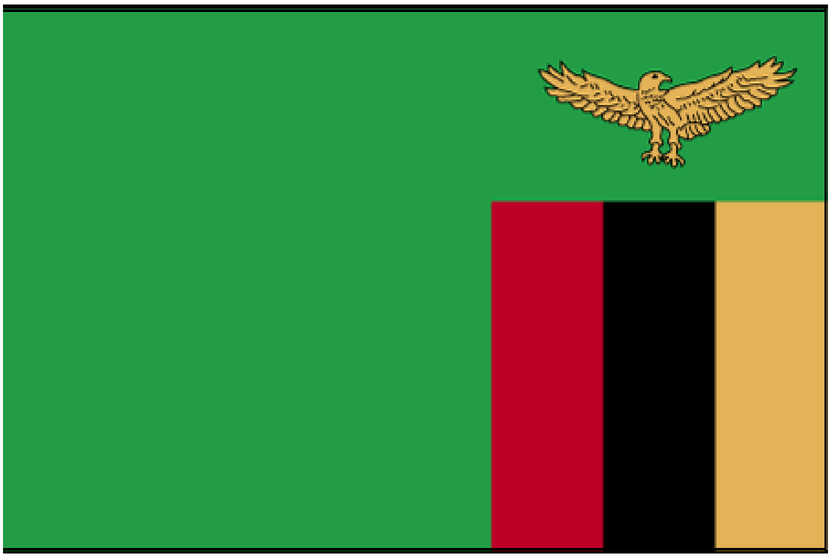
Country report **ZAMBIA**



Summary

While Zambia has continued to grow at a healthy pace of over 5% a year since 2000, the high growth rate has failed to achieve inclusive growth. Copper accounts for over one-sixth of Zambia's GDP and for over 80% of its total exports, making Zambia highly dependent on international commodity price movements. Inflation has been largely contained, thanks to greater food security and favourable weather conditions. The Bank of Zambia introduced a new benchmark interest rate, the BoZ Policy Rate which should leave monetary policy more forward-looking and quicker to respond to current or expected price shocks. The most notable event this year was the USD 750m Eurobond issue which was significantly oversubscribed and had a yield of 5.6%, which is bargain by African standards. The political climate has been stable since elections last year and is expected to remain so.

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Zambia

National facts	
Type of government	Republic
Capital	Lusaka
Surface area (thousand sq km)	753
Population (millions)	13.1
Main languages	English (Official)
	Local Languages
Main religions	Christian (65%)
	Muslim and Hindu (34%)
	Indegenous Beliefs (1%)
Head of State (president)	Michael Sata
Head of Government (president)	Michael Sata
Monetary unit	Kwacha (ZMK)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	20	0.03
Nominal GDP at PPP	22	0.03
Export value of goods and services	9	0.04
IMF quotum (in mln SDR)	489	0.23
Economic structure	*2011*	*5-year av.*
Real GDP growth	6.6	6.4
Agriculture (% of GDP)	21	21
Industry (% of GDP)	34	33
Services (% of GDP)	46	46
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1482	14
Nominal GDP per head at PPP	1643	13
Real GDP per head	784	10

Social and governance indicators	rank / total
Human Development Index (rank)	164/187
Ease of doing business (rank)	94/185
Economic freedom index (rank)	96/ 179
Corruption perceptions index (rank)	91/182
Press freedom index (rank)	86/179
Gini index (income distribution)	54.6
Population below $1.25 per day (PPP)	69%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
China	35	South Africa	33
Switzerland	18	Dr Congo	22
South Africa	12	China	11
DR Congo	5	Kuwait	6

Main export products (%)	
Copper	81
Non-metal exports	13
Cobalt	5
Main import products (%)	
Capital goods	48
Manufactures	24
Fuels	17
Primary products	7
Openness of the economy	
Export value of G&S (% of GDP)	46
Import value of G&S (% of GDP)	39
Inward FDI (% of GDP)	10.0

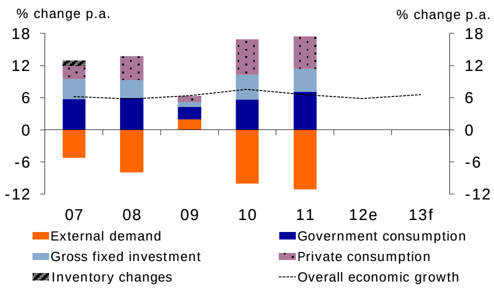
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Zambia is a land-locked country covering a total area of about 753,000 sq. km. It is populated by about 13 million inhabitants. Zambia shares borders with eight other countries, the Democratic Republic of Congo, Tanzania, Malawi, Mozambique, Zimbabwe, Botswana, Namibia and Angola. The country has an abundance of natural resources, such as copper, cobalt and water resources. Agriculture and mining activities, together, account for 21% of the GDP. The manufacturing and construction sectors combined account for 34% of output, with most of the growth coming from the construction sector (25%) while the contribution of the manufacturing sector is just close to 9%. The services sector, consisting of sub-sectors such as financial services, transport, retailing and tourism makes up for over 46% of the economy. Agriculture is by far the largest employer in the economy. It provides employment for 85% of the formal labour force while services and industry contribute 9% and 6% respectively. Overall, it is estimated that 70% of Zambia's rural population is engaged in agriculture, largely subsistence farming. Zambia is a fairly open economy with exports amounting to over 46% of the GDP and imports amounting to 39% of GDP. As the largest copper producer on the African continent, the Zambian economy largely benefits from high commodity prices. The copper sector accounts for an estimated 10%-15% of Zambia's GDP, and over 80% of its total exports. Its importance for the economy is stronger, though, owing to related services.

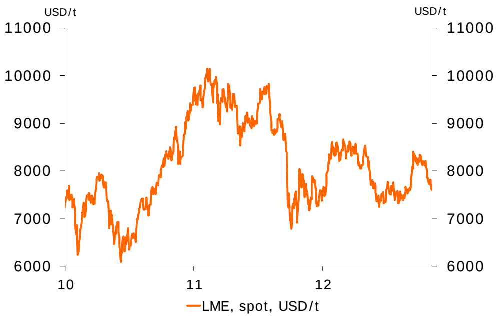
Zambia's economic growth slowed to 6.6% in 2011 from 7.6% in 2010, mainly as a result of a weaker mining sector performance. Growth is expected to slow down further to 5.8% in 2012 due to the impact of tumbling copper prices. However, a rebound is expected in 2013. In the medium-term, growth will be underpinned by sustained expansion in agriculture, construction, manufacturing, transport and communications, and by a rebound in mining. Infrastructural inefficiencies continue to impede growth in almost all sectors. To this end, the government has made substantial progress in infrastructure construction in 2011 and 2012, and has invested in manufacturing through the establishment of Multi Facility Economic Zones. Zambia's prospects for sustained growth depend on increased economic diversification, away from mining. While efforts are being made to boost other sectors, the positive impact will be felt only in the medium to long run. Zambia remains vulnerable to risks posed by a global economic slowdown that could dampen export growth and reduce donor aid, as Zambia is highly dependent on donor aid to fund its economic and social reforms programmes.

Chart 1: Growth performance



Source: EIU

Chart 2: Copper price



Source: Reuters EcoWin

The banking sector accounts for more than 90% of Zambia's total financial industry assets. At the end of 2011, there were 19 commercial banks in Zambia, up from 18 in 2010. However credit supplied to the private sector was less than 10% of GDP in 2011. Banks prefer to invest in public debt instruments and, in 2011, held more than half of total treasury security holdings. High interest rates, upward of 25%, remain a barrier to accessing credit, especially for small-and-medium-sized businesses. In a bid to reduce lending rates, the government cut corporate tax rates for the banking sector and reduced the statutory liquidity requirement while increasing the required minimum capital base across the industry. However, this has not yet fully translated into higher credit availability for the private sector.

Political and social situation

Zambia has held democratic elections since 1991, culminating in the September 2011 polls won by the opposition Patriotic Front, with Michael Sata becoming president on promises to help the poor and ensure that all get to reap the benefits of the country's abundant mineral wealth. Elections take place every 5 years, with the next presidential and national assembly elections due in 2016. During the first quarter of 2012 the ruling party threatened to disband the main opposition party in the country, the Movement for Multiparty Democracy (MDD). Many senior officials in the government and judiciary who were considered too close to the previous administration were replaced. Time and again, issues crop up concerning lack of clarity in appointments and dismissals of people in the legislature and judiciary.

On the social front, much remains to be done to alleviate poverty and unemployment. With two-thirds of the population living on less than USD 1.25 a day, extreme poverty remains rampant in the country and is mostly concentrated in rural areas. Growing youth disillusionment over unemployment is creating political and economic tensions in the country and was one of the main reasons behind the defeat of the incumbent government in the last election. Obstacles to youth employment include the inability of the educational system to equip people with relevant skills required by the job market, high school dropout rates, a lack of entrepreneurial opportunities and poor access to labor market information for job seekers and employees. Access to health services has significantly improved. Nevertheless, the HIV/aids rate remains one of the highest in the world. In 2011, nominal per-capita income in Zambia rose to an average of USD 1,482, up from USD 485 in 2004, which led to Zambia being classified by the World Bank as a low-middle-income country for the first time.

A few of the new economic policies introduced in 2012 deserve to be mentioned, as they highlight the nature of rule by the present government. A new statutory instrument (SI) was introduced during the third quarter, making it illegal for any business to pay for goods and services in foreign currencies within Zambia. This was done to provide support to the Zambian currency which has experienced a steep depreciation in recent times. Zambia's business environment was shaken and prone to misinterpretation when key privatization deals were reversed by the Patriotic Front (PF) such as the compulsory acquisition of railway concession rights awarded to private company Railway Systems of Zambia (RSZ).

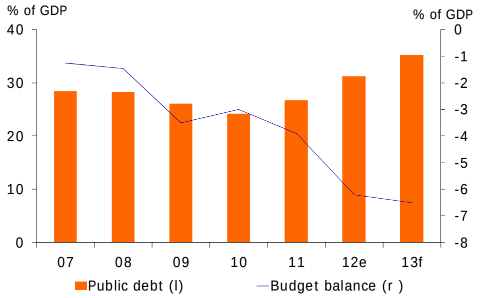
Economic policy

The fiscal policies dictated by the government are in general targeted towards improving the social and infrastructural deficiencies in Zambia. The monetary policies dictated by the central bank target an inflation rate of 7%. To meet this goal, The Bank of Zambia (BoZ) introduced a new benchmark interest rate, the BoZ Policy Rate. The rate has been set at 9% presently.

Improving domestic resource mobilization remains a key priority for the government. The main challenge for fiscal policy remains that of widening the tax base, increasing tax collections from the mining sector and allocating these resources to productive use. In 2011, the fiscal deficit was 3.9% of GDP, which is expected to widen to 6.2% in 2012 and to 6.5% in 2013. The total government expenditure stood at 9.8% of GDP in 2010, which further increased to 17.5% in 2011 and is expected to reach 22.6% in 2012, after which it will likely moderate again. This reflects the new government's policy of increased expenditure on social and infrastructure development. Part of the increased spending on infrastructure will be financed by external borrowing. To this end, proceeds from the hugely successful USD 750m Eurobond issue in September 2012, which was significantly oversubscribed and had a yield of 5.6%, which is bargain by African standards, will be utilized. In 2005, IMF and World Bank granted debt forgiveness to Zambia under the Highly Indebted Poor Countries programme. As a result, the ratio of public debt to GDP decreased from 130% in 2004 to 30% in 2006. This debt relief in combination with other Multilateral Debt Relief Initiatives placed fiscal finances on a more solid footing. This decreased to 24% in 2010 but now is again on an increasing trend to an expected 33% by 2013.

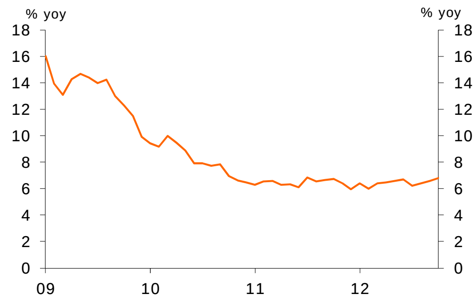
Inflation has been largely contained, thanks to greater food security and favourable weather conditions. However inflationary pressures have increased due to the introduction of minimum wages in July 2012. This is despite the fact that food price pressures were contained substantially owing to higher maize production and government subsidization, which should have otherwise led to lower inflation. Sticky high international oil prices and a marginally weaker kwacha exchange rate will only add to the inflation woes. Nonetheless, inflation is expected to remain in single digits.

Chart 3: Public finances



Source: EIU

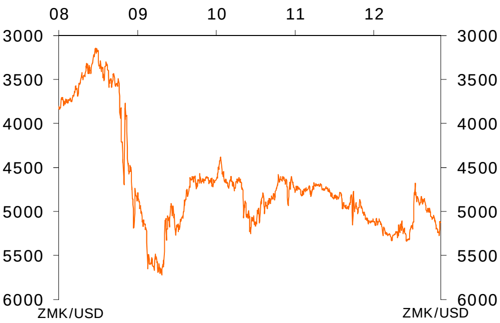
Chart 4: Inflation



Source: Reuters EcoWin

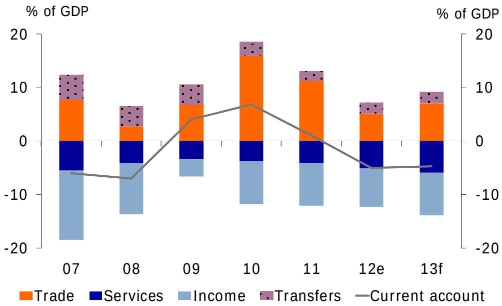
The objective of Zambia's exchange rate policy is to maintain external competitiveness and the Bank of Zambia intervenes from time-to-time in the exchange rate. The Kwacha has seen substantial depreciation this year due to weak copper prices, volatility in emerging market currencies and high inflation. In 2013, this situation is expected to reverse a bit as a copper price recovery is expected.

Chart 5: Exchange rate



Source: Reuters EcoWin

Chart 6: Current account



Source: EIU

Balance of Payments

Zambia's current account remained in surplus from 2009 through 2011 on the back of supportive commodity prices and good agricultural production. However, the global slowdown is expected to push the current account back in the red in 2012, at around –5% of GDP, as exports decrease. Export demand from Switzerland and China, Zambia's largest exporting partners, is expected to slow down in the coming year.

Due to favourable commodity prices, the trade balance has been in surplus over the past few years, posting a surplus of 11.2% of GDP in 2011, and is expected to fall to around 5% of GDP in 2012, led by tumbling copper prices and reduced global demand. In 2013, the trade surplus is projected to increase to around 7% of GDP. The services and income balances were in deficit in 2011. The income deficit is expected to slightly narrow in 2012, before increasing in 2013 due to increasing repatriation of profits by foreign mining companies. The services deficit is expected to widen in the next two years, reflecting the increasing need of services for the development of the mining sector. The transfers balance has always shown a surplus. However the surplus had narrowed in 2011, but is expected to increase again in 2012 and 2013.

On the financial account, FDI inflows of 10.1% of GDP were recorded in 2011, reflecting continuing investments from particularly China and India in the country. We expect these inflows will go on, as we think the new government will see the importance of continuing foreign investment for the country. However new legislation announced for the mining sector, which lowered the capital expenditure deduction rate from 100% to 25%, could impede foreign direct investment spending to a certain extent in the medium term in the extractive sector.

Net debt flows are expected to increase from USD 7.2bn in 2011 to USD 8.3bn in 2012, due to the USD 750bn Eurobond issue launched in September.

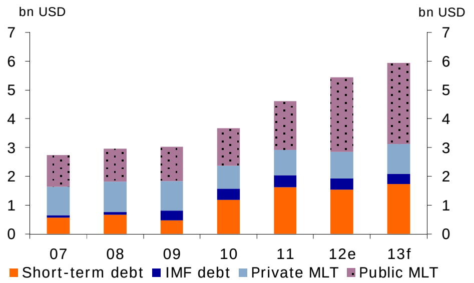
External position

After significant debt relief under the Heavy Indebted Poor Countries (HIPC) and Multilateral Debt Relief initiatives in 2005 and 2006, external debt was reduced to a sustainable level and stands at around 23% of GDP, of which about one-sixth is short-term debt. External debt is mostly held by the public sector. The large social and infrastructural demands will keep Zambia dependant on external funding, thus increasing the risk that the advantages the country gained under HIPC programme could be mitigated over the longer term. The risk of rising external debt levels over the longer term is thus present.

Foreign debt shows an increasing trend from 23% of GDP in 2011 to 27% of GDP in 2013. In 2012, Zambia made a successful USD750m 10-year Eurobond issue. Further external borrowing is likely to take place as the government needs external assistance to fund its huge social and infrastructural development plans.

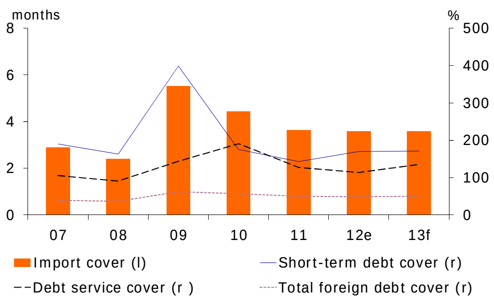
FX reserves increased from USD 2bn in 2010 to USD 2.3bn in 2011 and are expected to further increase in 2012 and 2013, as a result of increasing external funding flows, FDI inflows and remittances inflows. However the import cover fell from 4.4 months in 2010 to a just acceptable level of 3.6 months in 2011 and is expected to stay around this level in 2012 and 2013. The liquidity ratio, which had seen a steep increase in 2010 to 143%, moderated to 119% in 2011 and is expected to moderate further to 105% in 2012.

Chart 7: Foreign debt



Source: EIU

Chart 8: External liquidity



Source: Covers offered by official FX-reserves, EIU

Zambia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.2	5.7	6.4	7.6	6.6	6.0	6.9
Consumer prices (average % change pa)	10.7	12.4	13.4	8.5	8.7	6.5	6.2
Current account balance (% of GDP)	-6.0	-7.1	4.0	6.8	1.1	-5.1	-4.7
Total foreign exchange reserves (m USD)	1090	1096	1892	2094	2324	2610	2950
Economic growth							
GDP (% real change pa)	6.2	5.7	6.4	7.6	6.6	6.0	6.9
Gross fixed investment (% real change pa)	15.0	6.0	3.0	9.0	15.0	7.5	14.0
Private consumption (real % change pa)	6.0	3.0	4.8	6.4	8.0	8.1	6.8
Government consumption (% real change pa)	16.0	7.4	5.5	9.8	17.5	23.6	10.8
Exports of G&S (% real change pa)	5.1	15.3	13.1	15.3	3.8	2.6	6.0
Imports of G&S (% real change pa)	10.2	12.7	10.2	15.8	9.7	8.7	9.2
Economic policy							
Budget balance (% of GDP)	-1.3	-1.5	-3.5	-3.0	-3.9	-5.7	-5.5
Public debt (% of GDP)	28	28	26	24	27	31	33
Money market interest rate (%)	12.0	13.5	15.4	6.3	9.6	9.8	9.4
M2 growth (% change pa)	21	22	7	31	22	20	19
Consumer prices (average % change pa)	10.7	12.4	13.4	8.5	8.7	6.5	6.2
Exchange rate LCU to USD (average)	4002.5	3745.7	5046.1	4797.1	4860.7	5100.0	5343.0
Recorded unemployment (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Balance of payments (m USD)							
Current account balance	-698	-1038	539	1144	215	-1080	-1060
Trade balance	899	408	906	2704	2218	1060	1580
Export value of goods	4510	4962	4319	7414	8672	8320	9740
Import value of goods	3611	4554	3413	4710	6454	7260	8160
Services balance	-642	-607	-464	-629	-818	-1050	-1280
Income balance	-1486	-1399	-419	-1363	-1563	-1480	-1740
Transfer balance	531	560	516	432	378	400	380
Net direct investment flows	1324	939	689	634	832	750	940
Net portfolio investment flows	42	-6	-75	74	48	10	10
Net debt flows	414	235	49	881	717	830	560
Other capital flows (negative is flight)	-711	-125	-405	-2531	-1582	-230	-110
Change in international reserves	370	6	797	202	230	290	340
External position (m USD)							
Total foreign debt	2749	2975	3039	3689	4619	5440	6000
Short-term debt	575	674	474	1191	1632	1540	1720
Total debt service due, incl. short-term debt	1029	1212	1317	1095	1827	2300	2200
Total foreign exchange reserves	1090	1096	1892	2094	2324	2610	2950
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	7.8	2.8	6.8	16.0	11.2	5.0	7.1
Current account balance (% of GDP)	-6.0	-7.1	4.0	6.8	1.1	-5.1	-4.7
Inward FDI (% of GDP)	11.5	6.4	7.2	10.3	10.0	9.2	9.7
Foreign debt (% of GDP)	24	20	23	22	23	26	27
Foreign debt (% of XGSIT)	51	51	60	45	49	60	57
Debt service ratio (% of XGSIT)	19	21	26	13	19	25	21
Interest service ratio incl. arrears (% of XGSIT)	4	3	4	3	2	2	2
FX-reserves import cover (months)	2.9	2.4	5.5	4.4	3.6	3.6	3.6
FX-reserves debt service cover (%)	106	90	144	191	127	114	134
Liquidity ratio	105	97	138	143	119	105	108

Source: EIU