CHAPTER 2

MACROECONOMIC PERFORMANCE AND STRUCTURAL REFORMS

2.1 Macroeconomic situation

The attainment of macroeconomic stability has continued to be elusive largely due to the effects of unsustainable fiscal deficits and occasional exogenous shocks. Real GDP growth was 3.3 percent in 2002 and is estimated at 4.2 percent in 2003. To the extent that the country was faced with unforeseen difficulties such as the withdrawal of Anglo American Corporation from KCM in February and the drought that affected agricultural production, overall growth in 2002 was satisfactory. In 2003, the recovery of agriculture largely explains the expected pick up in growth. Other sectors that are expected to contribute to the positive GDP growth are transport and communications, energy, construction, wholesale and retail trade and tourism. The growth rates are, however still dismally low to make any significant impact on poverty. Due to a sharp acceleration in food prices arising from the drought, the 12-month inflation rate shot up to 26.7 percent in 2002 from 18.7 percent in 2001. In 2003, 12-month inflation fell to 17.2 percent. This is however, still high considering the year target of a single digit figure.

The domestic fiscal deficit in 2002 reached 4.1 percent against the target of 3 percent while in 2003 the domestic deficit, is estimated at 3.5 percent compared to the target of 1.6 percent. The deficits have been financed largely by domestic borrowing, which reached 2.1 percent of GDP in 2002 and it is estimated at over 5 percent in 2003. This fuelled a higher than targeted money supply growth which also contributed to a slower pace in the decline in inflation, while the high levels of borrowing have been a major factor in the prevailing high real and nominal interest rates. The weighted commercial bank lending rates were 43 percent in 2002 and only declined slightly to 39 percent in 2003. Such high levels of interest rates have held back stronger and robust private sector activity and therefore real GDP growth.

In the external sector, the current account deficit (including grants) improved from 10.8 per cent of GDP in 2001 to 6.5 percent in 2002 and is estimated at 5.6 percent in 2003. In absolute terms, the deficit narrowed from US $758 million in 2001 to US $652 million in 2002 and a projected US $627 million in 2003. The narrowing in the deficit has been due to a narrowing in import growth and a higher export growth. Merchandise exports in 2002 amounted to US $916 million, up from US $884 million in 2001. Merchandise exports are estimated at US $1.1 billion in 2003. There are signs that the economy is diversifying as evidenced by the impressive growth in non-metal exports which have continued to register double-digit growth. In 2002, they grew by 35.2 percent to reach US $357 million from US $264 million in 2001. In 2003, non-metal exports grew by 13 percent to US $405 million. This impressive growth in non-metal exports is attributed to the improved export regime including fiscal incentives and a competitive market based exchange rate. The attainment of macroeconomic stability will be important in consolidating these gains.

Table 2.1: Trends in selected Key Macroeconomic Indicators 2000-2003

Indicator	2000	2001	2002	2003 est
Real GDP Growth	3.6	4.9	3.3	5.1
CPI Inflation end Year	30.1	18.7	26.7	17.2
CPI Inflation annual average	26.1	21.7	22.2	21.5
Domestic Fiscal Deficit (percent of GDP)	-3.3	-4.7	-4.2	-3.2
Domestic Revenues (percent of GDP)	19.4	19.1	18.0	18.4
Expenditures (percent of GDP)	-	-	31.9	30.6
Domestic Financed Capital Expenditure percent of GDP	2.3	3.8	2.6	2.5
Poverty Reduction Programmes (percent of GDP)	-	1.4	0.7	1.4*
Money Supply Growth (percent Change)	74.1	10.8	31.4	13.8
Government Borrowing from BoZ (in K Billion)	1,517.9	1,900.1	1,700.8	---
Government Borrowing from BoZ (annual percent Change)	80.5	25	-10.5	---
Government Borrowing from Commercial Banks (In K'billion)	357.1	777.3	916.3	---
Government Borrowing from Commercial Banks (annual percent change)	54	117.7	17.9	---
Nominal Weighted Commercial Bank lending rates	45.9-	54.6-	50.0-	44.8
Nominal Exchange Rate Depreciation end period	58.0	-7.9	13.2	25.3
Exports c.i.f (US$ Million)	746	884	916	1,134
Metal Exports (US$ Million)	497	590	560	729
Non-Metal Exports	249	295	357	405
Of which agriculture (US$ Million)	102.3	115.1	134.2	---
Gross International Reserves (Months of Import Cover)	2.8	1.4	2.2	1.3
Balance of Payments Support (US $ Millions)	186.0	74.6	137.3	55
Current Account Balance (including grants) (percent of GDP)	(11.4)	(10.8)	(6.5)	(5.6)
Foreign Direct Investment (US Millions US Dollars	278	301	178	233
External Debt Stock (US $)	6,253.1	7,270.4	7,140.4	6,495.1
Stock of Domestic Debt (in K, Billion)	---	3,971	3,077	3,695
Stock of Domestic Arrears (In K Billion)	-	-	433.6	635.5

Source: Ministry of Finance and National Planning and Bank of Zambia
* Under HIPC Initiative

2.2 Debt Stock

2.2.1 External

Zambia's external debt overhang continues to be enormous. As at end June 2003, the external debt stock stood at US$ 6,862.6 million or 182 percent of GDP (See Table2.2). Total debt service payments amounted to US $285 million in 2002 and US $196.8 million in 2003. Because of shortfalls in external support, some of the external debt service has had to be paid from domestic revenues. As a Highly Indebted Poor Country (HIPC), Zambia is eligible for relief under the HIPC Initiative and has already reached the Decision Point, at which stage creditors provided interim relief and pledged to provide the bulk of the relief on condition that Zambia meets certain conditionalities or triggers. The point at which these triggers would have been satisfactorily met is called the Completion Point. Zambia was expected to reach the Completion Point in December 2003 upon which, it was expected to obtain relief amounting to US$3.8 billion. However, due to slippages in fiscal policy in 2003 and the resultant failure to reach a new Poverty Reduction Growth Facility (PRGF) programme with the International Monetary Fund (IMF) the attainment of the Highly Indebted Poor Country (HIPC) Completion Point has been delayed and is now expected in 2004.

As a result of failure to conclude a new PRGF arrangement with the IMF, the donor community withheld budget support. As of October 2003, only US $9.6 million was disbursed out of the expected US $56 million for the year. The withholding of programme support affected the execution of some poverty reducing programmes.

Table 2.2: External Debt Stock 2000 – June 2003 (US$ Million)

	2000	2001	2002	June 2003
Bilateral	**2,438.5**	3,091.8	2,614.8	2,013.5
Of which:				
Paris Club/1	22,638.5	2,713.9	2,343.1	1,728.2
Non Paris Club/2	459.3	377.9	271.7	285.3
Multilateral	**3,404.3**	**3,346.1**	**3,854.9**	**4,106.8**
Of which:				
ADB/ADF	328.4	318.7	296	4,016.8
World Bank	1,788.7	1,837.1	2,491	2,527.5
IMF/3	1,128.5	992.0	965.9	1065.1
Other Multilateral	158.7	198.3	102	96
Private/3	**410.3**	**832.3**	**670.4**	**832.3**
Total Debt Stock	**6,453.1**	**7,270.2**	**7,140.1**	**6,862.6**

Source: MOFNP

2.2.2 Domestic Debt Stock

In 2002, the domestic debt stock continued to increase. As at end of June 2003, total domestic debt stock rose to K 4,988.7 billion from a total of K 3,976.1 billion as at end of December 2002. The stock of treasury bills increased from K611.8 billion in 2002 to K1, 134.7 billion at the end of June 2003. The increase in debt stock was largely attributed to the continued Government deficits, which are mainly financed through borrowing from the banking sector. In addition, the increase in domestic debt was also attributed to financing of parastatals and accumulation of interest on various other liabilities such as domestic arrears, awards and compensations.

Domestic arrears have increased from K433.6 billion at end December 2002 to K635.5 billion as at end June 2003 representing an increase of about 47 percent. The accumulation of domestic arrears is attributed to unpredictable and inadequate budgetary releases and lapses in the procurement procedures.

Table 2.3: Domestic Debt Portfolio As at end June 2003.

DEBT CATEGORY	2002 K' billion	End June 2003 K' Billion
Treasury bills	611.9	1,134.7
Bonds and stocks	882.4	2,793.70
loans/overdrafts		
Forex bridge loan	1,233.5	89.5
Kwacha bridging loan	467.8	---
Arrears		
Suppliers arrears	433.6	635.5
Pension cont. arrears	270.7	273.8
Awards & compensation	70.0	61.6
Contingent liabilities	6.2	
Recapitalisation bonds	3,976.1	4,988.7

Source: MOFNP

2.3 Budget Performance

The execution of the budget in 2002 and 2003 continued to be faced with difficulties mainly due to extra budgetary pressures and the withholding of support from donors. In 2002, the Government had to import food so as to mitigate the effects of the drought. Additional pressures arose from purchase of agricultural inputs for the 2002/2003 agricultural season, which were needed to ensure food security. Consequently, the government recorded a deficit of K674.3 billion representing 4.2 percent of GDP compared to a target of 3.0 percent of GDP. In 2003, the budgetary situation worsened and was compounded by the decision in April to award wage and salary increments and housing allowances to civil servants, which were far in excess of budget allocations. In addition, the Government in September 2003 started paying out retrenchment cost to miners at Roan Antelope Mining Corporation of Zambia (RAMCOZ). This was being done in an effort to facilitate the privatisation of the Luanshya mine.

These budget overruns were largely financed through domestic borrowing, which by October 2003 had reached 4.6 percent of GDP compared to 2.1 percent in 2002. The consequence of extra budgetary expenditures in both 2002 and 2003 meant that poverty reduction programmes and capital projects were suppressed. In 2002, the allocation for Poverty Reduction Programme (PRP's) was K450 billion, out of which K240 billion was to be disbursed from the domestic budget and K210 from donors. Out of the K240 billion that was supposed to be domestically financed, a total of K110.2 billion was released representing 45.9 percent of the total budgeted amount. In 2003, allocations for PRP expenditures amounted to K420.7 billion out of which K240.8 billion was to be financed by Government and K179.9 billion by donors. By November 2003, the Government had disbursed K212 billion representing 89 percent of the government PRP allocation. Most of these resources were disbursed in the second half of the year.

2.4 Structural Reforms

The Public Service Reform Programme (PSRP), which started in the 1990's, has the objective of improving the efficiency and service delivery in the public sectors. Through the PSRP, strategic plans have been developed for almost all government ministries and other spending institutions. Similarly, almost all ministries have been restructured with job descriptions and specifications done. In addition, the Annual Performance Appraisal Systems (APAS) were introduced in 12 ministries and 3 institutions. Despite these efforts in the PSRP, the cost of running government has continued to be enormous.

Government has also been undertaking Public Expenditure Management and Financial Accounting Reforms (PEMFAR), which are aimed at improving on fiscal discipline, effectiveness in resource allocation and realization of value for money in the execution of expenditures. A number of actions are being implemented within the PEMFAR. These are: Development of a Medium Term Expenditure Framework (MTEF), which is aimed at ensuring that over the medium term, resources are allocated according to Government priorities as outlined in the PRSP; The designing of the Integrated Financial Management Information System (IFMIS) which, is aimed at tracking expenditures on a timely basis and the Commitment Control Systems (CCS) which, is aimed at ensuring that no expenditure is made without being backed by cash so that arrears can be minimized.

Work on the various components of these reforms was at different stages. The Ministry of Finance and National Planning (MoFNP) introduced CCS in some ministers Programmes and Spending Agencies (MPSA's) in January 2003 and considerable improvements on the time in which MoFNP receives monthly expenditure returns from line ministries have been recorded. This has helped to limit to some extent the accumulation of arrears. In addition work on the Medium Term Expenditure Framework (MTEF), is advanced and the 2004 budget is being prepared according to the MTEF. In an effort to improve on the efficiency of the financial system, Government, working with cooperating partners is preparing a Financial Sector Development Plan.

Other reforms undertaken were the approval of the National Transport Policy in order to address fragmentation in the road transport sector. The policy advocates for the establishment of three agencies, namely, Road Development Agency (RDA), Road Fund Agency (RFA) and Road Transport and Safety Agency (RTSA). The agencies would be responsible for Management and disbursement of road fund, construction, maintenance and rehabilitation of all roads in the country and the enforcement of road traffic and safety regulations in the country respectively. In the education sector, the Government introduced the policy of Free Primary School Education from grades 1-7. Additionally the Judicial, Electoral, Parliamentary and Decentralization reforms are being implemented (See Appendix 5).

2.5 2004 Macroeconomic Framework and Medium Term Outlook

The macroeconomic framework outlined in the PRSP has undergone several revisions based on changes in the economic circumstances. Taking into account the developments in 2003, especially with regard to slippages in the budget and the attendant larger than expected domestic financing, Government has proposed revisions to the macroeconomic framework for the period 2004-2007 (See table 2.4). These revisions are also expected to be made to the MTEF and will be regularly reviewed depending on economic circumstances.

In the light of the larger levels of domestic borrowing in 2003 and the failure to reach the HIPC Completion Point in the same year, Government has placed fiscal adjustment at the center of macroeconomic policies in 2004. To this effect, a tighter fiscal policy has been proposed which envisages to reduce the overall fiscal deficit to 4 percent of GDP and domestic financing to 2 percent from 5.1 percent of GDP in 2003. This is expected to be achieved mainly through expenditure restraint. The containment of domestic borrowing should help in bringing down the high interest rates and the domestic interest costs. Based on the developments in 2003, inflation is not expected to exceed 20 percent in 2004.

In the medium term (2005-2006), Government plans to sustain the growth momentum to at least 5 percent and to raise it to 6-7 percent beyond 2006; further bring down inflation to around 10 percent by 2006 and single digit levels thereafter; contain the overall fiscal deficit to no more than 1.4 percent of GDP; and to build gross international reserves to about 2 months of import cover by 2007.

The growth objectives are premised on continued expansion in mineral production as a result of favorable world prices, re-investments in the domestic mines and the coming on stream of two large mines in the net two years. The other growth sectors will be agriculture especially that most poverty is in rural area, tourism, and light manufacturing. The continued improvements in the business environment including the investment climate, a drop in interest rates and inflation, stability in the exchange rate coupled with continued improvements in infrastructure should contribute favorably to the growth prospects. Thus beyond 2006, Government will aim at attaining growth of at least 6 percent.

The fiscal objectives are expected to be achieved mainly through expenditure restraint, while domestic revenue are expected to be sustained at around 18.6 percent of GDP in the medium term. In addition to domestic revenue, donor inflows are also expected to support public expenditure programmes.

In the external sector, metal exports are projected to grow by an annual average of at least 12 percent in the period 2005-2006 premised on increased prices and domestic production. Government expects that Zambia will reach the HIPC Completion Point in 2004 as a result of a firm fiscal policy. This together with improved export outlook, is expected to contribute to a favourable external sector position. As discussed earlier, Government is on course in meeting the other HIPC triggers. These are the combating of HIV/AIDS, implementing health and education sector reforms, commercialization of ZESCO, and the evaluation of bids for the sale of majority controlling interest in the Zambia National Commercial Bank (which has already been done).

Table 2.4: Key Macroeconomic Targets: 2004-2007

	2002	2003	2004 Proj.	2005 Proj	2006 Proj	2007 Proj
Real GDP growth rate	3.3	5.1	3.5	4.5	5.0	5.0
inflation rate (end period)	26.7	17.2	20.0	15.0	10.0	5.0
Inflation (period average)	22.2	21.5	18.5	17.4	12.6	7.5
Nominal GDP (K' billions)	16,202	20,338	25,578	30,444	35,340	39,333
Current account deficit as % of GDP (including grants)	6.5	5.6	4.6	3.9	3.7	3.8
Exports growth (Annual % Change)	2.4	23.4	21.5	12.6	8.4	1.4
Domestic Revenue as % of GDP	17.9	18.1	18.7	18.6	18.6	18.6
Domestic Borrowing % GDP	2.1	5.1	2.2	1.2	0.9	0.5
GIR months of Import Cover	2.2	1.3	1.7	1.3	1.7	1.9

Source: Ministry of Finance and National Planning