# Caleb M Fundanga: Zambia's economic outlook - what have we learnt in the last 40 years and where do we go from here?

Paper presented by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the CI*M*A Zambia annual business discussion on the theme "Zambia's economic outlook - what have we learnt in the last 40 years and where do we go from here?", Lusaka, 7 January 2005.

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- Mr Chairman
- The President of CIMA Zambia, Mr Cleaver Mulundu
- Distinguished Invited Guests
- Ladies and Gentlemen

I wish to thank the President of the Chartered Institute of Management Accountants (CI*M*A) Zambia Chapter, Mr. Mulundu and his Executive for inviting me to present a paper to this distinguished gathering on the theme "**Zambia's Economic Outlook: What Have We Learnt in the Last 40 Years and Where Do We Go from Here.**" The topic is timely, as it is very important to take stock of our past economic development efforts, including the mistakes and good policies of the past and assess the current economic conditions in order to put up a future strategy. In this respect, I will discuss what I consider to be the key lessons of macroeconomic management and present an outlook for the period ahead. In so doing, I will also highlight the challenges that lie ahead in our quest to develop our economy.

**Mr Chairman**

May I start by reviewing our economic performance during the last 40 years. As many of you maybe aware, at independence in 1964, Zambia had one of the most vibrant economies in Sub-Saharan Africa, which was supported by a strong mining industry. The country's external position was in surplus between 1964 and 1974; inflation rates were low, averaging 7.7 percent; and experienced high economic growth rates. In addition, GDP per capita was one of the highest in Sub-Saharan Africa at about US$ 950. Further, unemployment levels were low.

Between 1968 and 1972, Government announced sweeping economic reforms under which 80 percent of industry was nationalised, giving the state greater control over the country's resources, with which it could implement an ambitious industrialisation programme to bring about rapid economic development. In addition, nationalisation was aimed at empowering Zambians economically, which was important following political independence.

However, following the outbreak of the 1973/74 international oil price shock and the world economic recession that ensued, Zambia experienced a significant change in her economic fortunes. For instance, the external position deteriorated; inflation increased; per capita GDP fell; the performance of the mining sector, which accounted for over 80 percent of total export earnings declined; and Government capacity to finance economic and social infrastructure was severely curtailed. As a result of these budgetary difficulties, Government began to run huge fiscal deficits, which were financed, primarily, by borrowing from the domestic banking system and the international financial markets.

Other important events that affected Zambia's economic development in her early stages of nationhood included:

(i) The pronouncement of the Unilateral Declaration of Independence (UDI) by the Ian Smith regime in the then Southern Rhodesia (now Zimbabwe). The declaration of UDI had both positive and negative impacts on the Zambian economy, although the negative effects outweighed the positive gains. The positive gains relate, mainly, to the relocation of industries from Southern Rhodesia (now Zimbabwe) to Zambia to avoid being affected by the sanctions imposed by the International Community, as a result of the declaration of UDI in 1965. This contributed to the growth of the Zambian manufacturing sector and the increase in employment levels.

    However, the declaration of UDI had serious adverse effects on the blossoming Zambian economy. As you may recall, at independence, the economies of Southern Rhodesia (now

Zimbabwe) and our economy were intertwined. Southern Rhodesia was Zambia's biggest trading partner as well as the main supply route to the sea. The severing of trading, commercial and transportation relations with Southern Rhodesia on account of UDI therefore, meant that Zambia had to invest heavily in her own transportation infrastructure, which finally led to the construction of the TAZAMA oil pipeline, Indeni refinery, TAZARA, the Great North Road (which used to be known as the Hell Run), etc., in order to transport her essential imports and exports. These were huge projects whose construction required enormous borrowing from countries like China, Italy, France, etc. and other international financial creditors. This explains, in part, the huge external debt the country is overburdened with today.

(ii) By 1964, most of Zambia's neighbours, such as Mozambique, Zimbabwe, Namibia, and Angola, were at the height of their liberation struggles and Zambia had no option but to offer refuge and logistical support to the liberation movements like, FRELIMO, ZANU, ZAPU, SWAPO, UNITA, and MPLA. This meant that Zambia had to sacrifice some of its scarce developmental resources for the sake of assisting these liberation movements to gain their independence, and in some instances, Zambia had to borrow to finance this expenditure.

(iii) As a result of the liberation wars in the neighbouring countries, Zambia had to arm herself, militarily, against possible foreign aggression by procuring weapons and other military hardware from friendly countries such as Russia, China, etc. This again explains why Zambia today has a huge debt with Russia. Military expenditure was unavoidable as the colonial regimes used to attack Zambia directly. In this regard, one can mention the bombing of Lusaka as well as the destruction of Luangwa bridge.

**Ladies and Gentlemen**

I have endeavoured to include these seemingly simple but critical factors so that we understand the historical context of some of the policies implemented during the last 40 years and their impact on national development.

Therefore, to contain the deteriorating macroeconomic situation, the Government introduced a myriad of economic policies including price controls because the economic shocks were considered transitory and, thus, the Government would easily balance its budget. This never happened!

Hence, during the 1980s, policymakers realised that economic reforms were needed as a lasting solution to Zambia's economic woes. For instance, between 1985 and 1987, Zambia undertook an IMF/World Bank-sponsored adjustment programme. This led to a partial decontrol of interest rates and the introduction of a Dutch Foreign Exchange System as a way of allocating scarce foreign exchange through a quasi-market system. It also entailed the removal of some subsidies as a remedy to the persistent fiscal deficits. The reforms proved to be highly unpopular and culminated in public protests and abandonment of the IMF supported reform programme in May 1987.

Instead, the Government pursued an indigenous programme called 'New Economic Recovery Programme' (NERP) whose theme was "Growth from Own Resources". Although this programme was successful in some respects, it suffered major setbacks, such as the overvaluation of the Kwacha, soaring inflation, lack of external financing, among others, that made the programme unsustainable, thus prompting the Government to go back to the IMF and agreed on a new IMF supported programme in 1989. The main policy measures under the programme included the following:

- Privatisation;
- Decontrol of prices;
- Decontrol of interest rates;
- Abolition of exchange controls and a movement to a market-determined exchange rate regime;
- A shift to the use of indirect instruments of monetary policy;
- Introduction of Government securities auctions;
- Establishment of an inter-bank money market;
- Modernisation of the national payments system;

- Strengthening of the legal framework; and
- Establishment of a stock exchange.

**Ladies and Gentlemen**

After a new Government came to power in 1991, its priorities were to restore economic growth through market-based stabilisation policies and promotion of the private sector as a prime-mover of the economy. Consequently, the economy was liberalised, giving market forces a greater role in the allocation of resources. Prices were decontrolled, while subsidies on all consumer items were removed. In addition, the Government embarked on a privatisation programme, whose objectives were to:

(a) Improve efficiency and service delivery in the economy;

(b) Inject fresh capital and entrepreneurial skills given the ailing nature of the state owned enterprises (SOEs);

(c) Secure, on a sustainable basis, employment in the privatized companies;

(d) Enhance the companies' revenue contribution to the Government budget; and

(e) Overall, increase the private sector's contribution to economic growth and, ultimately, poverty reduction.

In the financial sector, the Government undertook further reforms that included the use of market-based monetary instruments in the conduct of monetary policy. As a result of monetary tightening, inflation fell from 197 percent in December 1992 to about 40 percent in 1995; 18.7 percent in 2001 and 17.5 percent in December 2004.

Similarly, the Government took fiscal reforms in 1993, such as the cash-budget to curtail the monetisation of fiscal deficits. Consequently, since 1993 we have seen the Government take measures to strengthen fiscal performance through limiting domestic borrowing as a ratio of GDP to levels below 5 per cent. This should be commended.

**Ladies and Gentlemen**

Having outlined a brief history of our economic management since 1964, allow me at this juncture to summarise the lessons learnt. From the foregoing, several macroeconomic management lessons can be drawn. These include:

(i) Attaining lower rates of inflation, as in the 1960s and early 1970s, continues to be elusive. However, lower rates of inflation could be attained if the Government maintained fiscal discipline by sticking to the budget and minimising its borrowing from the central bank and the financial sector, as a whole. This would contribute to the achievement of price stability, which in turn would facilitate sustainable economic growth and poverty reduction.

(ii) Lowering of interest rates requires that all key stakeholders play their part. The Government reduction of domestic borrowing contributes to lowering of yield rates on Government securities, which are sometimes used as anchors by commercial banks. The commercial banks should also respond to changing macroeconomic indicators consistent with low interest rates, while borrowers need to improve their credit culture. As for the Bank of Zambia, we continue monitoring financial conditions and take appropriate actions to contribute to lowering of interest rates.

(iii) A relatively stable and competitive exchange rate has a positive impact not only on inflation, but also on the performance of the external sector. In this regard, policies for stabilising the exchange rate must aim at increasing the export earning capacity of the country through stimulation and maintenance of strong export sector by, among other things:

  - Developing a diversified and competitive export base; and
  - Ensuring food self-sufficiency to reduce food imports.

  In addition, continued implementation of appropriate monetary and fiscal policies, particularly the reduction in the fiscal deficits, is critical to maintaining stability in the exchange rate.

(iv) External debt should be contracted to finance the productive sector so as to lessen the burden of debt service. Otherwise, it will result, as we have seen in the last 40 years, in huge outflows at the expense of expenditures on social and economic infrastructure development, which are pre-requisites to sustainable poverty reduction efforts.

(v) The need to diversify the economy, including the external sector, cannot be overemphasised. Diversification is a sure way of preventing external shocks to the economy and will contribute to maintenance of macroeconomic stability. Dependence on one or a few products leaves the economy susceptible to external shocks.

(vi) In the financial sector, the key lesson is that liberalisation of the industry is not tantamount to relaxing of regulatory and supervisory measures. In fact the legal, regulatory, and supervisory frameworks should be strengthened to deal with any excesses arising from entry of institutions with poor management or governance practices due to the attractive liberal environment.

(vii) Legal and operational framework requires continuous reviews to remain relevant in this technologically fast moving world.

**Ladies and Gentlemen**

After learning the lessons from the past 40 years, the following are some of the challenges we have to confront:

- Achievement and maintenance of price stability, i.e. low and stable single digit inflation;
- Maintenance of a stable and competitive exchange rate;
- Diversification of the economy and the export base;
- Enhancing economic policy credibility. Policy reversals tend to undermine gains made in achieving macroeconomic stability; and
- Sustained reduction of fiscal dominance (deficits) to contribute to low inflation, lowering of interest rates and release more funds for lending to the private sector.

Turning to the question of where we go from here, I wish to state that all indications are that the economic outlook for Zambia, in the medium and long-term, is favourable. This is premised on the continued favourable performance of a few sectors, such as agriculture, mining and tourism.

With respect to the agricultural sector, the favourable performance is, largely, on account of the affirmative Government agricultural policy that is supportive of expansion activities in the sector as well as good weather conditions. For instance, the continued improved performance in cash crops such as tobacco, sugar, cotton, groundnuts, floriculture and horticulture, among others, all point to increased economic activity in the medium term. In addition, improved investor confidence in the Government's economic policies has also contributed to increased production in the sector.

In the mining sector, the prospects are buoyant, mainly, due to favourable international metal prices as well as the increase in production due to the recapitalisation of the existing mines. Further, the coming on-stream of greenfield mines, such as Kansanshi and Lumwana, are expected to boost production in this sector. This will further enhance economic activity in the country since growth in the mining industry positively affects several sectors of the economy, such as manufacturing and construction.

With regard to the tourism sector, the potential for growth is immense, as long as Government support to the sector through tax incentives and, most importantly, infrastructural development, such as improvement of access roads and airports, continues. If well nurtured, this sector could be a major employment generating and foreign exchange earner in the country.

Given the above favourable economic outlook, it is anticipated that the annual rate of inflation would be in the single digit region by the end of 2006, mainly, due to the current momentum in policy implementation and developments in the real sector. This in turn will provide an environment for further stability in the exchange rate and lowering of lending interest rates.

In the financial sector, enormous progress has been made towards the development and deepening of the financial markets in Zambia. Additionally, significant achievements have been made in areas, such as monetary policy formulation and implementation, broadening of the money markets, foreign exchange policy management and establishment of the capital market. Improvements have also been made in the formulation of prudential and regulatory regulations to enhance financial system stability and development.

However, the development of a more active secondary financial market to enhance efficiency in the financial system remains a key challenge for all stakeholders in the financial services industry. To address this challenge therefore, the Government approved the Financial Sector Development Plan (FSDP), which, after implementation, will enhance financial intermediation and efficiency of the financial sector.

**Ladies and Gentlemen**

As I conclude, I wish to reiterate that during the past 40 years, several achievements have been made in macroeconomic management in Zambia, but more could have been done had it not been for the reasons I alluded to earlier. However, there have been a lot of challenges and lessons have been learnt from the experiences we have undergone through as a country. These lessons must be turned into a platform to design and implement more effective medium and long-term policies.

It is also important to note that one of the challenges confronting developing countries such as Zambia is the need to reduce inflation and ensure affordable credit through low lending interest rates. In this regard, I wish to appeal to professional bodies, like yours, to come up with options or ideas on how the issue could be tackled within the existing liberal financial environment.

Although significant steps and progress have been made in improving the performance of the foreign exchange market, a number of challenges still remain. The main challenges in this area remain that of maintaining a stable and competitive exchange rate as well as diversification of the export base in order to tap into alternative sources of foreign exchange. Zambia’s continued reliance on the mining sector as a major source of foreign exchange has contributed to volatility in the exchange rate. Hence, there is an urgent need to explore all possibilities of diversifying the export base. To this effect, the different exchange rate regimes implemented since independence have provided us with good lessons upon which we can build our foreign exchange market and contribute to the buoyancy of our external sector.

With respect to the current stability obtaining in the macroeconomic arena, I wish to commend the Government for its commitment to fiscal discipline as shown in its implementation of the 2004 budget. The Government’s adherence to fiscal discipline, has, in part, contributed to macroeconomic stability during 2004. To this end, I wish to challenge the private sector to take advantage of the stable macroeconomic environment to expand their productive capacities. This would enhance the stability in the macroeconomic environment and facilitate higher economic growth and development.

Finally, may I also take this opportunity to remind ourselves of the importance of staying the course. By this I mean, consistency and credibility of policy reform. As you maybe aware, experience the world over has clearly shown that for a country to benefit from policy reforms, it is important that policy remains in place for a long time. This is so because a country has to convince the investor community that it will not change course tomorrow and this takes time to do.

Also remember that good policies alone do not make the economy grow. It is people who make the economy move. Policies help those that are willing to work. Remember that even in very harsh economic policy environments some people prosper!

I thank you!