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Shifting Inflation Drivers in Zambia: Lessons for Credibility and Resilience

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Abstract

Zambia's inflation dynamics have evolved markedly across successive monetary policy regimes. Using a time-varying parameter error correction framework, this study highlights how the drivers of inflation shifted from unstable expectations and exchange rate pass-through in the early 1990s, to money growth under monetary targeting, and back to exchange rate shocks under the interest rate-based regime. Despite reforms, inflation remained weakly mean-reverting, underscoring the persistence of shocks and limited self-correction. The findings emphasize that while reforms reshape inflation channels, external volatility continues to pose significant risks. Durable price stability requires credibility, diversification, and adaptive policy design.

Introduction

Inflation management in Zambia offers a compelling case study of how reforms alter the transmission mechanisms of shocks. Successive regimes—exchange rate-driven, monetary targeting, and interest rate-based—each reoriented inflation dynamics, yet none fully insulated the economy from external disturbances. This paper examines the evolution of inflation drivers and distills policy lessons for sustaining stability in a structurally vulnerable economy.

Evolution of Inflation Dynamics

- **Early 1990s (Exchange Rate Dominance):** Inflation was driven by unstable expectations, rapid exchange rate pass-through, and foreign price shocks. Money and output shocks were inert, reflecting structural rigidities and weak central bank credibility.
- **Monetary Targeting Era:** Money growth emerged as the dominant driver. Expectations became more anchored, though volatility persisted. Output shocks gained moderate influence, while exchange rate and foreign inflation shocks gradually moderated as reforms deepened.
- **Interest Rate–Based Regime:** Expectations were firmly anchored, weakening the money–inflation nexus. Output shocks assumed a stabilizing role. However, exchange rate shocks re-emerged as the dominant channel, with episodes such as the 2015 depreciation and COVID-19 disruptions reigniting strong pass-through.

Across regimes, inflation exhibited weak mean reversion, underscoring limited self-correction and the persistence of shocks.

Policy Lessons

1. **Credibility and Signalling:** Sustained central bank credibility and disciplined communication are essential to anchor expectations and prevent shocks from becoming entrenched.
2. **Structural Diversification:** Reducing dependence on imports and commodity exports is critical to limit exposure to external price swings.
3. **Adaptive Frameworks:** Policy design must complement credibility gains with flexibility to absorb shocks without destabilizing inflation expectations.
4. **Resilience over Insulation:** Reforms can moderate volatility and reorient inflation channels, but resilience against external disturbances ultimately depends on credibility, diversification, and adaptive management.

Conclusion

Zambia’s experience demonstrates that monetary reforms reshape inflation dynamics but cannot eliminate vulnerability to external shocks. Durable price stability requires more than technical adjustments—it demands a coherent blend of credibility, structural diversification, and adaptive policy frameworks. These lessons hold relevance not only for Zambia but for other emerging economies navigating similar external and structural constraints.

