Abstract

This paper reviews 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 percent over the last three years. However, formidable challenges still lie ahead in terms of reducing inflation further and establishing a stable and sustainable macroeconomic environment.

The author would like to acknowledge the support and assistance of many colleagues. In particular, he wishes to thank Ivan Zyuulu, Evans Luneta, Francis Chipimo, and Kellyford Nkalamo for helpful suggestions. The views expressed however are the sole responsibility of the author and do not necessarily reflect the official position of the Bank of Zambia.
1.0 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 last 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 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 rate 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 financial sector reforms that the country has undertaken over the last 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.

2.0 FINANCIAL SECTOR REFORMS IN ZAMBIA

Soon after gaining political independence in 1964, the in-coming Zambian Government embarked on, among other programs, a rigorous program of nationalization of what were considered 'commanding heights' of the economy. By the 1980s about 80% 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).

As the economic situation in the country continued to deteriorate, towards the end of the 1980s the Government, with the support of cooperating partners, in particular, the Bretton Woods Institutions, undertook to carry out some economic and structural reforms. Re-emergence of plural politics in 1990 and the consequent change of Government in October 1991 provided additional stimuli to the reform process. More importantly, unlike the previous Government the newly elected Government
embraced fully the structural adjustment program introduced in June 1989 (UNZA, 1993). The core of these reforms was 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 Bank of Zambia, played effective roles in the transformation process. To facilitate 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 process in the financial sector with several measures being implemented between 1992 and 2000. The developments that have taken place, as a direct consequence of the financial reform process in Zambia that require special mention include:

(a) Interest rates

The decontrol of interest rates in 1993 was the cornerstone to the liberalization of the Zambian financial system as ceilings were eliminated to improve real interest rates, which were negative for many years. Since then financial institutions are free to 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 rent-seeking behaviour, characteristic of exchange controls, liberalization was aimed at maintaining competitiveness of the domestic currency vis-à-vis foreign currencies, promoting efficient external payments system, and the attainment of 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\(^2\), 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.

\(\text{(d) The interbank market}\)

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

\(\text{(e) Establishment of a stock exchange}\)

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.

\(\text{(f) Modernization of the national payments system}\)

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).

\(\text{(g) Strengthening of the financial sector legal framework}\)

The enactment of appropriate legal framework for the banking sector is essential for the establishment of a well-functioning financial system and effective implementation of monetary policy. In this regard, the Banking and Financial

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\(^2\) The cash budget was introduced as one of the tools for tightening fiscal policy with a view to complementing monetary policy in controlling inflation.
Services Act was enacted in December 1994. Substantial amendments were 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 law 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.

3.0 MONETARY POLICY FRAMEWORK IN ZAMBIA

It should be stated from the outset that Zambia as member of the International Monetary Fund (IMF) since 1965 has over the years undertaken quite a number of Fund-supported programs. This, as Cottarelli and Giannini (1997) have rightly argued, 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 programs goes beyond the scope of this paper. For an interested reader, there is a variety of IMF and World Bank documents that 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 were also not very well defined and implementation of monetary policy relied mainly on direct instruments, which included fixed interest rates and credit allocation, core liquid assets and statutory reserve requirements. Equally important, financing of the Government fiscal budget was heavily dependent on central bank borrowing.

As it turned out, real interest rates were for the most part negative which resulted in high levels of dis-intermediation, 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, monetary policy was more often than not loose mainly as way of providing relatively cheap credit to the state-owned enterprises, resulting in high growth rates of domestic credit and consequently 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 the widening of domestic savings-investment gap.

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

The combined effects of the above factors as well as structural rigidities in the economy, such as, heavy dependency on the production and export of copper, inefficient and hence inappropriate import substitution industrial strategy and public sector was the pushing of 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 very 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 prime mover of economic growth and development.

In early 1992, Zambia reached agreement with the IMF for a shadow program through the first half of the year to be monitored informally by the Fund staff. In July of the same year the Fund approved Zambia's Rights Accumulation Program (RAP) for the next 3½ years, with a maximum amount of SDR 836.9 million or 309.6 percent of quota. Zambia managed to successfully graduate 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 should be expected, being on a Fund program and given the amount of resources Zambia has accessed as a result (SDR 898.37 million or 183.7 percent of quota), she has had 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 (hereafter, the Bank or BoZ), 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 No. 43 of 1996 narrows the central bank's objective to price and financial system stability.

In its conduct of monetary policy, the Bank is increasingly placing greater reliance on indirect than 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

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3 On May 1, 1997 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.

4 In April 1991, the Fund had approved rights accumulation for Zambia, but due to elections and other difficulties the program went substantially off track and therefore it had to be cancelled when the new Government came into office.
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, both in the short and long run. Equally important, they promote 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 world over is increasingly relying on such instruments.

In contrast, direct instruments are only effective in the short run as commercial banks in the long run devise ways, such as, creating non-bank subsidiaries through which to channel credit and transactions with financial institutions not subjected to direct controls to circumvent regulation. Further, 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 Treasury bills and Government bonds auctions and auctions of short-term credit and term deposits to and from commercial banks. The Bank does also auction foreign exchange, either in its own right or on behalf large players in the market (that is, suppliers of foreign exchange in excess US $100,000 per week). However, due to the still underdeveloped nature of financial markets it has not been possible so far to do away with direct instruments completely. In this regard, the Bank has, until late last year due to sudden pressures (of a speculative nature) on the exchange rate of the domestic currency (the Kwacha) against major currencies, been using direct instruments sparingly. 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 program, in Zambia financial programming forms the core of the monetary framework. This means that, as Cottarelli and Giannini (1997) have argued, Zambia falls in the category of countries following a discretionary-cum-external agency delegation 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 program, good progress has been made in this area. There are now quite a large number of countries, including Zambia, that have allowed publication of their programs (i.e., authorities' Letter of Intent to the IMF Managing Director) on the internet, i.e. the IMF web site. Some countries have gone so far as to allow 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, how many people have access to this information, let alone the internet?

As is well known, breach of performance criteria results in cancellation of a Fund-supported, unless waivers are granted. The latter is not easily granted, but are (is) only granted if the Fund Board is satisfied that the breach can be remedied within a reasonable period of time or it 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 expected, this is one of the reasons, apart from the issue of ownership of programs, that members of the IMF, from developing world especially, are raising concerns about conditionality in Fund-World Bank supported programs. 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 throws into question the issue of sustainability once that that external stimulus has been lifted off.

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 made that 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 programs engage in.
Financial Model (BOZFM)

**Monetary Policy Instruments**
- OMO
- TBs, Bs

**MONETARY AUTHORITY**
- Reserve Money (RM)
  - $RM = mmM2$
  - $NFAc$
  - $NDAc$
  - $NCGc$
  - Credit to commercial banks

**EXTERNAL SECTOR**
- Current account
- Capital Account
  - $NFA$ (e.g. BoP inflows) and $E$

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

**FISCAL SECTOR**
- NCG
  - Revenue
  - Expenditure

**REAL SECTOR**
- $P = f(Y, M^e, E)$
- $Y = \text{sectoral VA}$

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$OMO = \text{open market operations; } mm = \text{money multiplier; } NFAc = \text{net foreign assets of BoZ; } NDAc = \text{net domestic assets of BoZ; } NCGc = \text{BoZ's net claims on government; } NCG = \text{total banking net claims on government; } TBs = \text{GRZ Treasury Bills; } Bs = \text{GRZ Bonds; } NFA = \text{total net foreign assets; } BoP = \text{balance of payments support; } E = \text{exchange rate; } M = \text{money demand, } V = \text{velocity; } P = \text{price level; } Y = \text{output; } Inf = \text{inflation rate, } M^e = \text{money supply; } NDA = \text{total net domestic assets; } VA = \text{value added}$
Financial programming refers to 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 applies basic macroeconomic relationships to generate targets for monetary and fiscal policy. The derived quantitative targets become policy targets and constitute the program.

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 full-fledged macro-model can be built.

The framework is mainly built around four macro-economic 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 text book.

National accounts identity:

\[ Y + M = C + I + X \]

**Total supply** \( Y \)

**Total demand** \( C + I + X \)

**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:
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 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, is 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 Net International Reserves (NIR).

*Money supply (broad money):*

\[ M = NFA + NDA + \text{Other items, net (OIN)}, \]

*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 equals 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 leaving credit to non-government as 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. On the other hand, government expenditure influences the level of total output in the economy. The total output also has an impact on 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 of Financial Programming**

Financial programming like any other forecasting exercise 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 critically reviewed. 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 8 steps, as follows:

i) determining objectives and assumptions;

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

iii) making projections for 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 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 2: Reserve Money Framework**

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

To forecast reserve money, on a daily basis, the Bank assesses the liquidity position of all deposit money banks, which reflects the central bank’s NFA and NDA position. The other component of 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.

### 4.0 CHALLENGES OF MONETARY POLICY

All things considered, over the last 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 percent a year in the last three years (Table 2 provides more information). Much of the credit can be attributed to a well-defined monetary framework that is being followed. Admittedly, the progress that has been made on the inflation front and the macroeconomic situation is still quite fragile. Growth, though positive, remains below 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 rise to.

The weak and undeveloped nature of the financial system poses a serious challenge to 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 stage), a savings bank, mortgage and
leasing finance 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.

The financial system is not only shallow, but the range of financial
instruments and services offered is quite narrow with Treasury bills and Government
bonds being the main financial instruments available on the market. The stock
exchange has yet to grow. Currently, there are only nine companies floating shares on
the market. Meanwhile, commercial banks have continued to provide the traditional
banking services, which customers are complaining to be 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 could 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 money supply.

Money market imperfections can also be cited as a challenge for monetary
policy in Zambia. This is clear from the volatility of overnight inter-bank lending
interest rates, sticky market lending interest rates 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 over eight banks being liquidated or placed in
receivership. This development has largely been responsible for inter-bank market
segmentation, as many participants are averse to risking their funds to other banks.

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

The above challenges notwithstanding, the central bank remains quite
committed to playing the role of a catalyst to support diversification and deepening of
the money and capital markets. The introduction, last October, of Government
securities with long maturity periods, i.e., the 273 days Treasury bills and the 24-
months 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.
5.0 CONCLUSION

In the discussion above it has been established that although achievement of monetary policy objectives has been quite remarkable, there have been major challenges, most of which are factors outside the country's monetary policy framework. It is clear that monetary policy contributes to the achievement of growth and poverty reduction through 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 program 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.

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 hardly over-emphasized.
## Appendix

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

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<tr>
<td>MS growth</td>
<td>-</td>
<td>73</td>
<td>-</td>
<td>102</td>
</tr>
<tr>
<td>Inflation</td>
<td>9</td>
<td>165</td>
<td>9</td>
<td>184</td>
</tr>
<tr>
<td>GDP growth</td>
<td>2.08</td>
<td>-0.24</td>
<td>-8.6</td>
<td>-2.46</td>
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<td>35</td>
<td>-</td>
<td>19</td>
</tr>
<tr>
<td>GDP growth</td>
<td>6.59</td>
<td>3.26</td>
<td>5.0</td>
<td>-1.84</td>
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<table>
<thead>
<tr>
<th><strong>PRGF (1999-2001)</strong></th>
<th>2000</th>
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<tbody>
<tr>
<td>Target</td>
<td>Actual</td>
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<tr>
<td>MS growth</td>
<td>25.2</td>
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<tr>
<td>Inflation</td>
<td>19</td>
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<tr>
<td>GDP growth</td>
<td>4.0</td>
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</tbody>
</table>

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

1/ Estimate
References


