sector in the monetary accounts, while in the latter, it will show as that by the non-banking sector.

The current account and capital accounts together represent the change in the Net International Reserves, which in turn, are an essential part of the monetary accounts.

CA + CAP = NIR

However, the main link between the monetary accounts and the balance of payments is via the Net International Reserves (NIR).

Money supply (broad money):

M = NFA + NDA + Other items, net (OIN),
where
NDA refers to net domestic assets and consists of the net domestic credit to the Government (NCOG) and net domestic credit to the private sector (NCNG). NFA refers to Net Foreign Assets and includes NIR and Net Foreign Assets of the Banking Sector (NFAB).

This is an accounting identity which states that the liabilities equal the assets in the monetary survey. In financial programming, one component is determined as a residual to ensure that the identity holds. Usually, credit to Government plays this role. However, in Zambia's case, the ceiling is placed on credit to the Government and leaves credit to non-government as the residual.

Above are the overall relationships between the four accounting systems. Clearly, in reality the links are much more complex. As a simple illustration, total output in the economy affects the national income and therefore Government revenues. By contrast, Government expenditure influences the level of total output in the economy. The total output also has an impact on the demand for imports and supply of exports, which in turn are items in the balance of payments. Services are linked to the level of activity in the economy as well. In addition, the level of output and inflation are major determinants of the demand for money in the economy.

Steps in financial programming

Like any other forecasting exercise, financial programming follows a certain sequence, starting from making assumptions on the values of the exogenous variables, i.e. those variables which the model cannot generate. In the next phase the endogenous variables are derived from the model, and the outcome is reviewed critically. If the outcome does not seem to be consistent or otherwise desirable, the exercise will be iterated several times, until the results are acceptable.

The current framework in Zambia involves the following eight steps:
i)   Determining objectives and assumptions;

ii)   calculating the targeted or projected paths for sectoral output volumes and values;

ii)   making projections of the balance of payments developments in accordance with the assumptions, targets, and GDP calculations;

iv)   designing the Government budget that takes into account the targets and revenue and expenditure projections based on GDP and other developments;

v)   compiling projections for the monetary accounts in accordance with the inflation target and real sector, BOP as well as budget developments;

vi)   choosing the benchmark and performance variables;

vii)   monitoring actual developments against the benchmarks and performance criteria; and

viii) updating and revising the projections as and when necessary.

From the above steps, it can discerned that there are four kinds of variables in the financial programming framework:

1 Objectives (Step i)
2 Exogenous variables/assumptions (Step ii)
3 Derived variables (i.e. the ones that the model produces) (Steps ii - v)
4 Policy targets (Step vi)

In terms of the implementation of monetary policy, reserve money and/or liquidity programming has been the main guide since 1992. This approach takes reserve money as the operating target of monetary policy, based on a given money multiplier. Broad money is treated as the intermediate target, while low and stable consumer price inflation serves as the ultimate target of monetary policy.

Table 1 presents a summary of the programming framework.

Table 1: Reserve Money Framework

SOURCES (Supply = 1 + 2)	USES (Demand = 3 + 4 + 5 + 6)
1) Net foreign assets (i-ii) i) BoZ foreign assets ii) Foreign liabilities	3) Currency in circulation 4) Commercial banks' deposits
2) Net domestic assets (iii+iv) iii) Net claims on Government (a-b) a) BoZ claims on Govt (loans, securities) b) Govt assets with BoZ (deposits) iv) Claims on others (loans and bank overdrafts)	5) Statutory reserves 6) Other deposits

To forecast reserve money, the Bank assesses on a daily basis the liquidity position of all deposit money at banks, which reflects the central bank's NFA and NDA position. The other component of the reserve money supply is the net claims on Government (NCG). This is forecast on the basis of Government revenue to be collected and deposited at the Bank and the anticipated Government expenditure. Treasury bills and bond transactions and Treasury bill rediscounts are also considered. Claims on commercial banks are predicted through open market operations and overdraft facility, with the commercial banks' overall current account position projecting the overdrafts to commercial banks.

On the demand side, reserve money is the sum total of currency in circulation, statutory required reserves, commercial banks' positive current account balances and other deposits.

4.   CHALLENGES OF MONETARY POLICY

All things considered, over the past ten years monetary policy has performed reasonably well. Inflation, although still quite high in comparison to other successful reforming countries in the region and to what we would want it to be, has been reduced from three digits to two digits, averaging 23 per cent a year in the past three years (Charts 1 and 2 as well as Table 2 in the Appendix provide more information). Much of the credit can be attributed to the well-defined monetary framework that is being followed. Admittedly, the progress that has been made on the inflation front and the macroeconomic situation are still quite fragile. Growth, though positive, remains below the levels necessary to reduce unemployment and widespread poverty on a sustainable basis. To this end, there are several challenges that monetary policy would be expected to meet.
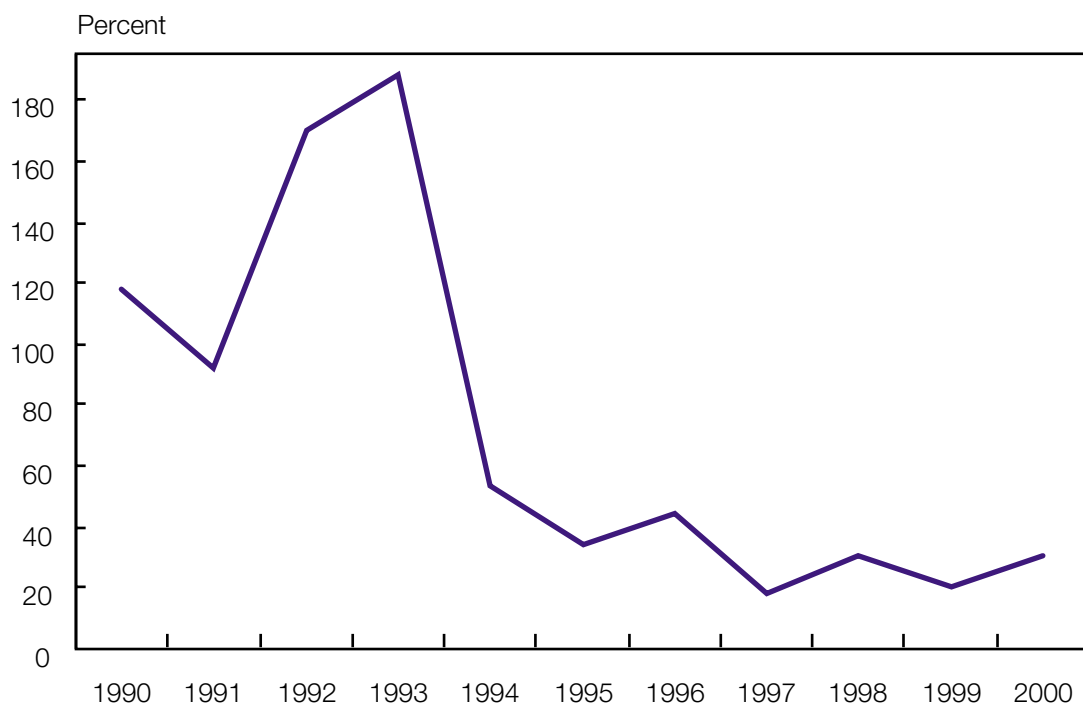
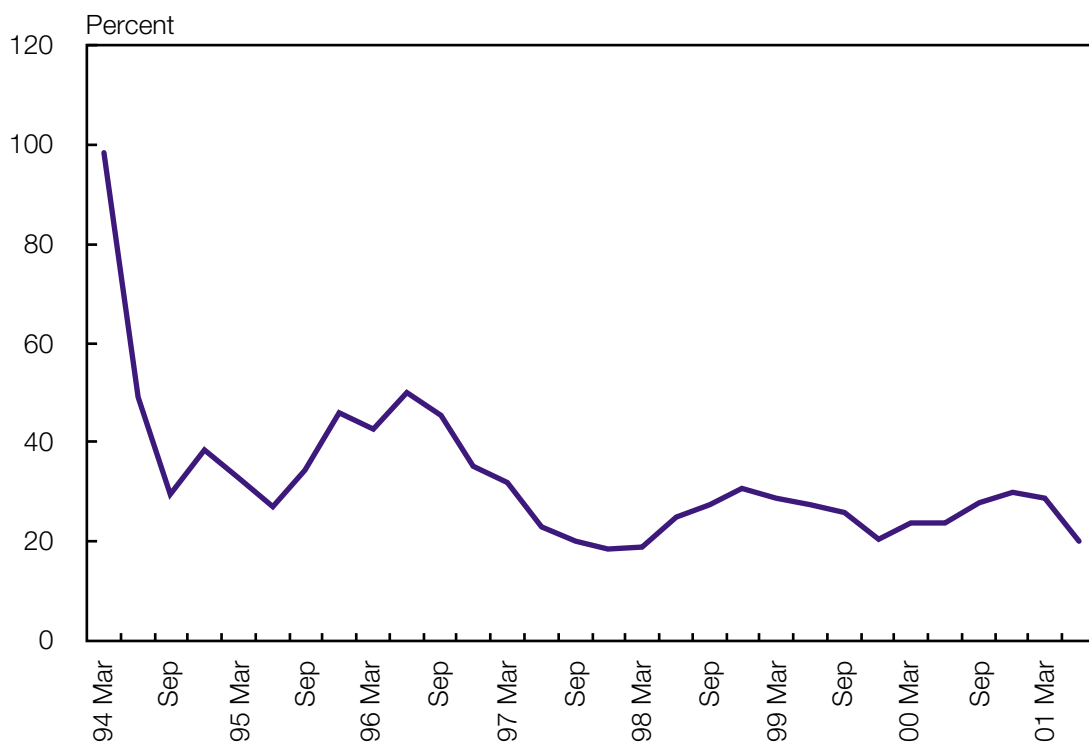Chart 1. Annual Headline Inflation (1990 -2000)

Percent

Chart 2. Zambia: Quarterly Annual Inflation (1994 Q1 - 2001 Q2)

Percent

The weak and undeveloped nature of the financial system poses a serious challenge to the effectiveness of monetary policy. The Zambian financial system, like that of most developing countries, remains shallow as reflected by the domination of the operations of commercial banks despite the reform effort. Among the banks, four of the five largest banks are branches of foreign banks. The remainder of the financial sector can be classified as non-bank financial institutions that include a development bank, a discount house (still in its infancy), a savings bank, mortgage and leasing finance companies, and insurance companies. In addition, as alluded to earlier, the nascent stock exchange needs to be developed to claim its rightful place in the economy. Currently, there are only nine companies floating shares on the market. Meanwhile, commercial banks have continued to provide traditional banking services, but customers complain these services are very narrow and costly.

The undeveloped nature of the secondary market for Government debt (despite the establishment of a discount house) has also retarded the efficient functioning of the primary market, as most investors are not prepared to invest in new bond issues unless these bonds can be sold at short notice and at as little expense as possible. The lack of an active secondary market entails that there is some inflexibility in using Government securities to regulate the money supply.

Money market imperfections can also be cited as a challenge to monetary policy in Zambia. This is clear from the volatility of interest rates for overnight interbank lending, high and sticky interest rates for market lending and a segmented money market.

Financial distress in the Zambian financial system is another problem. A number of commercial banks that mushroomed following financial liberalization have found it difficult to compete, resulting in more than eight banks being liquidated or placed in receivership. This development has largely been responsible for interbank market segmentation, as many participants are averse to risking their funds by lending to other banks. In addition, the bank failures pose challenges for confidence building in the financial system.

Weaknesses in fiscal policy will also continue to undermine the effectiveness of monetary policy. There are expenditure control problems as evidenced by the accumulation of arrears. Tax collection has largely been rigid mainly due to a narrow tax base that requires broadening. In addition, the fear of increasing the domestic debt to unsustainable levels, especially in view of Zambia's access to the enhanced Heavily Indebted Poor Countries (HIPC) Initiative last December, poses a dilemma in using Government securities for controlling growth in the money supply.

The above challenges notwithstanding, the central bank remains quite committed to playing the role of a catalyst to support the diversification and deepening of the money and capital markets. The introduction, last October, of Government securities with long maturity periods, i.e. the 273-day Treasury bills and the 24-month bond, is a good demonstration of this commitment. The bonds are also traded on LuSE. These efforts are aimed at creating a well-diversified financial system through which monetary policy tools would be effectively implemented to foster economic development. I must add here that without efficient and well-developed money and capital markets, the scope for implementing effective monetary policy will continue to be severely limited, in spite of having a well-defined monetary framework.

5. CONCLUSION

In the discussion above it has been established that although the achievement of monetary policy objectives has been quite remarkable, there have been major challenges, most of which were factors outside the country's monetary policy framework. It is clear that monetary policy contributes to the achievement of growth and poverty reduction through the reduction of inflation. A strong anti-inflationary policy will require improvement in the effectiveness of monetary policy, including broadening of instruments. In this context the Bank of Zambia will intensify the use of indirect instruments, such as open market operations, and reduce reliance on direct instruments. An enhancement of confidence in the internal and external value of the Kwacha will help the central bank to develop a market for medium and long-term financial instruments so as to widen the available options for

open market operations and reduce the sensitivity of the government budget to short-term fluctuations in interest rates.

The financial sector reforms have made fundamental changes to the operations of the economy, which are encouraging innovations and many of these we believe are irreversible. While there are many challenges to developing the financial system, the humble beginning that has been made will need to be nurtured and developed further. Now that the privatization programme is almost complete following the successful sale of the mines, the prospects for active private sector and public-private sector participation in productive activities are quite bright.

The supportive role of improved and stable fiscal performance to effective monetary policy implementation can hardly be overemphasised. To this end, active and effective co-ordination of fiscal and monetary policies will need to be strengthened.

Finally, as a country there will be need to face the issues of political and economic good governance head on. The well-defined monetary framework that has been developed to deliver, the need for transparency, accountability, and efficient allocation of resources cannot be over-emphasized.

Appendix

Table 2: Selected Programme Targets and Actual Outturn for Zambia (1992-2001)

Programme RAP (1992-1995)	1992		1993		1994		1995	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual
MS growth	-	73	-	102	-	63	-	55
Inflation	9	165	9	184	9	38	9	46
GDP growth		2.08		-0.24		-8.6		-2.46

SAF/ESAF (1996-1999)	1996		1997		1998		1999	
MS growth	-	34	-	24	-	23	20.3	29.2
Inflation	-	35	-	19	-	31	15	21
GDP growth		6.59		3.26	5.0	-1.84	5.0	2.44

PRGF(1999-2001)	2000 Target	Actual
MS growth	25.2	7.5
Inflation	19	30.1
GDP growth	4.0	3.5[1]

Source: Ministry of Finance and Economic Development; Bank of Zambia; Central Statistical Office

[1]   Estimate

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