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Sequencing of Trade and Exchange Reforms: Lessons from Zambia

Zambia's return to multi-party democracy with the change of government in October 1991 led to the adoption of a comprehensive structural adjustment program. This "New Economic Recovery Program" (NERP) was generously supported by the international donor community.

Trade and exchange rate reforms were fundamental to the NERP. Trade reforms involved the elimination of export and import licenses, the removal of state monopolies on trading and distribution, and reform of the tariff system. Exchange rate reforms emphasized the introduction of bureau de change, the lifting of exchange controls, and the liberalization of both current and capital accounts of the balance of payments.

All of these changes were consistent with well-established patterns of trade and exchange rate liberalization. Yet, a growing number of development specialists have argued that in order to succeed trade and exchange rate reforms need to be properly (even "optimally") phased or "sequenced." This policy brief considers that argument in light of Zambia's experience.

From the start, Zambia's adjustment program was heavily influenced by the donor agencies. Because of the economy's difficulties it was essential that the new government gain access to additional financial support. Therefore, in framing the adjustment package, the overriding consideration was a set of measures that would be seen by the international community as credible and sustainable. How the reforms were sequenced within that package was incidental. But this is getting ahead of the story.

The Sequencing of Economic Reforms: Since the early 1980s specialists in trade and finance have made the case that policy reforms need to be "properly" (or "appropriately," "correctly," "optimally") sequenced. The argument is that by arranging reforms in a pre-determined order, governments greatly increase the prospects of having their economies stabilize and return to a sustainable growth path.

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When placed in its proper context, this argument is a sub-theme of the general development problem of how economies achieve *(or return to)* particular growth paths. Indeed, since the beginning of formal study of growth and development, theorists have understood the need for phasing of some sort. They have done this by highlighting specific processes that either boost or accompany growth and development. Well known examples are the division of labor, the expansion of the market, "creative destruction," "leading sectors," and "patterns of growth." Even the theory of the "big push" focused on the need for specific types of investment to jump-start the growth process.

The novel aspect of recent discussions of sequencing has been their focus on optimal (or appropriate or correct) sequences. There have been two considerations. First, in practice, all governments have limited capacity to administer and monitor policy change. Second, since all economies comprise systems of inter-linked markets, institutions, and organizations, successful adjustment requires well-ordered, complementary, changes. Changing one policy at a time in such a setting is ineffective and often counterproductive. An obvious example is when a government floats its currency (as Zambia did in 1985) without curtailing its budget deficit. From these considerations, it is a short step for economists (versed in the Tinbergen/Theil tradition of "optimal economic policy") to argue that the policy reforms should also be optimally sequenced.

Thus, the basic sequencing argument is that there is (or ought to be) a widely applicable, clearly identifiable set of policy and institutional changes which, if implemented in a pre-determined order, will "optimize" the pace and direction of economic reform. While only a limited number of studies provide what their authors see as "correct" or "optimal" sequences, the literature has numerous references to "mistakes" in policy sequencing. Evidently, those "mistakes" have been evaluated relative to policy sequences that are seen as "optimal" or "correct" in some sense.

While the intellectual background to policy sequencing is clear, there are problems applying the approach. A major difficulty is that there is no theoretical basis upon which "optimal" sequences of policy reforms can be formulated. To formulate such sequences, policy makers need to understand the basic structure of the economy *in advance*. Yet, African governments have been promoting policy reform so that the structure of the economy will change. These reforms, whether they succeed or not, modify the structure of the economy in ways that cannot be foreseen in advance. (This is a variation of the so-called "Lucas critique" of policy modeling which makes the point that economic policy is designed to change the underlying structure of the economy. Thus, the parameters of any dynamic model used to derive an optimal sequence of policy reforms would change at every point along the adjustment path. This makes economic reform path-dependent invalidating the view that reforms can be optimally sequenced in advance.)

Without a theoretical foundation, analysts have no formal basis for determining *in advance* whether particular sequences of policy changes are "optimal," or even "right." Comparative analyses may highlight what has worked in specific instances, but they reveal nothing about whether the sequences were "optimal."

A further problem is that the pressure for adjustment (and implicitly the way policies are sequenced) depends crucially on the availability of finance. Economic imbalances can persist only as long as they can be financed. Even when partial financing is available, governments have considerable scope with respect to the timing and types of reforms they implement. The Zambian government, like others across Africa, has often used the arrival of additional finance to delay reforms rather than ensure the changes they adopt are sequenced according to one or other recommended pattern.

A third difficulty is that policy sequencing requires that governments specifically plan, control and direct the policy change. That is, policy sequencing implies that African governments need to formally re-structure how they intervene in economic affairs. To illustrate, a commonly recommended sequence is that governments maintain capital controls while they gradually easing trade restrictions. Based on the damage their governments have caused with such gradualist approaches, few members of the African public are likely to believe that their governments have the capacity to undertake restructuring of this type in a constructive way.

The principal means by which African governments can begin rebuilding their credibility is to disengage broadly and quickly from the economy. This involves the removal of controls on markets and resource allocation, the withdrawal of the State from commercial activity, and the redirection of public resources to areas (infrastructure, education, health, and law and order) that are *public* responsibilities. The crucial element in this process is tangible evidence that government intervention has diminished. Whether the policies were adequately sequenced is of secondary and lower importance.

Zambia's Experience – Lessons Learned: Zambia's experience with economic reform provides a number of lessons about policy sequencing.

Prior to the 1991 elections, policy sequencing was largely irrelevant. The Kaunda government could not sustain policy reform irrespective of how the policies were sequenced. Furthermore, there is no evidence that the lack of sequencing hastened the abandonment of reforms. The problems were more deep-rooted. There was no effective lobby for reform. This led the government to abandon economic reforms even when they were working. For example, the foreign exchange auction introduced in 1985 was successfully allocating the existing supply of foreign exchange. Yet, because the government would not exercise prudence in its fiscal and monetary policies and inflation accelerated the auction was blamed and then abandoned.

Since the 1991 elections, a number of different lessons about policy sequencing have emerged.

First, the initial success of the reforms was not due to any well-articulated or well-ordered pattern of policy change. The reforms worked as a result of measures, particularly the "cash budget," taken as an emergency means of stabilizing the economy. Indeed, the cash budget (an obvious dimension of institutional reform) is itself a challenge to the conventional view of sequencing that stabilization must precede structural reform. Second, policy sequencing was not needed to generate consensus for reform. The economic collapse prior to the elections had created that consensus. The new government's main task was to restructure the economy as rapidly as possible. Third, the new government was composed of people who knew what they did not want. They were less certain about what they did want. It was only after inflation continued to accelerate in 1992 that policy makers began to focus on ways of sharply reducing it.

Fourth, the package of policies that was approved and implemented as part of the 1992 budget could not have represented an "optimal" sequence. Within months the whole budget had begun to unravel and the rate of inflation, instead of declining as the government had anticipated, accelerated.

Fifth, immediate action is needed to promote institutional reform. Zambia's experience shows that institutional and policy reforms require the same (high) priority. Policy reform has been difficult to sustain in Zambia because of the weaknesses in the basic economic institutions. In the process, government credibility has suffered. The performance of all the key entities – the budget office, the Bank of Zambia, and revenue departments – has been sub-standard. Moreover, despite some significant changes, improvements have been exceedingly slow.

Sixth, even if a "correct" sequence of policy changes had been adopted in Zambia, that sequence would have been quickly and substantially modified due to resistance from various interest groups. Several examples stand out. The Bank of Zambia succeeded in delaying the removal of exchange controls. ZIMCO, the state-owned holding company, resisted privatization. Civil service reforms continue to be dragged out. And, although ZCCM, the copper company's financial position was increasingly untenable, the government dithered over selling the enterprise. That action caused billions of dollars of losses further delaying reform.

What these examples show is that policy reform needs to be based on a series of contingent scenarios, *not* a predetermined sequence of policy changes.

Overview: Zambia's experience with policy reform provides no evidence that policy sequencing would have made any substantive difference to the outcomes achieved so far. Nor is there any evidence that policy reform was not sustained because it was not "properly" or "correctly" sequenced. Furthermore, there is no evidence that policy reforms could have been 'optimally' sequenced in any sense. The basic requirement in Zambia, which was not met, was for the government to adopt policy reforms – trade liberalization, the removal of exchange controls, the cash budget – and sustain them. That has not been the case. As a result, reform has languished and economic growth and development have not revived.

This policy brief is based on EAGER Discussion Paper Number 66, *Sustaining Trade and Exchange Rate Reform in Africa: Lessons for Macroeconomic Management*, 2001, by Malcolm F. McPherson [Malcolm_McPherson@harvard.edu], Belfer Center for Science & International Affairs, John F. Kennedy School of Government, Harvard University.

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