KPMG

Economic Snapshot H2, 2016

Zambia

Inflation - Zambia grappled with a rapid erosion of domestic purchasing power over the past 10 months as the regional drought weighed on food availability and power generation capacity. Growth in consumer prices was further exacerbated by exchange rate pass-through. However, Zambia recorded a moderate pace of disinflation since reaching an estimated peak in February, partially on the back of monetary policy tightening undertaken in 2015 Q4. While still near multi-year highs, inflation slowed modestly in July to 20.2% y-o-y from a June reading of 21% y-o-y, marking the fifth month of disinflation.

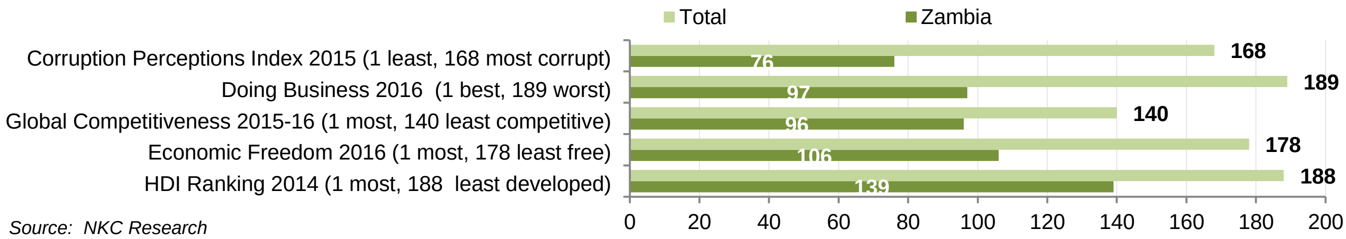
Growth – The Zambian economy is under duress as a cyclical downturn exacerbated structural challenges of weak infrastructure and a narrow economic base. On the production side, the drought-induced power crisis aggravated the structural power deficit, while the decline in disposable income weighed on consumer spending. We project that the real economy will expand by a meagre 3.3% this year, before recovering modestly to a projected 4.5% p.a. over the medium.

National development plan - Zambia's macroeconomic policy platform is embedded in the strategic Sixth National Development Plan (SNDP) for 2011-15, which has been revised in October 2014. The Revised Sixth National Development Plan 2013-16 (R-SNDP) is aimed at achieving the objectives set out in the Vision 2030 of becoming a prosperous middle-income country by 2030.

OPPORTUNITIES	STRENGTHS
Zambia boasts a wide spectrum of natural resources, including copper and emeralds.	Strong economic growth potential, especially within the hydropower and agricultural sectors.
Zambia is strategically and geographically favourably positioned as a trade and investment hub in Africa.	Track record of political stability.
Strong focus on road, rail, freight and power infrastructural development.	Healthy foreign direct investment (FDI) inflows on the back of natural resource wealth.
Low commercial penetration levels and attractive fiscal and non-fiscal incentives for investment in priority sectors, including agriculture and manufacturing.	Conservative monetary policy reduces pass-through of exogenous shocks to core price inflation.

VULNERABILITIES	WHAT IS BEING DONE?
Dependence on a single commodity (copper) for export receipts and FDI renders Zambia vulnerable to exogenous shocks.	Government has secured 100,000 hectors of land for industrial development in all ten in order to develop non-mining commercial activity
Regular power outages (due to inadequate electricity generating capacity) is weighing on the commercial sector	European Union's Energy Efficiency Quick Win Actions and Specific Electricity Indicators Programme is working on reducing electricity consumption in targeted sectors
Challenging business environment, including poor infrastructure and inefficient bureaucracy.	Recent reforms include increasing access to credit information, electronic filing of VAT and other taxes, and centralising border clearance administration
In order to keep Zambia on a progressive political trajectory, corruption will need to be addressed in the medium to long term – the country's corruption levels are anked 76th out of 168 countries by Transparency International.	Government has set up a National Program on Governance, strengthened specialised anti-corruption units, and directed the formation of Integrity and Ethics Committees in all government institutions.

MEGA TRENDS	
Population	15,066,266 (July 2015 est.); Age 15 - 64: 51.5%
Population growth rate (%)	2.88% (2015 est.)
Life expectancy at birth	Total population: 52.15 years; male: 50.54 years; female: 53.81 years (2015 est.)
HIV/AIDS	Adult prevalence rate: 12.9%; People living with HIV/AIDS: 1.2 million (2015 est.)
Adult literacy rate (age 15 and over can read and write)	Total population: 63.4%; male: 70.9%; female: 56.0% (2015 est.)
Urbanisation	Urban population: 40.9% of total population (2015); Urban population growth: 4.2% (2015)
Population below national poverty line	60.5% (2010 est.)
Unemployment rate	13.3% (2014)
Employment (% of total)	Agriculture: 52.2%, Industry: 9.5%; Services: 38.3% (2012 est.)
Labour participation rate (% of total population ages 15+)	79.3% (2014)
Business languages	Bemba, Nyanja, Tonga, Lozi, Lunda, Kaonde, Luvale, English
Telephone & Internet users	Main lines in use: 116,165; Mobile cellular: 11.56 million; Internet users: 3.16 million (2015)
Sources: CIA World Factbook, World Bank, UNESCO, ITU, UNAIDS & NKC Research	



Source: NKC Research

Risk environment / Risk outlook

Sovereign Risk Ratings		
S&P Global Ratings	**Fitch**	**Moody's**
B/Negative	B/Negative	B3/Negative

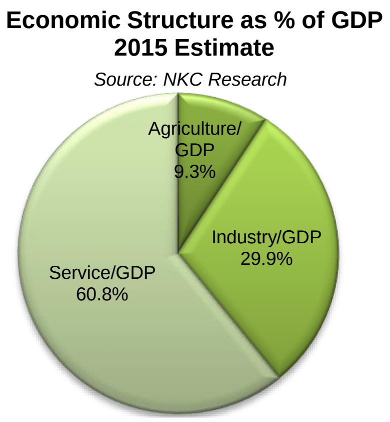
S&P Global Ratings maintained the sovereign credit rating at "B", while the outlook was downgraded from stable to negative, in a credit note dated March 18. S&P alluded to Zambia's fiscal fragility in the run-up to the August elections and rising tensions in the political environment as rationale for the downgrade in the outlook. An additional factor was the downward revision in Zambia's economic growth outlook for the period to 2019. The latter is in reflection of S&P's revised assumptions regarding the copper price and domestic production capacity. Additional factors undermining economic growth relate to continued poor rainfall, which lowers both agricultural activity and manufacturing via power shortages, the impact of expected fiscal consolidation, and high external vulnerabilities. The negative outlook furthermore reflects S&P's concerns that "*the weaker growth environment may not be sufficient to offset prevailing fiscal, external, and monetary risks*". S&P cautioned that the slowdown in the real economy will translate into a deterioration of banking sector asset quality, and stated that a high degree of loan restructuring and local currency depreciation will weaken bank capitalisation. With deposits increasingly dollarised, S&P warns that the impact of monetary policy could be hampered**.** In turn, **Fitch Ratings** downgraded the outlook on Zambia's sovereign credit rating from stable to negative, while the credit rating was affirmed at "B", on February 24. This came as a result of the deterioration in the fiscal account amid softening copper prices and a slowdown in economic growth. Persistent fiscal deficits, partially attributable to poor mining sector policies and higher-than-expected fuel subsidies and interest payments, and a depreciating exchange rate have inflated government debt at an alarming pace. Fitch cautioned that progress on fiscal reform has been slow, and warned that fiscal consolidation will fall short of target in 2016 on account of suppressed mining revenues and election-related expenditures. Furthermore, Fitch warned that external fragility has increased in light of tightening global conditions and low export earnings. On the other hand, **Moody's Investors Service** downgraded Zambia's long term issuer rating from "B2" to "B3" – equivalent to a downgrade of "B" to "B-" on our scale – on April 19. The outlook on the rating was furthermore downgraded to negative from stable. The downgrade on the outlook further reflects Moody's view that the balance of risk is skewed towards even greater fiscal slippages and a slower pace of fiscal consolidation, which introduces significant ambiguity with regard to funding challenges and the outlook for the debt profile. In turn, the negative outlook reflects heightened uncertainty with regard to election-related spending. The negative rating action came as a result of fiscal slippages in excess of Moody's initial projections, and the prospects of further deterioration in the debt matrix.

Infrastruc-ture	Diversity of the Economy	Banking Sector	Continuity of Economic Policy	GDP Growth	Key Balances	Foreign Investment	Socio-economic Develop-ment	Forex Reserves
Poor, but improving	Fairly limited; dominated by the copper sector	Fairly liberal	Broad continuity expected	Strong medium-term potential	Twin deficits	Reasonable	Low	Modest

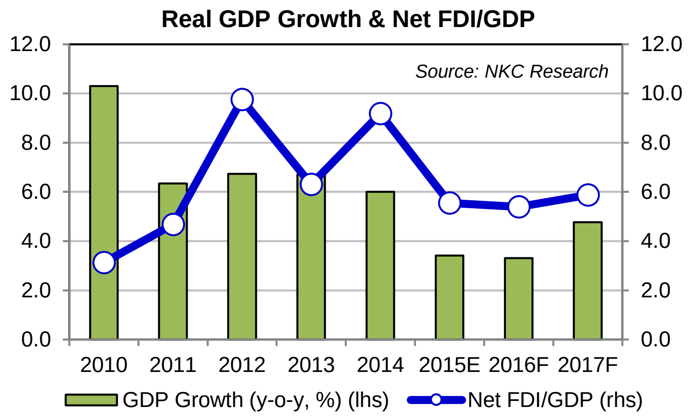
Stock Market	Listed Companies	Liquidity	Market Cap	Dominant Sector	Daily Trading Volume
Yes	24	Relatively limited	ZK59.63bn (August 15)	Retail	N/A
Capital Market	**Development**	**Liquidity**	**Maturity Range**	**Municipal Bonds**	**Corporate Bonds**
Yes	Relatively developed	Relatively limited	91-days to 364-days (T-bills) 2-Yr to 15-Yr (Govt. bonds)	N/a	Yes

Macro-economic overview

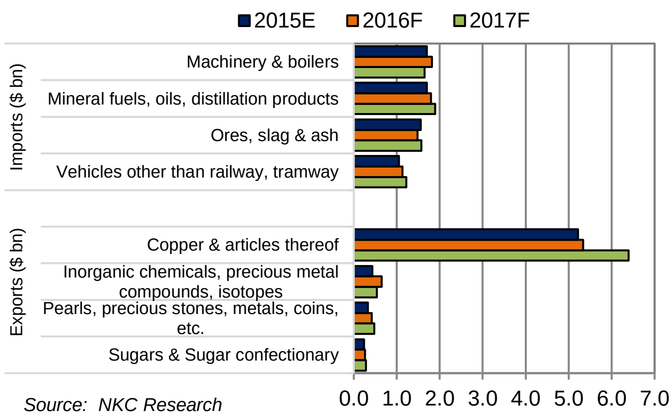
The Zambian economy is under duress as a cyclical downturn exacerbated structural challenges of weak infrastructure and a narrow economic base. On the production side, the drought-induced power crisis aggravated the structural power deficit, culminating in frequent and prolonged power outages, increased labour costs as power outages forced employees to work outside conventional hours to meet production targets, and expensive imports of emergency power. Low commodity prices furthermore discouraged extractive sector production. On the expenditure side, economic activity was constrained by the high cost of credit, tight interbank liquidity conditions, and the lagged impact of exchange rate pass-through, weighing on consumer and investor confidence during the first half of the year. On a positive note, domestic power capacity will improve during the latter half of 2016 as power projects come on-stream. On balance, we project that the real economy will expand by a meagre 3.3% in 2016, from an estimated 3.4% in 2015, before recovering modestly to a projected 4.5% p.a. over the medium. This will be driven by a moderate demand-driven recovery of copper prices and the lowering of structural impediments to domestic production capacity as the energy deficit narrows. Zambia is expected to post growth in excess of 5.5% p.a. by 2018.



The services sector is firmly in the lead as the primary contributor of real economic growth at an estimated 60.8% share of GDP in 2015, while the industrial sector contributed an estimated 29.9% to GDP in 2015. The latter is dominated by copper mining operations and downstream-related activities. Soft international copper prices and erratic power supply undermined mining sector potential since mid-2014, incentivising high-cost miners to mothball operations as profit margins were squeezed. Moderate recovery in global commodity prices and closing the large infrastructure gap will however support extractive sector growth over the medium term. On the other hand, the agricultural sector contributed an estimated 9.3% of GDP in 2015. Zambia suffered a devastating drought attributable to the El Niño-Southern Oscillation (ENSO) weather phenomenon in 2015, which resulted in reduced crop yields. Despite its relatively low contribution to GDP, agriculture remains one of the economy's most important sectors with regard to job creation, and provides a livelihood for the majority of the working population.

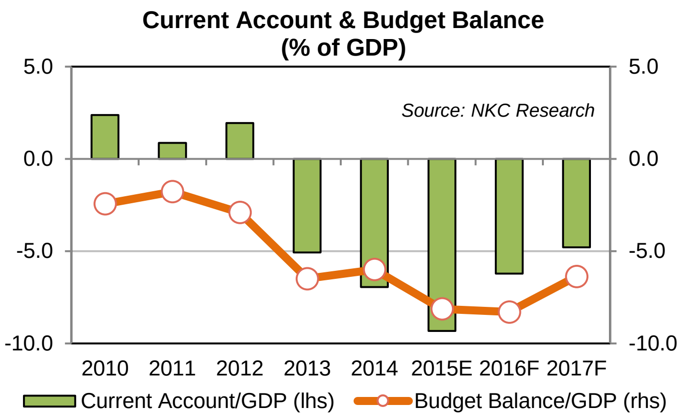


Richly endowed with a wealth of mineral resources, encompassing copper riches, gemstones and industrial minerals, Zambia is expected to remain a primary drawcard of foreign direct investment (FDI) inflows over the medium term. In the short term, however, stressors to the extractive sector including a wide drought-induced power deficit, punitive tax policies and a softening commodity price environment have incentivised high-cost miners to place loss-making operations under care & maintenance. On the other hand, the severe drought-induced electricity crisis has however opened an array of attractive FDI opportunities in the energy sector as Zambia seeks to broaden the energy supply base. This relates in particular to opportunities within the solar energy field.

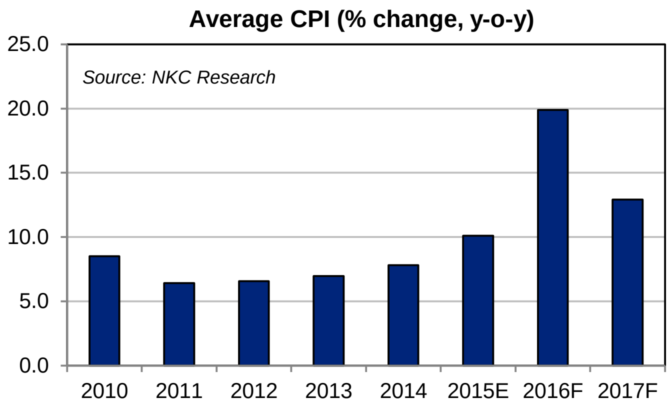


Main Imports: % share of total	2015E	2016F	2017F
Machinery & boilers	19.77	21.41	18.97
Mineral fuels, oils, distillation products	19.77	21.18	21.72
Ores, slag & ash	18.14	17.41	18.05
Vehicles other than railway, tramway	12.21	13.34	14.08
Main Exports: % share of total	**2015E**	**2016F**	**2017F**
Copper & articles thereof	71.99	71.33	76.00
Inorganic chemicals, precious metal compounds, isotopes	5.93	8.69	6.41
Pearls, precious stones, metals, coins, etc.	4.55	5.61	5.70
Sugars & Sugar confectionary	3.24	3.45	3.33

Along with the Democratic Republic of the Congo (DRC), Zambia is the African continent's leading producer of copper, with the red metal accounting for three-quarters of export receipts. This renders the export position vulnerable to both international price and domestic supply developments. As a result, domestic challenges faced by the mining sector, such as erratic power supply and frequent amendments of mining tax policy weigh on domestic production capacity. Numerous high-cost miners announced in 2015 that operations have been placed under care & maintenance until the international copper price recover and domestic conditions improve. Despite difficulties suffered, however, copper production increased in 2015 to 711,515 tonnes from 708,000 tonnes produced the previous year. In addition to copper, Zambia exports precious stones, agricultural produce and inorganic materials. In turn, the import bill is dominated by capital goods consumed by the primary sector, as well as power and petroleum products utilised as industrial inputs.



Zambia is highly susceptible to shocks to the terms of trade due to single commodity dependence on copper and a narrow export base. High direct trade ties to China and implicit exposure to the Asian giant due to its position as primary global consumer of copper imply that sectoral rebalancing and a slowdown in economic growth – hence, demand for base commodities – in its trading partner have far-reaching consequences for Zambia via the merchandise trade channel. The merchandise trade account has worsened significantly over the past annum due to the spillover effects of severe supply-side shocks and structural vulnerabilities. However, a modest demand-driven recovery in copper prices and reduction of the infrastructure shortfall will aid a moderate recovery in the current account position by 2017. In turn, Zambia is structurally on a poor footing with regard to the fiscal position, owing to large recurrent expenditures, a fairly narrow revenue base and spillover effects from previous years' fiscal spendthrift. Zambia has furthermore shown increased signs of a drift towards populism due to the government's reluctance to pass on the high costs of emergency power imports to voting citizens. High spending on social goods & services, as well as rising interest costs on outstanding debt, limit the funds available for capital expenditure.



Zambia grappled with a rapid erosion of domestic purchasing power in recent months as the regional drought weighed on food availability and power generation capacity. Growth in consumer prices was further exacerbated by exchange rate pass-through. Due to the supply-side nature of the shock to inflation, traditional monetary policy tools were largely inadequate to arrest the rapid growth in consumer prices. The apex bank focused on the absorption of excess liquidity, thereby slowing growth in monetary aggregates, reducing kwacha erosion and anchoring inflation expectations to limit pass-through to core prices. By soliciting support from a range of liquidity absorption tools, the central bank has been successful in reining in growth in credit and money supply via de facto tightening of financial conditions, notwithstanding a negative real interest rate differential. July marked the fifth month of modest disinflation, although growth in consumer prices remained stubbornly above the 20% y-o-y threshold. The consumer price index increased by 20.2% y-o-y in July, compared to a previous month inflation reading of 21% y-o-y. Our baseline projection is for modest and gradual disinflation during the latter half of the year, and accelerated disinflation towards year-end on the back of base effects and improved food availability.

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