The Macroeconomic Situation and Its Bearing on Future USAID Program Directions

SUBMITTED TO
USAID/Zambia

UNDER
Contract No. AEP-5451-I-00-2058-00
Delivery Order 1

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March 1993

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Executive Summary

The Kaunda administration, which took control of Northern Rhodesia in 1964 and renamed it Zambia, inherited a country with one of the higher standards of living in Africa, based primarily on Northern Rhodesia's position as a major world exporter of copper. The country also had other mineral resources, abundant fertile land in a region of adequate rainfall, and a small population. When the Kaunda turned over power to the Chiluba government after being defeated in an election in 1991, Zambia had become less competitive as a copper producer, the population had increased two-and-one-half times, per capita income was perhaps 60 percent of its preindependence level, and agriculture had been stifled by decades of pervasive state intervention.

Kaunda and his party believed in an ill-defined socialism that, although well-intentioned, was hostile to the working of markets and to private business—domestic as well as foreign. The results were devastating. Specifically they were

1. **An overvalued exchange rate and a set of internal incentives.** An overvalued exchange rate blocked the growth of exports and starved the economy of foreign exchange. Under these conditions only the products with the highest comparative advantage—copper and a few other minerals—were still competitive. Price controls hindered the diversification of agricultural exports and production and manufacturers were so heavily protected that they were neither interested nor able to sell abroad in any substantial way.
2. **A very large external debt.** Service of this debt would have eaten up new assistance if it had been paid; in reality little debt service was paid and huge arrears accumulated. Even after a partial recovery of copper export earnings, scheduled service still exceeded 60 percent of earnings in 1990–1991;
3. **Low share of GDP allocated to fixed investment.** Compared with even the poorest LDCs, Zambia has an exceptionally low share of GDP allocated to fixed investment and conversely, a relatively high share directed to private and government consumption. In an effort to protect consumption as output per capita declined, the Kaunda government had set up a system of disincentives such as price controls and use of state enterprises to promote social rather than productive spending; the result was a decline in fixed investment to about 10 percent of GDP, making growth practically impossible.
4. **The creation of a public sector so large that it directly or indirectly dominates productive activity.** All the utilities and railroad transport, the important mining activity, and 50 percent of industrial production are under the control of the state buttressed by subsidies or monopoly positions; the public sector was most unresponsive to market incentives.
5. **High rate of inflation.** The rate of inflation has accelerated in each subperiod. The problem has been especially acute since 1985, when prices rose more than 50 percent per annum in the first few years and exceeded 100 percent from 1989 on. In an economy with interest rates well below price rise and lagging exchange rate adjustments, this is an invitation to capital flight, hoarding of goods, and narrowing of investment to the shortest possible focus.

The Chiluba administration, in contrast to its predecessor, is led by men who favor eliminating controls on the private sector and expanding it and, conversely, selling all the parastatals. During its first year in office, with a leadership that was inexperienced and accustomed to working closely together, the Chiluba administration sought to carry out this program while trying to satisfy the demands of its followers. Its record, although mixed, is good overall. The main achievements are listed next.

1. The most important single achievement is the establishment of a realistic market-determined exchange rate.
2. The government has made a significant and largely successful effort to establish prices that reflect market values.
3. A privatization program has been well-launched politically, and the first phase of divestiture has begun, but the more important benefits and more serious problems are yet to come.
4. The government has demonstrated through statements and its administration of the Investment Act that the promotion of foreign investment is an important policy goal.
5. Although the high rate of inflation reflects, in part, the adjustment of artificial prices to market levels, the failure to substantially reduce the rate of inflation has endangered the success of the reform program in general and relations with the International Monetary Fund (IMF) in particular.
6. Social welfare measures have been designed largely to offset the effects of the drought. The government has not yet the time or the resources to do more than begin progress toward the important goals of improved health and education.

The outlook in 1993 is for a much improved economic performance than 1992, with the resumption of growth arising from the end of the drought and better incentives to produce in the agriculture and agro-industry area. Inflation should almost certainly be lower, but whether it will be low enough to ensure stabilization is questionable. Finally, there is the uncertainty of whether export growth will be sufficient to pay for the imports a growing economy needs without an extraordinary depreciation of the exchange rate.

Given the limited resources at USAID's command in even an expanded program, it would be more effective to pursue a policy of influencing the formulation and implementation of policies that fundamentally affect the operations of major commodity and factor markets with a combination of technical assistance and conditioned nonproject aid than paying for a program.

At this stage, the administration's achievements during the first year in re-establishing realistic price incentives, and the expectation that they will be consolidated in 1993, suggest the following strategic areas for which there is now a chance of success:

1. Undertake a project to make exporting a major development goal that goes beyond promotion and marketing to facilitating investment and production by clearing away the obstacles of the former government.
2. A population control project to curb Zambia's unchecked birth rate, which makes any substantial increase in the standard of living unlikely; and
3. Place on the donors' agenda the problem of shortages of skilled personnel as a constraint on development through a focused and well-timed study.

Well-designed projects in all three areas could promote and shape, in the next decade, the broad-based economic growth that is the ultimate goal.

1. Introduction

The purpose of this report is to provide a summary of how the Chiluba administration's macroeconomic policy has tackled the problems it inherited from its predecessor, the Kaunda government, in its first year in office and the outlook for 1993. The report examines the policy objectives that would be most appropriate in the current macroeconomic situation and in promoting private investment, particularly in the areas of agriculture and mining.

Section 2 examines how Zambia reached its current state, the problems that the new administration had to tackle, and its successes and failures in its first year. Section 3 examines the policies under consideration and the outlook for 1993. Several projects are proposed in Section 4 that tie together macro and sectoral objectives.

2. Current Macroeconomic Policy: Antecedents, Problems, and Objectives

BACKGROUND

This section briefly reviews Zambia's post-independence economic policy from 1964 to 1991 and summarizes the problems inherited by the new administration.

Current policy can be understood only in the light of Zambia's recent economic history. The Kaunda government created most of the problems from which the economy is suffering and the constraints on its future development. These problems are as follows.

1. A long history of exchange rate overvaluation with its depressing effects on exports;
2. A large state sector, including utilities, transport, mining, and much of manufacturing;
3. Extensive controls on international and domestic transactions and prices that distorted investment decisions.
4. A low level of investment since 1975 that has left the current capital stock in very poor condition,
5. Increasingly serious inflation, reflecting the breakdown of monetary discipline;
6. A very large foreign debt, leaving the country bankrupt internationally; and
7. Substantial major internal debts and arrears that are hampering the financial reorganization of the parastatals and depriving the central government of revenues.

The most damaging legacy, in terms of future progress, is the philosophy that government intervention to prevent markets from working is a superior form of policy and that the government, not business and other private associations, should lead development. Fortunately, the results of this philosophy were so bad that it has been discredited in general but lingers in many areas.

As in most developing countries, longer term growth trends can best be explained by movements in export earnings, which reflect a combination of external events and policy response. Capital inflows in whatever form—direct investment, concessional loans, and grants—can only supplement a country's own income. To simplify, the analysis is divided into three subperiods defined by years of balance-of-payments crisis. The key growth and inflation indicators for each period are presented in Table 1; the situation in the boundary years is presented in Table 2.

In the first subperiod (1964–1975), high copper exports, based on a growing world market and supported by investment within Zambia, provided the foreign exchange income to fuel a respectable 2.3 percent annual per capita growth of GDP. World recession, after the first major oil price increase in 1973, led to a 40 percent drop in export receipts in 1975 and the largest current account deficit Zambia had ever had.

Money supply expansion was relatively moderate for an expanding economy (20 percent+), and prices rose about 10 percent per annum. The exchange rate was unchanged except for an appreciation against the U.S. dollar when it floated after 1971.

Table 1. Exports, Growth, and Inflation, 1964–1991

A. Gross domestic product (rate of growth, in percent)	1964–1975	1975–1985	1985–1991	
Overall	5.2	0.0	1.1	
Per capita	2.3	–3.2	–2.2	
Money supply (M2)	23	21	69	
Prices	11	20	81	
B. Composition of gross domestic product (based on 100 percent total)[a]	**1964**	**1975**	**1985**	**1991**
Expense				
Consumption	49	50	67	87
Government consumption	11	21	24	11
Investment	15	38	10	8
External[b]	28	–19	0	–4
Balance of payments (millions)				
Exports	489	803	797	1,082
Imports	–221	–947	–571	–952
Current account balance	105	–721	–398	4
External debt (billions)[c]	0	1.4	4.6	7.2
Real effective exchange rate[d]	NA	NA	45	72

Note: NA = not available.

[a]Figures do not add to 100 because of rounding and omission of inventory movements.
[b]Equivalent to current account balance, excluding factor payments such as interest and dividends.
[c]End of year.
[d]Index, 1980 = 100, end of period.

Sources: IFS; IMF reports; Bank of Zambia.

No growth occurred in the second subperiod (1975–1985), and, therefore, a marked decline of per capita GDP occurred, equal to the more than 3 percent per annum population increase. Copper receipts failed to recover to the early 1970 levels, except during the worldwide inflationary surge that was produced by the 1979 oil price increase. New sources of supply in combination with slower growth of demand—slowing development in the industrial nations, substitution of plastics and fiber optics—made copper far less reliable as a source of regular export increases to pay for imports. Development would have been seriously affected no matter how quick and efficient the policy response.

Unwilling or unable to follow the Chilean example of making copper production more efficient and mounting a new strategy based on diversifying exports, the authorities fell back on borrowing and on strengthening the command economy to ration resources to conserve consumption.

The alternative of making the economy more competitive by seeking domestic and foreign private investment to diversify exports would have involved relying on the price system through measures such as devaluing the kwacha, giving investors leeway to decide where they believed the most profitable opportunities lay. Because these other modes of behavior were incompatible with official ideology, they were rejected.

The currency was devalued by only 20 percent (compared with a more than doubling of prices since 1964) in 1976 and then maintained until 1980. Although the kwacha declined almost continuously thereafter in relation to the dollar, the real effective exchange rate, which measures the relationship to other important currencies and the comparative rates of inflation at home and abroad, depreciated very little—net over this period. There were two cycles of appreciation, followed by devaluation until 1985. Because Zambia remained uncompetitive, the balance had to be achieved by quantitative controls on international transactions and external borrowing. The stock of debt increased from $1.4 billion in 1975 to $4.6 billion in 1985.

Internally, the combined effect of an overvalued exchange rate, price controls, and an extensive subsidy system, particularly where maize was concerned, directed agricultural production toward domestic consumption. Manufacturing, based on import substitution and developing behind high walls of protection, was too uncompetitive to contribute much to export receipts.

Growth in the money supply was roughly the same as in the earlier period (20 percent) while the rate of price rise doubled to 20 percent per annum, a measurement distorted by controls and subsidies that suppressed price increases.

Looking at the composition of GDP in the boundary years, 1964, 1975, and 1985, there is marked increase in investment and government consumption at the expense of the current account surplus from 1964 to 1975. From 1975 to 1985, gross investment declined to 10 percent (net investment was probably minimal or negative) while private consumption rose. The effect of economic policy was to adapt the economy to its lower volumes of resources by raising the share of consumption to partially offset the decline in per capita national product and reducing investment to the point where sustained growth was practically impossible.

By 1985, the futility of these policies and the unwillingness of donors to support them led to a shift in policy. Zambia was bankrupt: the projected external debt service for 1985 and 1986 was equal to 75 percent and 111 percent of exports of goods and nonfactor services, respectively.

The last subperiod, 1985–1991, is characterized by an attempt to reform economic policy to conform with the prescriptions of the IMF and the World Bank, but an unwillingness to stay the course. Because the single most important policy objective was achieving and maintaining a realistic exchange rate, the movements of the real effective exchange rate index are the best quantitative measure of this seesaw policy.

When the Zambian government entered into an agreement with the IMF in 1985, the index plummeted from about 100 to 45 by the end of the year. It then declined to 25 in the first quarter of 1987 after the Fund program was abandoned. From then on it appreciated continuously, approaching 95 again at the end of 1989 as adjustment fell behind accelerating inflation. A new accord with the Fund led to a fall to 60 followed by an appreciation to 70 as the program and the government came apart in the run up to the 1991 election.

Growth resumed slowly in 1986–1987, and Zambia received the windfall of an exceptional harvest in 1988. GDP rose 10 percent from 1986 to 1988 but then declined 3 percent from 1989 to 1991 so that per capita growth for the 6 years was still negative.

Although on an accrual basis, the budget deficit fell somewhat, the recourse to the banking system to finance it changed very little. Money supply growth and price increase reached record highs, exceeding 100 percent per annum for the first time in 1988. Real interest rates, as usual, were negative. (see Table 2).

Internally, some progress was made: subsidies as a percentage of GDP declined somewhat, some price controls were lifted, a new act to encourage foreign investment was passed; and privatization was accepted in principle. Not only was progress uneven but it had little positive effect when carried out by a government suspected of being prone to relapses.

Table 2. Fiscal and Monetary Developments, 1985–1991 (percent)

	1985	1989	1990	1991
Budget[a]				
Revenue	22.3	19.2	21.9	26.1
Tax	19.6	16.4	17.7	16.1
Other	2.3	2.1	3.9	9.6
Expenditure	36.7	28.8	29.3	30.3
Deficit[b]	–14.4	–9.6	–7.4	–4.2
Of which covered by domestic finance	8.4	5.9	5.9	5.2
Interest Rates[c]				
Bank lending rate	30	31	40	46
Treasury bill	27	31	31	40
Money supply (M2)	24	65	46	99
Prices[c]	58	158	105	111

[a]Percentage of GDP, Central Government only.
[b]Measured on an accrual basis; other sources of deficit finance are changes in domestic and foreign arrears, net borrowing, and foreign debt relief.
[c]End of period.

Sources: IFS; IMF reports; Bank of Zambia.

In conclusion, the Chiluba administration inherited the following:

1. An overvalued exchange rate and a set of internal incentives that blocked the growth of exports and starved the economy of foreign exchange. Under these conditions only the products with the highest comparative advantage—copper and a few other minerals—were still competitive. Price controls hindered the diversification of agricultural exports and

production, and manufacturers were so heavily protected that they were neither interested nor able to sell abroad in any substantial way.

2. A very large external debt, service of which would have eaten up new assistance if it had been paid. In reality the debt was not paid, and huge arrears accumulated. Even after a partial recovery of copper exports, scheduled service still exceeded 60 percent of earnings in 1990–1991.
3. Low share of GDP allocated to fixed investment. Compared with even the poorest LDCs, Zambia has an exceptionally low share of GDP allocated to fixed investment and conversely, a relatively high share directed to private and government consumption. In an effort to protect consumption as output per capita declined, the Kaunda government set up a system of disincentives such as price controls and use of state enterprises to promote social rather than productive spending; the result was fixed investment of about 10 percent of GDP, making growth practically impossible.
4. A public sector so large that it directly or indirectly dominates productive activity. All the utilities and railroad transport, the important mining activity, and 50 percent of industrial production is under the control of the state. Buttressed by subsidies or monopoly positions, the public sector was most unresponsive to market incentives.
5. A high rate of inflation that has accelerated in each subperiod. The problem has been especially acute since 1985 when prices rose more than 50 percent per annum in the first few years and exceeded 100 percent from 1989 on. In an economy with interest rates well below price rise, and with lagging exchange rate adjustments, this is an invitation to capital flight, hoarding of goods, and narrowing of investment to the shortest possible focus.

CURRENT MACROECONOMIC POLICY

The first half of this subsection summarizes what has happened to the economy, and the second half addresses the principal economic policy measures. Section 3 discusses the outlook for 1993 and beyond.

The Chiluba government, which took office in November 1991, inherited a dismal economic situation made even more difficult by a drought that decimated the maize crop, the country's principal foodstuff. Unlike its predecessor, the new administration understood the lesson of the failures of post-independence economic policy and firmly believed in reform and especially in increasing competition by lifting controls over private activity. The administration was prepared to enter into IMF and World Bank programs with fewer reservations than Kaunda had. But as a new government, representing a disparate coalition, it had difficulty in organizing to carry out its program. Because its officials lacked experience, the administration was sometimes not aware, except in retrospect, of the implications for policy flowing from its objectives and their impact on the economy. The record of the first 14 months is uneven: outstanding in some respects, respectable in others, and poor elsewhere.

The Record

Table 3 summarizes the principal economic indicators for 1991 and 1992. The following paragraphs discuss 1992 performance.

Table 3. Economic Indicators, 1991–1992

	1991	1992[a]
Gross Domestic Product	–1.8	–9–10
Balance of Payments		
Exports, free on board	1,082	1,064
Imports, free on board	–952	–1,286
Current account balance	4	–122
Real Effective Exchange Rate[b]	72	55
Prices	111	200+
Money Supply (M2)	98	95
Domestic credit[c]	147	93
Monetary Survey[d]		
Net foreign assets	–9.9	21
Domestic credit	55.2	90
Net claims on government	30.9	40
Bank of Zambia	(20)	(17)
Commercial banks	(11)	(23)
Private sector claims	24.3	50.4
Other	3.2	17.2
M2	48.5	94
(Reserve Money)	(22.0)	(37.5)
Interest Rates[e]		
Treasury bill	40	47
Bank lending rate	46	62
Budget[f]		
Total revenue	26.1	26
Of which taxes	16.1	16+
Expenditure	30.3	29
Balance	–4.2	–3
Of which covered by domestic finance		

[a]Estimated.
[b]Index, 1980 = 100.
[c]As percentage of M2 at beginning of period.
[d]In billions of kwacha; private sector includes parastatals; end of period.
[e]End of period.
[f]Accrual basis, percent of GDP. Financing is based on cash outlays and receipts and is influenced by changes in arrears outstanding and external debt relief.

GDP

Output fell in 1992 mainly because the drought affected production of maize, cotton for the textile industry, electricity (which is heavily dependent on hydropower), and other industry because of a shortage of power and consumer incomes. It has been estimated that the economy might have grown 2 percent in the absence of drought; thus, the drought's total effect was to reduce GDP by possibly 11 percent; there was sufficient foreign exchange to meet import demand so that it was not a constraint on growth.

Balance of Payments

In 1992, export receipts have been roughly the same as in 1991, with a higher volume of copper exports compensating for lower prices. There was little change in other metals. The data for nontraditional exports are too poor to determine the trend. Imports rose sharply, essentially because of drought-related maize, and also to meet the requirements of the metal sector. Although maize was easier to import, the depressed economy, tighter credit, and the rapidly depreciating exchange rate seemed to have dampened demand. Net reserves rose slightly. The picture of the balance of payments is partial because it omits unrecorded exports, imports, and capital movements through the black market.

Real Effective Exchange Rate

By the third quarter of 1992, continuing adjustments had wiped out the appreciation of the second half of 1991. The unification of the exchange market in December (except for a premium for donor-financed nonproject imports) at the highest legal exchange rate lowered the index to its most depreciated level since 1986 in spite of the most rapid price increase yet recorded. There seems to be little or no discount in the black market.

Prices and Money Supply

The key point is that price rise started accelerating from its more than 100 percent rate of increase of 1990 in the last quarter of 1991, reaching at the end of the first quarter of 1992 a year on year rate of increase of 180 percent; thereafter, it settled back to the earlier 100 percent trend line for a few months but accelerated to the 135 to 170 percent range in the last 5 months. The cause was mainly the acceleration of money supply expansion from 46 percent in 1990 to 99 percent in 1991 and 95 percent in 1992, and secondarily, cost increases arising from devaluation and other internal price adjustments; inflationary expectations were stimulated, causing the velocity of circulation of money to rise, a continuation of the trend that started in 1989—the ratio of price to money supply increase since then has been: 2.4 (1989), 2.3 (1990), 1.1 (1991), 1.9 (1992); that is price rise has been roughly twice as fast as money supply increase.

Factors Behind Money Supply Growth

Domestic credit change, which records government and private sector borrowing, is the component that best reflects monetary and fiscal policy. It is estimated to have grown 93 percent in 1992 as a percentage of money supply outstanding at the end of 1991 compared with 147 percent in 1991, both of which are Zambia's worst performances in the past 5 years. For 1992 as a whole, the driving force was apparently government borrowing from the Central Bank, which provides a liquidity base allowing the commercial banks to expand their lending. (The monetary survey indicates that an improvement in net reserves and "other" had a larger impact on money supply; when the final numbers have been received, a closer analysis will have to be undertaken.)

Bank Lending Rates

Although freed at the end of September, the base or prime rate was still below the rate of inflation, which is usual for Zambia. Although rates have risen, so has the pace of inflation.

Budget

After good performance in the first quarter of 1992, expenditures exceeded IMF program targets in the second and third quarters. In the last quarter, there was an emergency effort to bring them back under control. The problems centered on drought-related spending, where expenses have been incurred in distributing imported grain and proceeds from their sales have been delayed; civil and military pay increases; and the deficit of Zambian Airways, equal to 1 percent of GDP. Tax revenue as a percentage of GDP was slightly higher than in 1991.

RESULTS

The preceding conditions contributed to the following results.

1. The exchange rate was depreciated to what appears to be a realistic market-based exchange rate. (Nominally the change was from less than 100 kwacha to 320 kwacha to the dollar.)
2. Money supply rose just as fast as in 1991.
3. Related to that problem was the continuation of negative interest rates throughout the year.
4. Although the rate of inflation almost doubled, it was in part the consequence of necessary devaluation and elimination of internal subsidies and price controls.
5. By constraining production, the drought dampened the incentive effect of price decontrol on output, which should be more visible in 1993.
6. Other initiatives, such as privatization and the establishment of incentives to encourage private investment (discussed below), are too new to have any measurable impact on output or prices.

Economic Policies

The basic theme of the new administration is to expand the role of the private sector and make it work better. After the experience of three decades of a rather unintelligent variety of socialism, the leadership of the Movement for a Multiparty Democracy (MMD) is convinced that private enterprise, both domestic and foreign, will work better. It is probably also a political objective because a flourishing private sector is a safeguard against the return of the United National Independence Party (UNIP) or parties like it. Therefore, economic policy measures can be grouped under five headings:

1. A realistic market-based system of price incentives,
2. Privatization,
3. Promotion of private investment,

4. Macroeconomic stability, and
5. Improvement of social welfare.

Judging by performance in the first year, these measures are listed in approximately priority order.

A Market-Based System of Incentives

A market-based system of incentives involves six separate but related policies—a realistic exchange rate, reducing controls over international trade, eliminating price control, curbing state trading, lessening the protective effect of tariffs, and reforming taxes.

Exchange Rate and Exchange Market

The Kaunda administration had depreciated the official rate after returning to the IMF fold in 1989 and established other exchange markets whose rates were quoted at a discount to the official one. When the new government took over, two markets were in operation: the official market, which received its exchange from the repatriation of all of the Zambia Consolidated Copper Company's (ZCCM) earnings and nonproject donor aid, and the retention market, in which all other exporters had to surrender 50 percent of their earnings. Over the course of 1992, the Bank of Zambia allowed exporters, other than ZCCM, to keep all their earnings, shifted some foreign exchange demand for services into that market as well as supply in the form of inward transfers of nongovernmental organizations (NGO) and foreign investors. In October 1992, the Bank of Zambia once again broadened the market by creating *bureaux de change*, which drained the black market and added flexibility in meeting the demand for small amounts of foreign exchange.

In effect, the bank cautiously promoted an official free market against which to measure the overvaluation of the official market rate, which still accounted for 80 percent of transactions at mid-year. Although the nominal official rate had been devalued 30 percent in February 1992 and adjusted weekly in the second half of 1992, rapid inflation sustained a large gap between the prices in the two markets until they were unified in December. The difference, just before unification, was something like 320 kwachas to US $1 as compared to 250 kwachas to US $1, the same discount of almost 30 percent that had prevailed since mid-year.

There is now a single exchange rate, except for the sale of donor funds with restrictions on country sourcing or commodities at a premium that was initially fixed at 15 percent but will be determined in the future by auctioning each donor's contribution separately to reflect its particular disadvantages. Donor funds that are unrestricted, such as the World Bank loan, can be sold at the main exchange rate.

The change in the principal exchange rate is now determined in the commercial bank segment of the exchange market. The commercial banks look at the demand and supply in a given day and then estimate the price necessary to move toward balance the next trading day. The rate should then reflect trade, services, and small capital transactions, but not necessarily large capital transactions, which are still restricted by exchange controls. At an individual's level, the kwacha is de facto convertible since anyone can buy $2,000 per transaction at the *bureau de change*. For the moment there seems to be no unsatisfied demand from individuals since black market transactions are in the same range.

The exchange market continues to be segmented. First, there is the ZCCM market through which about 80 percent of Zambia's export earnings are channeled. About one-third is retained for its own imports and other foreign expenses. The remainder is passed through the Central Bank market, to which is added donor balance-of-payments aid. On the spending side, the Central Bank is responsible for the import of oil, still a government monopoly, other official imports and services, the service of foreign debt, and private sector imports financed by unrestricted donor money.

The commercial bank market receives nontraditional export receipts, tourism, diplomatic and NGO purchases and provides exchange for private sector invisibles and imports. The commercial bank market is the residual market with the lowest priority claim on and the most unfettered demand for Zambia's foreign exchange receipts.

The Central Bank can influence the exchange rate in the commercial bank market through (1) the supply of donor balance-of-payments aid it can put on the market and (2) the supply of exchange directly to the banks for resale to customers. The first source is controlled by the donors, and the second source depends partly on the allocation to ZCCM, which should not necessarily have a priority claim on foreign exchange.

To produce a properly functioning foreign exchange market, the Central Bank should withdraw from all transactions except where the central government debt or donor transactions are concerned. ZCCM should sell its exchange to the commercial banks, and ZCCM, the oil company, and other parastatals should buy what they need from the same source.

Trade Liberalization

The elimination of quotas and the reduction of prohibited items to a smaller number had already been accomplished in the Kaunda administration. In the past year, this situation has improved by decentralizing the administration of licensing from the Central Bank to the commercial banks and using a negative rather than a positive list for OGL imports. Processing time has reportedly been cut from 3 to 4 weeks to a couple of days except where donor supplied funds are concerned.

Price Control

General price control had already been abolished in principle in the Kaunda administration. The Chiluba government made that step more creditable by abolishing the Prices and Incomes Commission. Key prices still remain under the government's control because they are decided by parastatal monopolies such as those on oil, electricity, air freight, domestic air travel, and maize, which in this drought year is determined by government-distributed imports. However, the freedom to set grossly unrealistically low prices is limited by the policy of not providing subsidies. The authorities also showed much more political courage than their predecessors by raising the price of maize more than four times as fast as the general rate of inflation and by making the price of petroleum and electricity more realistic.

State Trading

State trading exists where the public sector controls the distribution and pricing of a product or service it does not produce itself, or at least controls the producer price where it enters the distribution system. Maize in Zambia, for example, had to be priced and channeled according to official directives. In 1992, although producers, traders, and mills are free to deal with each other, the drought has made the government the dominant supplier through its control of maize imports and setting of the "into-mill" price of import. Although the "ex-mill" price is free, it is influenced by the into-mill price and the practices of state shops.

The case of fertilizer imports illustrates the problems of transition. The government turned over to the private sector the importation of fertilizer for the 1992–1993 crop season. Imports were slow because of tight credit and because of doubts among businessmen that the government would allow them to resell at what they considered a profitable price. By September 1992 the authorities, fearful of the adverse consequences of insufficient fertilizer on maize production, stepped in and started importing for their own account. As a consequence, the bulk of the supply will be handled and to an extent financed officially, but the price, which was determined by auction, at least seems realistic.

Tariffs

Currently, the tariff schedule has seven categories and five rates of duty ranging from 15 to 100 percent. In addition, the 20 percent sales tax applies and is levied on a base that consists of the sum of the c.i.f price plus tariff, raised 20 percent (uplift). There is also a 10 percent license fee. This structure has evolved over the years partly for protective and partly for revenue reasons and is badly in need of reform. Nothing was changed in the 1992 budget and very little in the 1993 budget because revenue cannot be sacrificed.

Taxes

The new government took a number of tax measures in the 1992 budget, as follows:

- The top individual income tax rate was reduced from 50 to 35 percent and the minimum exemption allowance was raised.
- The basic company tax was raised to 40 percent but employee fringe benefits as a deductible item were eliminated.
- The sales tax was set at a uniform 20 percent.

Basically, these changes improved the incentives to save and work and to make the tax system more neutral in its impact on different branches of activity. The attempt at rectifying the tendency of the individual income tax to collect on lower and lower levels of real income by raising the level of exempt nominal income was partially nullified by a much higher than expected rate of inflation.

Privatization

Privatization has been an issue between Zambia and its donors for years. One of the obvious differences between past and current administrations is that the current administration really wants to carry out privatization. Among the government's recent achievements are passage of a privatization act by the Parliament in June 1992, establishment of the Zambian Privatization Agency, inclusion of a commitment on phased divestiture as part of the conditionality of the World Bank's "Privatization and Industrial Reform" loan, and considerable public effort to explain the government's position and develop support.

Nevertheless, it will take a great deal more than goodwill and technical assistance to cut back the sprawling parastatals to an appropriate size for an economy in which private capital is supposed to predominate and market incentives do the job. The government will have to decide how to help Zambians buy shares, determine what proportion of foreign ownership is acceptable, protect against private monopolies, and strengthen the capital market to support an enlarged private sector. Some 140 companies will be divested or closed over the next 5 years.

The first group of 19 enterprises consisted of small industrial, construction, agro-industry and service firms, tenders for which have already been have been offered for a sale that closed in November. The group comprised 10 firms picked by the Kaunda administration because they were unattractive and an additional 9 to ensure that at least 10 were sold. None presents particular political problems. This group of firms is essentially a trial run to work out operating problems for an agency that is new and understaffed.

The response was good—at least three offers were received for each company. Advertising was directed at Zambians, but a few foreign offers were also received.

A second group of 32 enterprises will be offered shortly. As agreed on with the World Bank, the goal is that at least 20 firms sold from both offers in 1993 will have a combined turnover of 10 percent of the whole group to be divested.

From a non-Zambian point of view, most firms on the whole list are small or medium-sized; only 10 have capital exceeding $20 million. Several, such as the fertilizer plant and Kafue Textiles, are "white elephants." The sizable money-makers are the breweries and the Zambia National Commercial Bank. The biggest public sector company, the Zambia Consolidated Copper Company, is formally outside the jurisdiction of the Zambian Privatization Agency, but a decision has been made to turn over subsidiaries unrelated to its main business for sale.

The original owners of ZCCM (Anglo-American and others) own 40 percent of the shares and have pre-emptive rights that give them the right of first refusal of a government share offering. The government has indicated it wants to sell but will want to retain a minority interest because of the importance of copper earnings to the Zambian economy and will want to be seen to be defending Zambian interests to its own citizens. Divestiture therefore will probably require long negotiation with the current minority shareholders. In the meantime, a plan is being developed to divest ZCCM of its non-copper-related enterprises. Three of these firms were included in the first group of firms privatized. Another 25 firms have been identified, but plans for their sale have not yet been developed.

The basic utilities—electricity, post office and telecommunications, the railways, and oil-related companies—are not slated for privatization. They will need improved management, restructuring, and a reduction in personnel. Ending subsidies to parastatals, except Zambian Airways, which will receive its last payment in 1993, ought to be a strong incentive to start the process of reforming the management of the parastatals.

In summary, the program has started out well, but the big decisions have not yet been made. Selling some large profitable companies and turning over ZCCM to majority private control would certainly establish the impression among local and foreign investors that the new administration has the capacity to implement the policy.

Promotion of Private Investment

Given the shortage of skilled labor at all levels in Zambia, lack of internal medium-term credit and bankrupt status internationally, more private investment is an essential element in growth policy. After years of dealing with the hostile Kaunda administration, investors are more prepared to give the new government the benefit of the doubt. There are many statements in favor of private enterprise, and for the first time in decades Zambia's European farmers (as exemplified in the government by the Minister of Agriculture) and Indian merchants and manufacturers (e.g., the

Minister of Information) are considered valuable enough to the economy to be worth cultivating. White farmers fleeing pressures in South Africa and Zimbabwe are looking for land in Zambia.

The most striking change is the new relationship with South Africa. Businessmen and technical experts visit constantly. They have the specialized knowledge of commodities production and trading that can be of great value in stimulating agricultural exports. South Africa is a major supplier of parts and machinery because its proximity gives it a competitive edge over other industrial countries.

The Investment Act was passed in 1991 before the Chiluba administration took office, and has been implemented since then. The objective of the act is to promote new investment that is either domestic or financed from abroad. That would be an incentive for the repatriation of the substantial Zambian assets abroad as well as "foreign" capital. Investor interest and government response have been strong. In the first 11 months of 1992, 400 investment applications, mostly in agriculture were approved, and 290 operating certificates were issued. The average size of the certificates is small, $100,000 to $300,000.

The criteria in the act, which are concerned mainly with increased foreign exchange earnings or savings, or both, have been applied loosely, indicative of new attitudes. In fact, the administration is so casual that domestic enterprise is worried about the competition and the Treasury is worried about the loss of revenue from tariff-exempt imports of capital goods, which it estimates to be as high as 2 billion kwacha in 1992 alone.

In addition, some experts who have studied the law believe that it has not been very useful in stimulating interest by new investors in Zambia. Rather, it has been used mainly by existing business directly or indirectly to mount projects they might have undertaken anyway. At best the law may have speeded up investment timing a year or so as a result of investors' taking advantage of the duty-free provisions on capital goods.

A different approach to private investment, which is described below, is being taken in 1993. Private investment, especially with a foreign component, is indispensable to Zambia's recovery. Even if the resource transfer is modest, the introduction of managerial, technical, and foreign marketing skills should raise productivity on a wider scale and help to solve Zambia's most serious problem—inefficiency in the use of resources.

Macroeconomic Stability

In an economy with a fairly simple financial system like that of Zambia, the reduction of inflation to modest levels (less than 10 percent per year) requires first that domestic credit (bank and central bank lending to the government and private sectors) be no more than that rate of inflation plus an allowance for projected output growth. Second, the expectations of future price increase have to be moderated so that the speculative activity that stimulates inflation ceases. To put it simply and crudely in quantitative terms, there has to be a very sharp reduction in money supply expansion and in the rate at which the money supply turns over (velocity of circulation).

Policy makers in 1992 started out with two strikes against them: a great burst of liquidity in the second half of 1991 and the need to make fundamental upward adjustments in prices that were well below their market levels, such as the exchange rate, mealie meal, electricity, and petroleum products. As noted earlier, prices rose 50 percent in the first quarter.

Monetary performance, on the other hand, improved in the same quarter: 120 percent rate of growth of domestic credit compared with 150 percent in December 1991, and a 70 percent rate of growth of money supply compared with 215 percent at the end of 1991. Building on that record, the government and the IMF developed a program for 1992 in June, with rates of expansion at year-end for both domestic credit and money supply at about 35 percent. As already mentioned, the actual rates are estimated to be about three times as much.

The rate of inflation was far greater than anyone predicted early in the year. The rate was too high for the trade union movement, one of the pillars of the MMD. The wage increase they received in compensation was about 150 percent. There was another 30 percent rise in October. Not only was most of the wage increase added to the budget deficit, but it became a guideline for other employers, both parastatals and private. Naturally they sought more credit from the banks to finance their wage bill. That credit was forthcoming because in spite of the very high reserve requirements, the increase in the monetary base was sufficient to provide excess reserves on which to base their lending. That liquidity rose in part from the government's own borrowing from the central bank and to an increasingly important extent the accumulation of foreign exchange.

The primary causes of the fiscal deficit have been (1) the supplementary agricultural relief budget prepared in response to the drought, and (2) uncollected agricultural credits in general. In principle, the emergency importation of maize, paid for by external grants, should have reduced the budget deficit. The government would be selling an asset given to it for free. It chose, however, to use the projected proceeds for various types of relief and agricultural support. In practice, funds were spent but much of them were not collected. Another reason for the deficit was the poor record of collecting agricultural production credit issued in the fall of 1991, partly explained by the fall in farm income because of the drought.

The third problem seemed to be a tendency to establish policies with fiscal and financial implications without determining how they affected the IMF targets or to make poorly founded assumptions that they would pay for themselves. The Ministry of Finance and the Central Bank, which has little autonomy in Zambia, do not appear to be able to modify or veto measures that contravene the IMF agreement.

Perhaps more alarming are the lack of a central monitoring mechanism and lack of up-to-date data. It seems to require an IMF mission to review what is happening. Compensatory actions are taken and then vigilance is relaxed once again. With the IMF coming only every 3 or 4 months, damage has been done that simply cannot be undone. The lack of or lag of collection in key data series is serious. Updating of Central Bank records of foreign exchange holdings is months behind. It takes several months to establish a comprehensive analysis of money supply. There are no monthly Treasury statements and no current data on the composition of exports and imports except for a few major commodities that are controlled by parastatals. Much more serious management will be required to detect and solve the problems posed by unforeseen deviations from the stabilization program.

Finally, there is the problem of real interest rates. In Zambia they have been "negative," that is, lower than the rate of inflation, for most of the independence period. Policy makers in 1992 seemed reluctant to recognize that the appropriate policy is not to wait for inflation to fall below nominal interest rates but to raise them above inflation to put a brake on price rise. Although bank lending rates were officially decontrolled in September and did rise significantly (from 46 percent to 60–64 percent depending on the bank), the market can hardily be said to be competitive. Three large banks dominate lending under the eye of the Central Bank.

These banks' marginal cost of funds is defined by the Central Bank's discount rate for buying Treasury bills, currently 52 percent, and for overnight loans, currently 58 percent. Although these rates have risen a little since September, the increase has not been enough to put the banks under any real pressure to raise their own lending rates. In other words, the Central Bank had been nibbling around the edges of this problem rather than squarely facing it.

The first Treasury bill auction, which took place on January 15, 1993, was a major step forward. The bills were sold to the banks at a fixed rate (47 percent) and are mainly held to meet reserve requirements. The result was a rate of 72 percent, which may be much closer to the rate of inflation if the 1993 program is successful.

As a result of the poor inflation record in 1992 and completely missing the government credit and reserve money targets for the end of September, Zambia was on the brink of a crisis with the IMF. The IMF has given Zambia a second chance by revising the original December targets and extending the agreement so that Zambia can still earn all the rights originally for which the agreement provided, including those that would have been credited for the third quarter. These revised targets have apparently been reached. Missing targets two quarters in a row could have led to the suspension of the IMF agreement, with repercussions on much of the rest of the aid and debt relief agreements. With a 200 percent annual rate of price increase, the Fund is unlikely to give Zambia a second chance.

Measures to Improve Social Welfare

Over the medium term, the reform program is the best hope for higher employment and real incomes for the poorer part of the population. In the short term, the new measures help some poor groups and hurt others. The Kaunda administration subsidized the cost of basic foods to the urban population—whether or not they were poor—at the expense of the farmers, most of whom were quite poor. The new policy of realistic market-based prices reverses the pattern.

The old policy gave work to thousands of employees of the central government and the parastatals that produced little or nothing and was paid for by others through either taxes or inflation. The present objective is to get these people off the payroll and use those resources for investment either in production or health and education. To facilitate retrenchment, the government is working out severance pay and retraining schemes that may be unnecessarily generous.

Cutting across the longer term is the distress caused by the drought with its impact on prices and incomes. To offset some of the effect the budget has allocated 1 billion kwacha for income support to the poorest people and 500 million kwacha for public works employment to supplement incomes. In addition, up to 75,000 tons of maize will distributed free, 75,000 tons will be distributed at half price, and a subsidy for milling provided for another 180,000 tons. Most of this cost is, in effect, being paid for by donors who provide the grain on grant terms to Zambia and to the final recipients, who do not pay for it.

For the future, the most important decisions in social welfare will concern the extent to which allocations to education and health can be increased. Tax policy will also play a role. Inflation has pushed the minimum taxable incomes down to extremely low levels and will have to be adjusted as rapidly as the availability of revenue permits.

CONCLUSIONS

On the basis of the foregoing discussion, the following points can be summarized.

1. The most important achievement is the establishment of a realistic market determined exchange rate.

2. The government has made a major and largely successful effort to establish prices that reflect market values.
3. The privatization program has been well launched politically and the first phase of divestiture has begun, but the more important benefits and problems are yet to come.
4. The government has demonstrated by statements and by its administration of the Investment Act that the promotion of foreign investment is an important policy goal.
5. Although the high rate of inflation reflects, in part, the adjustment of artificial prices to market levels, the failure to substantially reduce the rate of inflation endangered the success of the reform program in general and relations with the IMF in particular.
6. The social welfare measures have been designed largely to offset the effects of the drought; the government has not yet the time or the resources to more than begin progress toward the important goals of improved health and education.

3. Policies and Outlook for 1993 and Beyond

POLICIES

Inflation

Mastery of inflation is the primary issue facing the Chiluba government, as the Finance Minister said in a speech at the end of 1992. All the government's achievements to date—a market-determined exchange rate, the restructuring of relative prices, its credibility with donors—depend on it. To master inflation, three distinct groups of measures must be taken:

1. Elimination of the budget deficit.
2. Management of spending and income throughout the fiscal year so that budget targets are actually carried out (the so-called cash budget).
3. Ensuring through monetary policy that various measures, such as those establishing commercial bank reserves and interest rates (e.g., the Treasury bill auction), really restrain money supply growth.

Budget Deficit

The target for 1993, agreed on with the IMF, is no deficit in the primary budget (excluding interest payments from spending and foreign grants from revenue), compared with a deficit of 3.7 percent of GDP in 1992. The budget contains a provision for a substantial purchase of the marketable maize crop by the government. If financing of the maize crop other than the purchase of the reserve is transferred to the private sector, there would have to be a surplus of 15 billion kwacha to offset the creation of credit that would ensue. The surplus, if it occurs, would be used to reduce government borrowing from the Bank of Zambia.

With respect to spending, the important measures are the elimination of subsidies (Zambia Airways gets a final 2.5 billion kwachas to pay off domestic debts), a moderate wage increase (i.e., less than the 55 percent price increase projection for the year), a compression of military spending, and the full-year effect of the reduction of 20,000 temporary government employees in 1992.

With respect to revenue, the major measures to be taken are as follows:

1. Reduction of the company income tax as compensation for the withdrawal of certain other advantages in the tax code;
2. Significant reduction in personal income tax, which will have a significant effect on net salaries and is part of the strategy to restrain wage increases; and
3. A large increase in the revenue derived from import duties, resulting entirely from the effect of the devaluation on the kwacha valuation of imports.

Cash Budgeting

Cash budgeting is in theory a rather drastic system of the control of spending required by the freewheeling practices of some ministries of contracting for and even spending on items not budgeted. The loudly touted system of cash budgeting is just going into effect for the 1993 fiscal year, which means

1. Funds authorized but not expended at the end of 1992 are not automatically carried over;
2. The Central Bank will not pay on budget orders to disburse unless the funds have already been credited to a specific ministry's account at the Bank;
3. The Central Bank will not lend to the government;
4. The government will not increase its borrowing from the commercial banks through Treasury bill issues and will eventually reduce them, except for reserve management, by which the proceeds will be sterilized; and
5. The Treasury will rely on borrowing from the nonbank public, including corporate treasuries such as ZCCM, for very short-term loans to bridge gaps.

Monetary Policy

Zambia has not had a monetary policy in the past, in the sense that it manipulated instruments to determine what the growth of money supply should be. Money supply was essentially the counterpart of what was needed to finance the budget deficit plus what the Central Bank permitted the commercial banks to lend. Now Zambia is trying to create an interbank money market, a nonbank money market, and a Treasury bill tender, all of which will supply what has always been missing—market-determined interest rates. A learning process within the administration has begun that will take some time to work out. The process is an indispensable supplement to the objective of creating a budget surplus, which would not be reached if too much credit were issued for other purposes and high inflation persisted.

Savings and Investment

Savings and investment involves three types of policies:

1. Privatization,
2. Promotion of private investment, and
3. Restructuring of the parastatals that will remain in the public sector.

Privatization

The second tranche of parastatals that will be offered for sale in 1993 consists of 32 firms, most of which are medium or large compared with the first group. Included in the second group are principal sugar, milling, brewing, cement, explosives, and metal fabrication companies. The choice of firms was based on two criteria: (1) existing or recent private ownership or (2) activity in agriculture or agro-industry. The two clearly overlap. The objective of the first is to facilitate privatization by working with companies whose former private owners are known to be interested in regaining control. Only a relatively small investment may be necessary to create a majority holding. The continued participation of the government as a minority shareholder may also reassure those who are not fully committed to privatization.

The second objective is to remove the government from agriculture so that private companies acting in response to market forces will increase their activity and investment in the agriculture sector. Transfer of all the firms on the list would place the entire maize milling industry (except those belonging to co-ops) in the private sector. It would convert the parastatals that dominate sugar, tobacco, horticulture, cotton, and meat packing into private concerns.

Agriculture under private management is probably the best source for the increase and diversification of exports. The second list of firms to be privatized includes two of the largest firms exporting manufactures—cement and copper products. Unlike the first tranche, successful completion of this group has potentially important consequences on the level and efficiency of the agricultural sector and on its export activity.

Promotion of Private Investment

The best policies for promoting private investment are the liberalization undertaken in 1992, the establishment of a realistic exchange rate, the relaxation of restrictions on making payments abroad, and the reduction in the company tax. The best promotional measure for 1993 would be price stabilization carried out without endangering the economy's stability.

The special benefits of the Investment Act are less important. As noted earlier, there was a strong response to the act, in part for the wrong reasons—the right to import duty-free equipment and consumer durables that need not be part of the investment. The government is now considering the Investment Centre, established under the act, as an organization that will promote Zambia as a place in which to invest rather than as a dispenser of special privileges.

Restructuring the Parastatals

As noted earlier, restructuring the parastatals that will not be privatized in the near future means shedding excess personnel and improving the efficiency of operations to develop profits that can be reinvested or paid out to the central government. Unfortunately we have very little information on this subject except for the operations of ZCCM. The management has negotiated an agreement with its union to reduce the work force from 56,000 to 46,000 in 1993. Operations have generally been improved since the new team took over, but the cost of production is still relatively high. The management in the past few months has stated the cost to be $1.03 per pound, which is higher than the world price, or $0.75 a pound, which seems to make more sense. In any event, the company has a long history of neglected investment and wasteful management that will take years to correct. Another factor that will improve financial viability is the privatization of subsidiary enterprises unrelated to mining.

A Market-Determined Exchange Rate

The exchange rate was unified and a mechanism put in place at the end of 1992 to make it responsive to market forces. There are only three ways in which it ought to be managed.

1. Carrying out the measures described earlier to bring down inflation and thereby inflationary expectations,
2. Ending segmentation of the market so that ZCCM and parastatals are competing for exchange on the same footing as other importers, and
3. Having the Central Bank sell exchange to the commercial banks to smooth out rate fluctuations.

The first point is obvious. It is clear to anyone who has experienced the inflation of the past year that dollars or imports are among the best hedges. The rational businessman will seek to convert all the kwacha he can spare and not repatriate nontraditional export earnings or delay other inward transfers until absolutely necessary. The considerable business within the country that is being transacted in foreign exchange is not going to enter the conversion circuit until prices begin to stabilize. The consequence is that the rate is bound to depreciate rapidly as long as inflation is not curbed.

The present system gives ZCCM a priority claim on foreign exchange that is not an incentive to exporting as in the case of other exporters. There is no reason why ZCCM and other parastatals should have a favored access to foreign exchange. Having a much larger pool to draw from would make rate management much easier for the commercial and central banks.

To the extent that the Central Bank has spare funds, it can intervene by supplying the commercial bank market for resale. The bank has no experience in this area but is expected to begin shortly.

Export Promotion

The floating exchange rate and the restructuring of relative prices are the most important measures that have been taken to promote exports. They provide incentives not only to the "nontraditional" sectors but also to the metal sector. Zambia is entering a new era in which exporting can become profitable. It has already stimulated interest in wheat and oilseeds from commercial farmers. However, this process is hindered by the Ministry of Agriculture's habit of prohibiting exports of some products, such as maize and wheat, to control internal prices.

At issue is whether other assistance—marketing, selective credit, production advice—is necessary. The European Community has a project to promote a selected group of products: tobacco, cotton textiles, horticulture, and coffee. All have track records, and coffee and tobacco were much more important in the past than they are now.

The resumption of growth will require every dollar Zambia can earn from any source, metals, manufactures, and agriculture. The most promising area is agriculture because of the country's resources, export experience before the Kaunda era, and existence of commercial farmers and a commercial community that can take advantage of the new incentives. (This issue is discussed at greater length in Chapter 4.)

ECONOMIC OUTLOOK

The outlook for 1993 is clearly more promising after the disastrous experience of 1992. First, rainfall appears to be normal so far this season. Two consequences of increased rainfall will be

1. A more or less normal maize crop—that is, double the production in 1992 and
2. Increased production of wheat, oilseeds, and horticultural products responding to new price incentives that arise mainly from the exchange rate and are directed to the export market.

GDP should grow fairly rapidly, based on the increase in agricultural output and associated services and manufacturing, the greater availability of electric power, and the spillover of higher incomes on demand. The estimated 11 percent negative effect on GDP of the drought in 1992 is expected to be almost completely reversed, leading to a 12 percent increase in 1993.

Second, there should be some visible evidence of new investment in agriculture and agro-industry. Most of the approved foreign investments were in this area, and commercial farmers have also invested in projects of their own. It is uncertain so far whether manufacturers will respond to new international competition by retrenching or by investing to make themselves more competitive. A few of them will be in a position to benefit from the enhanced profitability of exporting. Any substantial and widespread rise of private investment will have to await the stabilization of prices, which will reduce uncertainty about the future stability of the economy and the government and allow the authorities to relax restrictions on bank credit.

Third, the IMF balance-of-payments outlook is not very encouraging (see Table 4). The world price of copper is assumed to be US$0.92 per pound, compared to US$1.03 in 1992, with the volume unchanged at 400,000 tons. The prices of other metals, especially cobalt, have fallen. The projected loss is US$140, million which should be set against a US$30 million increase in other, mostly agricultural, exports.

Maize imports are expected to fall by US$200 million while total imports decline by US$145 million. Increased metal sector purchases make up the difference and just $30 million for the rest of the economy's demand for everything else except fertilizer and petroleum. If the upswing is stronger, the question arises of how to finance import needs. Reserves are at minimal levels and the pipeline of nonproject aid is not very large. The two primary financing possibilities are higher-than-forecast nontraditional exports and repatriation of some Zambian exchange assets from abroad. The flexible exchange rate will help, depending on how responsive the supply of foreign exchange is, in a situation that is still unstable and in which speculative reactions continue to be strong.

Table 4. Balance of Trade, 1991–1993 ($ millions)

	1991	1992	1993
Exports, free on board	1,082	1,064	947
Copper	895	852	738
Other metals	103	112	79
Nonmetals	84	100	130
Imports, free on board	952	1,286	1,140
Metal sector	285	317	338
Fertilizer	34	44	45
Petroleum	83	83	82
Maize	—	269	72
Other	550	573	603
Trade Balance	129	−222	−193

Source: IMF.

Our inferences about what might happen are limited by the data based on the records of the Central Bank. With the decentralization of transactions to the commercial banks, the decision to allow nontraditional exporters to retain all their earnings and the activity of the black market before the *bureaux de change* were introduced, the Central Bank's knowledge of total earnings and many invisible transfers is declining, and accurate projections are more difficult to make. Nevertheless, there is still a problem because, although earnings may be higher than indicated, so may be payments.

The problem of inflation should be more manageable this year. Because the exchange rate and most basic prices have caught up to realistic levels, such adjustments should be considerably smaller than last year, which will moderate the rate at which the price index rises from the cost side.

From the demand side, the important issue is whether the government succeeds in keeping its accounts balanced and avoids financing the budget by creating credit. The management technique of "cash budgeting" will certainly help. This is a much more constraining system of operation than the ministries have been accustomed to. The temptation to make political appeals for "exceptions" will be strong. Another technique will be to contract for some politically appealing expenditure and then ask the Treasury for money. There is also the problem of what funds, frozen at the end of 1992, will have to be released for some essential purpose. Therefore, the deficit of "cash" operations during the calendar year may be a deficit even if the 1993 budget is balanced. Under these circumstances, the limited supply of funds in the nonbank market will probably have to be supplemented by higher borrowing from the banks via Treasury bills. Nevertheless, the budget deficit should be smaller. Even if budget performance is outstanding, and in a sense because of it, the argument will be advanced and possibly accepted, to substantially reduce the restraints on commercial bank lending to the private sector to promote investment. Some accommodation will probably be necessary.

The real unknown is the authorities' willingness to resist unaffordable wage demands of the kind that played havoc with the stabilization program in 1992. This willingness to resist, like "exceptions," is ultimately a political matter and depends on the president's view of how serious fighting inflation is compared with his other goals. It will also depend on how forcefully the IMF and the donors make their position known to him.

With the favorable factors now present, the rate of inflation should be far less than the 200 percent in 1992, but it seems doubtful that the guideline of 55 percent from year-end to year-end with prices rising at no more than an annual rate of 10 percent in the last quarter is realistic unless the government is prepared to control money supply very tightly and is prepared for a very forceful showdown with wage and salary earners.

In summary, the outlook is for much better economic performance in 1993 than in 1992, with a resumption of growth arising from the end of the drought and better incentives to produce in the agriculture and agro-industry area. Inflation should almost certainly be lower, but whether it will be low enough to ensure stabilization is problematical. Finally, there is the uncertainty of whether export growth will be sufficient to pay for the imports a growing economy needs without an extraordinary depreciation of the exchange rate.

4. The Economy and Future Direction of USAID's Program

INTRODUCTION

The purpose of this section is to summarize current Zambian economic policy and suggest how USAID's role might be expanded to strengthen trends that will eventually produce broad-based sustainable growth. The basic theme is "making the market work better," and all the proposals except one fit into that framework.

As stated earlier, the principal economic achievements of the Chiluba administration have been to raise key prices controlled by the government, including the exchange rate, to realistic levels in order to eliminate price controls in other areas and liberalize international trade transactions. To consolidate this progress, the severe inflation, from which the country is now suffering, must be curbed and the parastatal area sharply cut back. Otherwise, inflation will once again produce price distortions, while even the most enlightened managers of a public enterprise will not respond to price signals as would the leaders of a private company.

CONSTRAINTS ON GROWTH

In addition to inflation, constraints that remain are as follows.

1. A seriously inadequate export income and export base;
2. Low levels of savings and investment;
3. Institutions and laws that impede the working of markets;
4. Inadequate vocational, technical, and managerial skills;
5. Slow-moving, difficult-to-manage privatization;
6. An administered, slowly liberalizing market for maize;
7. A heavy external debt burden; and
8. A high level of population growth.

The rationale for the order of these constraints is as follows.

1. Inflation is the most urgent issue and real progress has to be made in 1993.
2. Low levels of exports, lack of investment and skills, and archaic institutions and laws are problems that must be tackled soon if growth is to resume on a sustainable basis.
3. Although the conceptual frameworks of privatization and maize marketing have been worked out, they both present difficult operational problems that will need technical support and policy advice.
4. External debt is not an immediate problem because of rescheduling and forgiveness arrangements negotiated in 1992, but at the end of the moratorium in 1995, the difficulties of 1991 are likely to return.
5. Population has been a neglected issue perhaps because it has the longest horizon. It affects growth and how its fruits are distributed. Any program expected to have an impact by the end of the century must be put in place soon.

NEW AREAS IN WHICH USAID MIGHT CONCENTRATE

In selecting areas in which USAID might concentrate its efforts, the agency should take into account the following criteria.

1. USAID's goals
2. USAID's current or potential resources compared with other donors
3. The priority in terms of economic development of some sectors compared with others, and
4. Other established donor programs.

The current program has two general goals: "a well-managed transition to a market economy" and "sustainable improvements in general health." Both goals are broad and compatible with a variety of projects. The current projects under the first goal relate to agriculture and privatization, and under the second, AIDS prevention. pharmaceuticals, and population.

USAID has been one of the smaller players in Zambia with a basic program of about US$20 millions per year, excluding the extraordinary food program. The larger donors—Japan, United Kingdom, Germany, the European Community, and the World Bank—have programs that range from $80 million to $200 million per year, heavily concentrated in balance-of-payments assistance. Even if the American program were to double or triple, it would be not be in a position to be a major provider of balance-of-payments aid. The program's future should continue to resemble its past, although at a higher level: a program in which projects and technical assistance predominate and are directed toward molding institutions and programs. Nonproject aid would be involved but essentially as a carrot.

Looking at the policy issues that were identified as constraints as targets for a program, several are not suitable because they require large amounts of balance-of-payments aid. These issues are inflation, low investment, and the current shortfall of export earnings in relation to the need for imports and debt service. External debt is not an immediate problem.

USAID is already involved in reforming legislation on agriculture and is heavily committed to developing a free market in maize and helping the privatization agency to carry out its ambitious program. That leaves three areas from which new projects could be fashioned:

1. Make exporting a major goal of economic policy, including reform of institutions and laws that impede the working of markets essential to it;
2. A high level of population growth; and
3. Improve vocational, technical, and managerial skills.

Priority of Exporting

Exporting is not only important for the obvious reason that it provides the income to buy essential goods and services, but also because the ability to sell abroad is a good test of national efficiency and competitiveness. Preparing to export better enables a country to avoid allocating investment to sectors of low productivity and provides policy benchmarks against which to measure how useful its economic institutions and regulations are.

A real export policy, that is, one that is not simply grafted onto policy declarations as a duty required by the donors of all self-respecting developing countries, has a number of elements that impinge on other goals and cannot simply be isolated in a compartment called "export promotion." To be successful it has to have a high priority in the minds of decision makers so that when it inevitably clashes with other objectives it can be accommodated and not overridden. These elements are price incentives for the products to be sold, access to low-cost imported inputs, investments in production, adequate credit, availability of skilled labor, and a knowledge of marketing.

Let us take an agricultural commodity produced in the private sector as an example. The exchange rate makes selling abroad attractive, but there may be a parastatal involved in marketing that does not pay prices commensurate with those in the foreign market. Assuming that this problem is solved, there may be important inputs that are high cost either because they are manufactured locally but heavily protected and produced by a parastatal or carry high import duties for revenue reasons. If the market is growing, the producer may not be able to expand because he cannot buy a leasehold on suitable land because there is no real land market. Other obstacles to exporting may be lack of medium-term credit and shortages of technicians and managers with the right mix of skills.

Marketing drives the whole operation. In the cases of Korea, Taiwan, and Hong Kong—the most successful examples of export-led development—marketing was supplied from the outside by American retailers and Japanese trading companies. The South Africans might be able to play the same role in the agricultural sector in Zambia. Once the connection is established then an incentive and a direction is given for decisions at the enterprise and at the government level. Setting up an Export Board, as was done in the past for nontraditional exports, is not an export policy as defined here. It is concerned, essentially, with marketing the existing production of a limited range of products. Like the EC project, it leaves out the most important export of all—copper—and does not establish conditions to motivate producers of other products to enter the market.

An export strategy is really a strategy for development that employs exports as the leading sector. It would have the following elements on the assumption that the exchange rate was competitive and a fair degree of price stability had been achieved.

1. Formulate the rationale and priority of an export policy;
2. Suggest ways in which an "export council" could be inserted into the policy-making machinery;
3. Work on a number of specific obstacles such as
   - The absence of a functioning land market,
   - Parastatals that are impeding input or output markets that can be privatized quickly,
   - A structure of official protection, including the operation of duty-free entry schemes and customs agents, which impedes competitiveness,
   - Export taxes and export prohibitions that inhibit exports, and
   - Costs of maintaining ZCCM as a major exporter in the future.

Export promotion is a fairly complex project that would require coordination with other USAID activities in agriculture and privatization, with the World Bank and the EC, as well as with several Government of Zambia ministries. It might have to be broken down into several sub-projects for administrative reasons. It would be worth the effort. Nothing is more essential to Zambian development than export growth other than its precondition, price stability.

Inadequate Skills

In addition to the issues addressed by the export project, which covers *institutional* changes related to export activity, there arise the issues of export-connected skills—part of the wider problem of a shortage of skilled personnel at all levels. In the first place, no one knows what its dimensions are. There is much anecdotal evidence that seems solidly based but very little study of where the shortages of skills are most acute and how they relate to existing training programs. We have been able to locate only one study, conducted by Alan Hackman for the Canadian Aid Agency, that surveys employers about their needs and their opinion of the value of the technical training institutes in supplying trained personnel (see bibliography, Appendix A).

It is unlikely that other studies exist because no other donor seems to be interested except for a small Japanese vocational project and an Official Development Assistance (ODA) program for professionals. ODA has also tried to support the technical training institutes but believes that with their current organization, it is practically a hopeless task without new leadership, and a major investment in equipment would be needed. ODA believes that a more fruitful approach would be to rebuild training under business auspices and is organizing a seminar for that purpose in mid-February 1993. For the others, the focus in education and training seems mainly on primary school ec ıcation.

There is also the problem of incentives. The earlier policy of flattening the hierarchy of salaries so that skilled and professional workers receive a smaller differential than they would in other economies has led to some emigration. The issue is to determine what role salary policy has played.

The first step in establishing a project would have to be the collection of more information to determine the size of the skilled labor shortage and the best way to tackle it. Even if USAID decided not to undertake a full-fledged activity, it could act to place the issue on the donors' agenda. An obvious partner would be ODA and possibly the World Bank.

Population Control

Finally, most neglected of all but over the long run one of the most critical problems is the high rate of population growth. A rate of increase of 3.5 percent means that the average family has five or six children. Infant mortality is rising, and the percentage of primary school age children actually attending school is falling. In the rural areas there are many single parent families, headed by women who must support their children usually at the cost of any improvement in their farm.

The strain on the economy of this essentially unchecked birthrate can only become worse. Per capita income has been falling since 1975. It compresses the consumption of the poorest and reduces the resources available for investment. It is odd, in these circumstances, why so little has been done in this field. About the only saving grace is that enough land has been available so that the economy's decline has had less effect on food production than in any other area.

The AIDS prevention project, which provides for the distribution of condoms, is a possible opening for some action. But something more is really needed. In the first stage, we need a market test in selected rural and urban areas. A project should pose the principle of planned parenthood and base an educational campaign on it and a distribution of birth control devices. Most of the younger people of Zambia are literate and could be reached by printed literature. If the response is good, then a more extensive campaign could be mounted.

The disadvantage of a population project is that it takes a long time to have an impact. The advantages are that a slowdown in population growth not only releases resources for investment, but also permits a higher rate of consumption among the poorer population, particularly women and children. It is difficult to see how Zambia can effectively improve the welfare of its people by the turn of the century without some progress in this area.

CONCLUSIONS

Given the limited resources at USAID's command in even an expanded program, its comparative advantage would be in influencing the formulation and implementation of policies that fundamentally affect the operations of major commodity and factor markets through a combination of technical assistance and conditioned nonproject aid rather than through balance-of-payments assistance.

At this stage, the achievements of the first year in re-establishing realistic price incentives and the expectation that they will be consolidated in 1993, suggest that the strategic areas for which there is now a chance of success are

1. A project making exporting a major development goal that goes beyond promotion and marketing to facilitating investment and production by clearing away the obstacles that the *ancien regime* has put in their way;
2. Beginning a population control project to curb Zambia's unchecked birthrate, which makes any substantial increase in the standard of living unlikely; and
3. Putting the problem of shortages of skilled personnel as a constraint on development on the donors' agenda through a focused and well-timed study.

Well-designed projects in all three areas could promote and shape, in the next decade, the broad-based economic growth that is the ultimate goal.

Appendix A
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GOVERNMENT OF CANADA

Labor Market Survey and Canadian Development Assistance
Technical Education and Vocational Training Component
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