Chapter 1

Macroeconomic Situation

1. 1 Introduction

Macroeconomic policy addresses growth in real output, balance of payments, inflation, and the exchange rate. Within the context of a poverty reduction strategy, consideration is also given to structural, employment and incomes policy. The government seeks to influence these variables through fiscal, monetary and external sector policies.

Macroeconomic policies impact on growth in both direct and indirect ways. The former relate to measures that promote growth, such as public investments in physical and social infrastructure and the associated incomes they generate and support, while the latter relate to measures that promote an enabling stable macroeconomic environment characterised by low inflation, a sustainable external sector balance and hence a stable and competitive exchange rate. Sustained growth in real output is necessary, although not sufficient, to reduce poverty. Equity alongside growth is also important. In particular, direct interventions aimed at certain categories of poor people, particularly the core poor and vulnerable, are often needed even with a growing economy.

The success of macroeconomic policies in reducing poverty will ultimately depend on how well balanced the trade-offs are in the light of competing demands under resource constraints. The key choices that have to be made include the following:

- Spending more resources in critical areas while reducing on less important ones.
- Immediate investment in institutional reforms that may reduce, in the short-term, money available for capital and social expenditures.
- The balance between social and economic sector investments.
- Increased budget deficit and potentially higher interest rates in the short term, against higher growth rates in the medium to long term.
- A slower build up of reserves, and perhaps a higher level of external sector vulnerability, over the short to medium term that lays the foundation for strong growth and the build up of international reserves in the medium to long term.
- A significant slow down in inflation, potentially leading to a real exchange rate appreciation in the short term, that allows for the financing of private sector growth in a low inflation, low interest rate environment.

1. 2 Situation Analysis

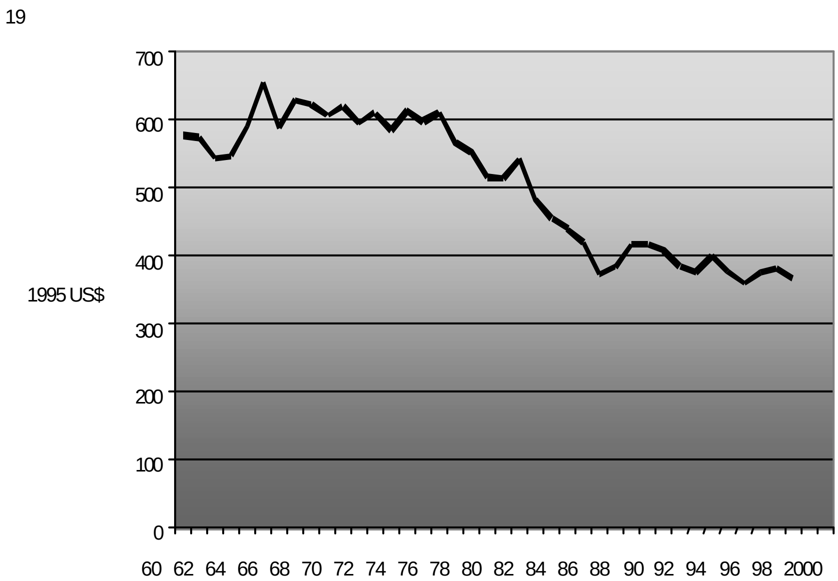
1.2.1 Economic Developments

At independence in 1964, Zambia inherited a strong mining-based economy. It deteriorated in the mid-1970s following a sharp decline in copper prices, compounded by the oil shock. The country's failure to make positive policy changes in response to the declining economic environment further worsened the situation. Instead, foreign borrowing was increased to minimise the decline in living standards. Zambia recognised during these early years the need to diversify her economy and reduce over-dependency on mining exports. The preferred strategy was import substitution industrialisation that was import-dependent. This encouraged firms to produce for the domestic market but did little to build the requisite capacity to export. With little foreign exchange being earned amidst the entry during the 1990s of highly competitive consumer imports, the industrialisation strategy failed, leading to increasing unemployment.

The 1980s marked the first phases of implementing Structural Adjustment Programmes (SAPs) amidst a stagnating economy. The implementation was, however, often piecemeal and failed to fundamentally alter the economic structure. In particular, the design and implementation of SAP often failed to sufficiently address the poverty challenges that increasingly became evident as the structural changes took hold. The pace of reform accelerated in the 1990s after a new government took over and public enterprises that constituted a fiscal drain on state revenue were closed and/or privatised. The privatisation process moved faster while price controls were lifted and agricultural input and output markets opened up to private sector entry. In foreign exchange, the rate was freed and capital controls were totally removed. Import controls were also abolished except for a small number of dangerous materials.

Structurally, Zambia's economy has changed little in spite of the above changes and consistent high economic growth has been elusive. Over the period 1980 to 1990, the country's economic growth was the second lowest in the Southern African Development Community (SADC) after Mozambique. Over the period 1990 to 1999, it had the least average annual growth rate in the SADC region at one percent. This was also below the Sub-Saharan Africa rate of 2.4 percent. Consequently, per capita GNP has shown a downward decline over the years since independence (see Figure 1).

Figure 1: Zambia GNP Per Capita



National savings that are so strategic to overall growth have fallen over the years to levels that are inadequate to fund desirable investment. The real gross fixed capital formation averaged 12 percent of real GDP and portrayed a steady but marginal increase from 8 percent in 1990 to 15 percent in 1999. While this is encouraging, the level is well below the 20 percent associated with sustainable growth. If Zambia were to depend entirely on its savings, investment would be low, resulting in a slow rate of capital formation, income generation, and employment creation. The country, thus, needs to attract credible foreign investments so as to augment its savings. Foreign investments, when carefully selected, can also assist to open doors in the export markets and transfer skills and technology.

The most serious structural challenge has been in the mining sector where a massive drop in output has complemented the negative impact of occasional price declines. Currently, copper output is only a third of the highest level ever attained. The contraction in mining drags the rest of the economy down as aggregate demand collapses.

In 2000, the government privatised its largest asset, the Zambia Consolidated Copper Mines. The step raised economic confidence due to the sector's expected catalytic role in reviving the general economy. However, the planned pull out of Anglo American Corporation, the major private shareholder in the largest mining company in the country (citing lack of viability due to low copper prices), brings with it great uncertainty. At present, it is expected that a major pull out would result in severe economic disruption of an already under-performing economy. Nevertheless, it is now imperative that economic diversification must quickly succeed if Zambia has to avoid getting deeper into economic adversity, generally, and worsening poverty, in particular.

1.2.2 Financial Developments

Monetary policy has two broad objectives, reducing inflation and sustaining financial system stability. Although inflation over the past decade has fallen, it has remained at unacceptably high levels. Some encouraging signs emerged in 2001 with the rate of inflation falling below 20 percent, which however is still too high. The crippling inflation level has largely been due to, *inter alia*, the high growth of money supply, the depreciating Kwacha, and occasional shocks such as the effects of drought and rising oil prices. With respect to monetary expansion, government borrowing from the Bank of Zambia (BOZ) has been important. This, in turn, is related to high external debt burden, inadequate donor budgetary support, and financial problems related to the ailing state enterprises. An undesirable situation that has prevailed for some time in Zambia is the high real interest rates, which make borrowing unaffordable. This is not supportive of stronger economic growth.

With regard to the financial system, the amendments in 2000 to the Banking and Financial Services Act of 1996 strengthened the ability of the central bank to respond promptly and comprehensively to any adverse developments in the financial sector. The key features of the amendments to the legislation included the following:

- Enhancing the supervisory and regulatory powers of the Bank of Zambia.
- Bringing existing law in line with best practice and internationally accepted standards for licensing, and prudential regulation and supervision.
- Establishing higher standards of responsibility, accountability and professional competence and integrity on the part of directors and senior officers of banks.

Zambia experienced severe financial distress during the past decade, which saw many banks closing, hence contributing to loss of confidence in the sector; the measures mentioned above were intended to help remedy the situation. However, Zambia suffers from another financial development shortcoming, namely the absence of reliable sources of long-term credit. Almost all economic sectors are adversely affected by this limitation.

1.2.3 External Sector Developments

Over the past decade, external sector developments in Zambia continued to be weak, characterised by falling metal exports due to declining production and occasional steep price declines such as the one prevailing now. Sharp rises in the price of petroleum oil and occasional maize imports due to drought in some years made the situation more difficult. To Zambia's credit, however, non-metal exports have risen sharply during the past ten years, mainly from agriculture and agro-processing.

There has been extensive reform of the trade regime in Zambia in the past decade and this has included lowering trade taxes, narrowing their dispersion, and collapsing the trade tax bands to three. Furthermore, most non-tariff barriers have been removed and import licences abolished. In October 2000, the Common Market for Eastern and Southern Africa (COMESA) Free Trade Area was launched and Zambia also signed up during the year to the SADC Trade Protocol that provides the country with duty free access to the regional market for specified products. These agreements are expected to expand Zambia's markets as well as expose local producers to competition. There have been complaints about unfair competition from imports, leading in some cases to companies closing or relocating outside Zambia. This has also happened at a time when the local industry faced high domestic interest rates and had little time to acquire competitive production technology. The problem has been compounded by expensive inputs, especially petroleum fuel, when compared to competitor countries.

In late 2000, Zambia obtained debt relief through the Enhanced Highly Indebted Poor Country (HIPC) Initiative. This is expected to help minimise the country's external debt commitments, standing at $6.5 billion at the end of 1999. By having reached the HIPC decision point in December 2000, Zambia will reduce its debt servicing payments during 2001-2003 from roughly $600 million to $165 million per year. At completion point, which is targeted for 2003, Zambia's creditors would write off some $3.8 billion of debt in nominal terms. Domestic debt, including arrears, has also risen to very high levels and the latter threatens the viability of small firms that supply food and services to government.

1.2.4 Employment and Incomes Policies

A limited number of initiatives, such as training and job search programmes associated with the privatisation programme and poverty alleviation, have been implemented to enhance employment and incomes. However, their thrust has been through the implied benefits of economic growth. Many formal sector jobs have been lost as described above and although some new jobs have been created, they have not been enough. Formal sector employment (which has not exceeded 20 percent of the labour force in a long time) went down from 12 percent to 11 percent between 1996 and 1999. However, unemployment also came down from 18.2 percent to 9.5 percent of the labour force, implying an increase in informal sector employment. This growth, however, has not contributed to a reduction in poverty for, between 1996 and 1998 while unemployment came down, poverty increased. This is because the average wage from informal sector jobs is insufficient to adequately meet livelihood demands.

1.2.5 Cross-Cutting Issues

There are several issues relevant to growth and poverty reduction that cut across economic and social boundaries, such as the HIV/AIDS pandemic, environmental degradation, and governance. The challenges of HIV/AIDS on Zambia are obvious. Principally, AIDS threatens the country's capacity building efforts because it strikes the educated and skilled as well as the uneducated. Consequently, it reverses and impedes the country's capacity by shortening human productivity and life expectancy. The long periods of illness of the skilled personnel in employment has translated into severe loss in economic productivity, which leads to considerable loss to the employer in lost person-hours. The complex relationship between economic growth and HIV/AIDS is increasingly being recognised: the epidemic is as much likely to affect economic growth as it is affected by it.

Environmental protection and care, another cross-cutting issue, is also important as the exploitation of the country's natural resources in a sustainable manner provides great potential for economic growth and poverty reduction.