Beating the Slowdown in Zambia: Reducing Fiscal Vulnerabilities for Economic Recovery

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September 2016

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Acknowledgements

This policy note was authored by Gregory Smith, Fiona Davies and Zivanemoyo Chinzara (World Bank). Peer review comments were provided by Habib Rab and Congyan Tan (World Bank), and Herryman Moono (Economics Association of Zambia). Overall guidance was provided by Sebastien Dessus and Mark Thomas (World Bank). The report was edited by Katarina Zeravica.

A. Introduction

1. Policy makers in commodity-exporting countries have faced increasing challenges in the past two years, in the face of reduced demand from China and uncertain economic recovery in developed economies[1]. Zambia is no exception. Falling copper prices and a power crisis have contributed to an economic slowdown. The effects of the slowdown could arguably have been counteracted in a sustainable manner by utilizing fiscal buffers, but this option was not available, as Zambia did not make savings or provide for stabilization measures when the economy was prospering. Furthermore, options to access external financing are limited, as Zambia's debt levels have soared in recent years following repeat non-concessional borrowing, making it more difficult and expensive to borrow from international debt markets.

2. Zambia recorded impressive economic growth for a decade from 2004, as copper prices soared on the back of global economic growth and increased demand from China. Its economic growth averaged 7.4% between 2004 and 2014, above the average for sub-Saharan Africa of 5.7% (WDI). During the same period Zambia's population grew at close to 3%, moderating the average per capita GDP growth rate to 4.4%.

3. Despite the buoyant economic growth, poverty reduction was limited as the growth was not sufficiently inclusive and its benefits mainly accrued to the richer segments of the population in urban areas. Although in 2015 the economy was more than twice the size it was in 2004, 54.4% of the population was found to be still living in poverty (Government definition), with 77% of the poorest households being in rural areas.[2] The benefits of growth have not been shared equitably, with the top 10% of the population found to have earned 56% of 2015 income.

4. Zambia's economic growth was initially accompanied by a marked improvement in key macroeconomic variables. Relative to the 1980s and 1990s, inflation, the fiscal balance, and the balance of payments[3] all improved. However, since 2013, Government has started accruing sizeable fiscal deficits. Between 2004 and 2011, the overall fiscal deficit excluding grants fell from 7.3% of GDP to 2.4%. However, by 2013 the deficit had risen to 8.7% of GDP. The estimated fiscal deficit for 2015 is 9.6% of GDP. These deficits have been financed in part by three Eurobond issuances totalling US$3 billion (in 2012, 2014 and 2015).

5. In 2015, real GDP growth slowed to an estimated 3.2%, its lowest rate since 1998[4]. This relatively low growth was a result of falling copper prices and below average rainfall which led to a weaker 2014-15 harvest and lower reservoir levels, exacerbating an already growing power crisis characterised by daily power outages. These pressures combined with the fiscal vulnerabilities to reduce investor confidence as the exchange rate depreciated rapidly, inflation spiked at over 20%, and a trade deficit returned after a nine-year absence.

6. Large fiscal deficits and inefficient government spending persist as sources of vulnerability for Zambia, limiting the scope for rapid economic recovery[5]. Year-on-year increases in public expenditure, funded by external borrowing, have increased the cost of maintaining macroeconomic stability and placed the burden on monetary policy and the private sector. The absence of fiscal

buffers has left Government with little room to maneuver in the face of revenue shocks and has limited fiscal space to sustainably compensate for slower growth, rising costs and recent job losses.

7. The broad policy choices facing Government, in light of the economic downturn and rising prices, are to expand spending to compensate for rising consumer costs or to reduce spending to create space for private sector-led growth and investment. Each choice comes with trade-offs; expanded spending increases government indebtedness and places pressure on monetary policy and private sector investment, while reduced spending lowers disposable income in households that have been benefiting from public subsidies. So far, Government has chosen to cushion the impact of rising maize, fuel and electricity prices on consumers by increasing public subsidies, rather than reducing the fiscal deficit to restore private sector confidence and lower the cost of economic recovery.

8. This policy note examines Zambia's fiscal vulnerabilities and the costs associated with its expansionary, subsidy-oriented fiscal policy. It then sets out the benefits of coordinating fiscal policy with monetary policy in a way that is mutually reinforcing and beneficial to private sector investment, instead of having the two pull in opposite directions, as is currently the case. Finally, it makes recommendations to help shift the fiscal position to a more sustainable path and in turn improve market confidence and the prospects for sustainable economic recovery.

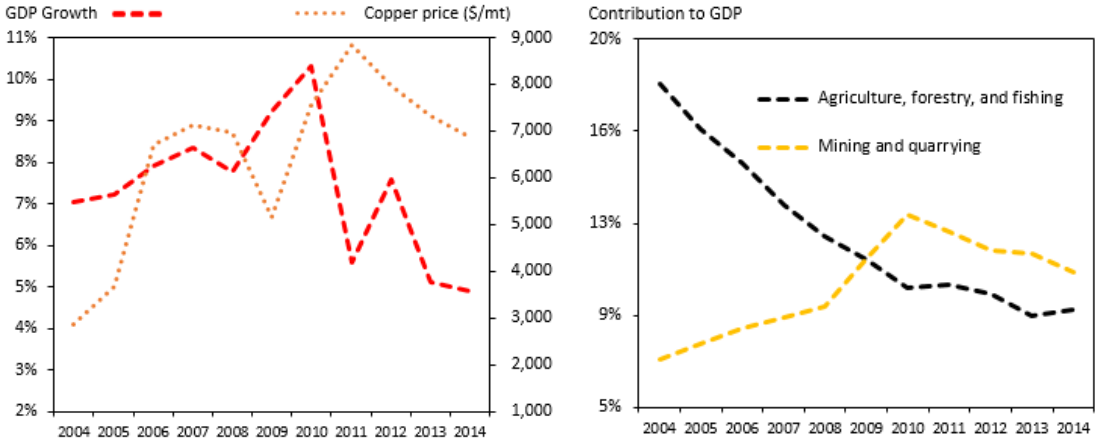
B. 2004- 2014: Buoyant Growth, but Underlying Fiscal Weaknesses

9. Zambia experienced a ten-year period of high real economic growth between 2004 and 2014. Growth averaged 8.3% per annum between 2004 and 2010, supported by a strong performance in the mining sector (real growth in the mining sector averaged 20.9% per annum), on account of rising copper prices and increased output. Growth levels were relatively lower between 2011 and 2014 as the copper price started to fall, but nonetheless still averaged 5.8% per annum (figure 1).

10. Copper prices more than tripled between 2004 and 2011, when they peaked at US$9,642 per metric tonne in the first quarter of 2011 (WDI). Prices started to decline from 2011 onwards, amidst uncertain global economic recovery and lower global demand, but prices (average quarterly) in 2014 were still more than twice the level realised in 2004 (figure 3).

11. Mining output rose consistently throughout the period, with copper exports almost tripling between 2004 and 2014, from 414,104 metric tonnes per annum to 1,146,315 metric tonnes. Mining accounted for 63% of exports over the period[6] and contributed an annual average of 10% of GDP between 2004 and 2014.

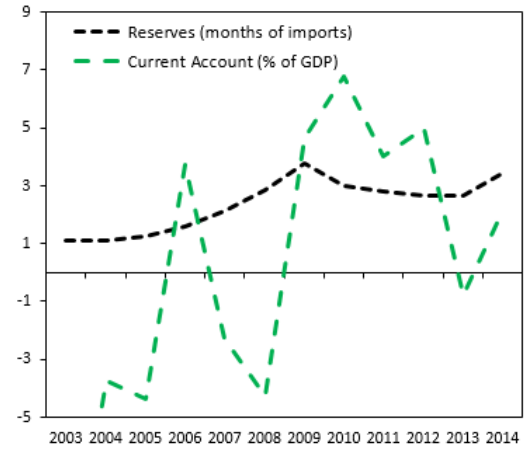
Figure 1 GDP 2004-14



Source: WDI, World Bank Commodity Prices and CSO.

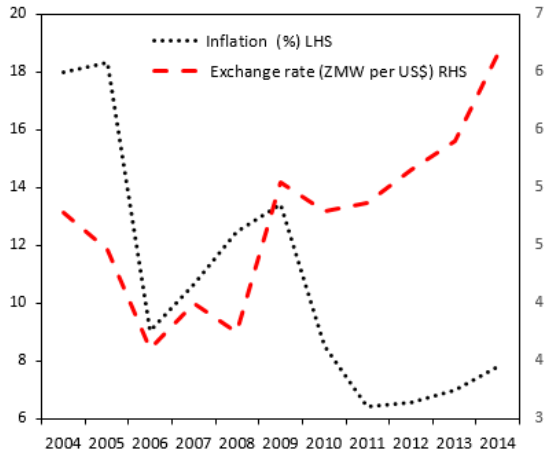
12. Strong export performance in the mining sector contributed to a significant improvement in Zambia's current account balance (figure 2). As a result, from 2009 onwards, the current account was largely in surplus. Strong growth performance also encouraged increased foreign direct investment (FDI). FDI inflows doubled from 6% of GDP in 2004 to 12% in 2014. By 2014, the total stock of FDI amounted to US$16.2 billion, equivalent to 80% of GDP, with the mining sector accounting for two-thirds of all investments.[7]

Figure 2: Current Account Balance and Reserves 2004 – 2014



Source: Bank of Zambia.

Figure 3: Annual Inflation and Exchange Rate 2004 – 2014



Source: Bank of Zambia and CSO.

13. The Bank of Zambia was able to build up its reserve position to 3.4 months of imports in 2014 following receipt of the second Eurobond. Performance of the kwacha (ZMW) against the United States dollar (US$) was relatively stable, with an average rate of depreciation of 3.2% per year, while consumer price inflation was contained to an average of 10.7% per annum across the period, and less than 8% per annum from 2011 onwards (figure 3).

14. High economic growth boosted domestic revenues but did not translate into a sustained improvement of the fiscal position. Domestic revenues grew by 3% of GDP from 15.9% in 2004 to

18.9% in 2014, on account of higher tax revenues and mining royalties. However, a fall in donor grants meant that overall revenues, including grants, contracted from 20.8% of GDP in 2004 to 19.7% in 2014 (figure 4).

15. Initially, as donor grants fell, Government consolidated its fiscal position. Expenditure as a percentage of GDP fell from 23.3% in 2004 to 18.1% in 2010, while the fiscal deficit excluding grants nearly halved from 7.3% of GDP to 3.9%. The bulk of the consolidation was born by investment spending, which shrank from 7.6% of GDP in 2004, to 2.6% in 2010 (figure 4). Recurrent expenditure remained broadly constant, at close to 16.0% of GDP.

16. From 2011 onwards, just as copper prices began to fall, Government started expanding its expenditure. By 2013, it had risen to 25.1% of GDP. Given the relatively slower growth in the total revenue (including grants), the expansion was largely financed through increased non-concessional external and domestic borrowing. By 2014, the deficit had risen to 5.5% of GDP excluding grants, while public debt had increased from 20.6% of GDP in 2011 to 35.2% in 2014.

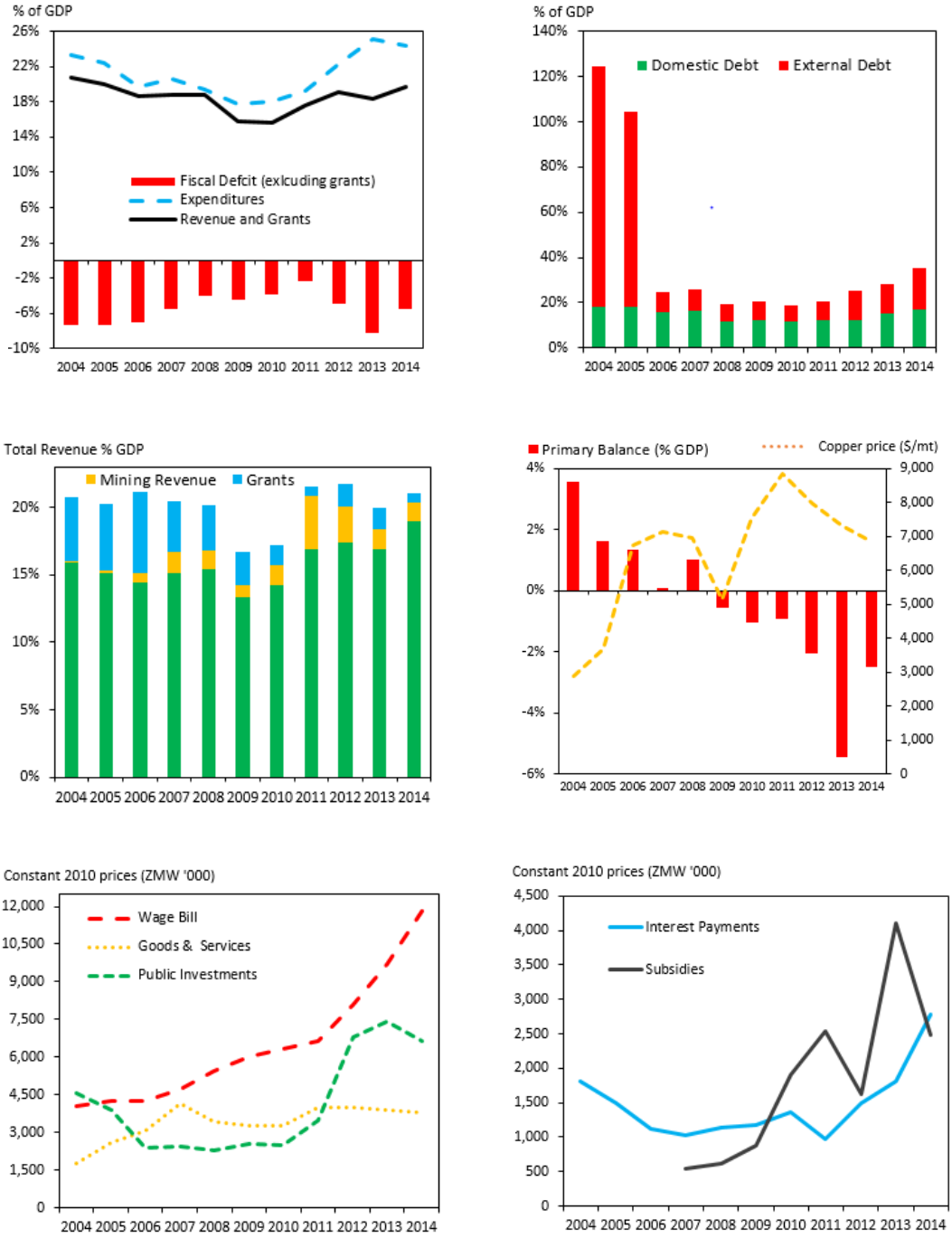
17. The expansion in debt from 2011 onwards was primarily driven by non-concessional external borrowing. Zambia's debt level had fallen from over 120% of GDP in 2005 to an average of 23% between 2006 and 2013, on account of multiple rounds of debt relief, including from the Heavily Indebted Poor Country (HIPC) initiative, for which Zambia attained the Completion Point. However, by 2014, total debt to GDP had risen to 35.2%. Non-concessional external borrowing more than doubled from 8.3% of GDP in 2011 to 17.9% in 2014, as Government issued a Eurobond in 2012 for US$750 million and a second in 2014 for US$1 billion (box 1)[8].

18. Government also increased its borrowing from the domestic market, and the outstanding stock of domestic debt increased from 12.3% of GDP to 17.3% across the same period (figure 4). Government has also borrowed from the Bank of Zambia. In 2013, for example, Zambia did not go to the international markets and the large fiscal deficit was largely financed by a bridging loan from the Bank of Zambia (equivalent to 4.1% of GDP) that was not planned as part of that year's budget[9].

19. The debt-financed fiscal expansion enabled Government to increase its level of public investments, which almost doubled to 5.3% of GDP between 2010 and 2014. It also led to a significant increase in recurrent expenditure, which rose to 24.4% of GDP across the same period (figure 7). The government wage bill rose by 17.1% per year on average in real terms over four years and public investments by 33.2% per year.

20. Even as Government expanded its expenditure, it also accumulated arrears. By the end of 2014, it was reported to have accumulated expenditure arrears equivalent to 3.3% of GDP, mainly owed to the public pension system, road contractors and obligations related to expenditure subsidies[10]. In addition, outstanding VAT refunds against tax payments (largely owed to mining companies) were estimated to amount to 2.9% of GDP.

Figure 4: Fiscal Policy and Debt 2004 to 2014



Source: Ministry of Finance. Note: Deficits excludes 2006 debt relief grants.

Box 1: Tapping International Debt Markets

There have been two important shifts in Zambia's external borrowing policy since the debt relief provided by HIPC and MDRI. First is the increased borrowing from donors such as China, India and Kuwait. Second is access to international debt markets. Between 2012 and 2015, Zambia issued Eurobonds totaling US$3 billion as the global search for yield (push factor) and improved economic growth debt levels (pull factor) connected investors to many African sovereigns for the first time. In Zambia, these changes have driven a rapid increase in external debt since 2012 and also a shift in its composition, including that it has become much less concessional overall.

The first Eurobond (US$ 750 million, repayable in 2022) had a coupon rate of 5.38% and was issued in September 2012. The second (US$ 1,000 million, repayable in 2024) had a coupon rate of 8.50% and was issued in April 2014. The third Eurobond (US$ 1,250 million, repayable in 2025-27) followed only 15 months after the second, but had a coupon rate of 8.97%. The issuance of Eurobonds also requires the payment of fees for lawyers and banks managing the transactions (estimated at US$4.1 million for the third Eurobond), plus the costs of marketing the issue to potential investors.

Zambian Eurobonds are attractive to international investors because they are issued in US$ and the investor is not subject to any risk related to the ZMW-US$ exchange rate. Instead, this risk must be managed by Government. If the kwacha depreciates, the cost to the budget of making coupon payments (paid bi-annually) increases relative to domestic expenditure, crowding out other budget lines and making the eventual cost of repayment higher in domestic currency terms. The rapid depreciation of the kwacha in 2015 highlights this critical foreign exchange risk.

The first two Eurobonds must be repaid in a single year, also raising repayment risks as large dollar payments have to be made in 2022 and 2024. Most sovereigns refinance their debt with the view that they will grow out of it via a larger economy in future. However, this strategy requires growth and that markets will be interested in buying more paper in the repayment year and the years running up to it. Given Zambia's reliance on copper for growth and US$ inflows, Zambia's current sustainable debt management strategy relies on the level of copper prices and the sector's output over the period 2022-26.

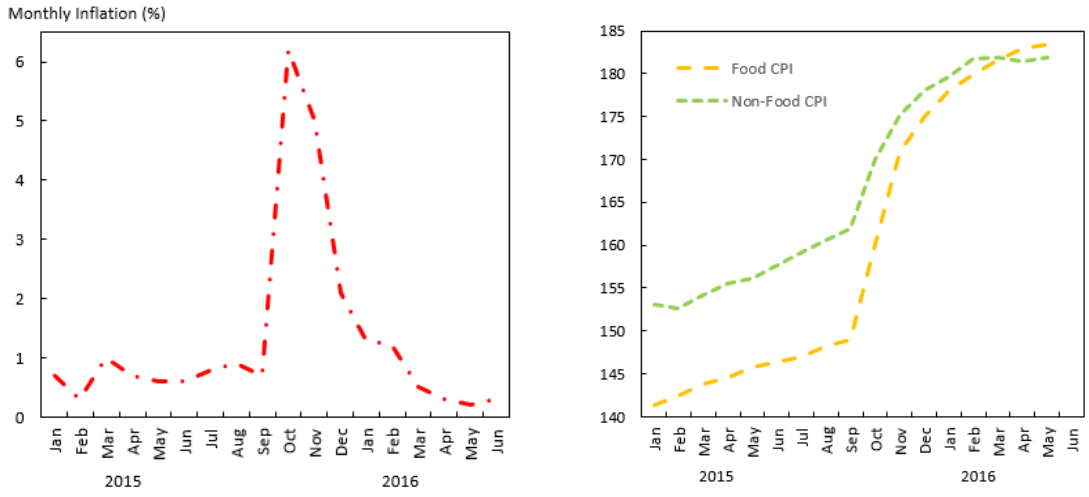
C. The Economic Shocks of 2015

21. In 2015, the Zambian economy experienced three simultaneous shocks to domestic output (poor harvest, power crisis, and sharply falling copper prices) which combined to place significant downward pressure on the exchange rate, upward pressure on domestic prices, and created further fiscal pressures. These effects in turn combined to reduce investor confidence and further weaken the economy. The kwacha lost 41.6% of its value in just 12 months, while domestic prices rose by an average of 10.9% on an annual basis, and ended the year 21.1% higher than in December 2014 (figure 5).

Shock 1: Poor 2014-15 harvest.

22. Lower than average rainfall across the 2014-15 (October to March) agricultural season led to reduced agricultural output in 2015 relative to 2014, which in turn increased domestic food prices. Agricultural output fell by 8% in real terms in 2015, while food prices, which account for 54% of the consumer price index basket, rose by 11.2% in 2015 (figure 5, box 2).

Figure 5: Inflation 2015 and 2016



Source: CSO.

Box 2: The Price of Food

Food inflation has been the key driver of the sharp increase in overall inflation since October 2015. Before then, average food prices had been below non-food prices from January 2013 to September 2015. This is despite a 4.0% contraction of the agriculture sector in 2013. However, in October 2015, food inflation doubled to 16.2% from 8.1% in September 2015, and further to 25.0% in December 2015. Food inflation has continued to rise and has averaged 26.2% during the first five months of 2016.

There are multiple factors impacting on prices. First are the weather conditions which impact crop production and the supply of food, especially maize meal (the staple food). Second, and applicable to maize, are prices controls (the Food Reserve Agency buys, stocks and sells maize to selected millers). Third are the prices of food in other countries (for example if prices are higher across the border then exports will likely increase). Fourth, many food products are imported and the exchange rate influences their price. Further, many major food retail outlets' costs have increased and been passed on to the consumer. Costs have increased due to the use of generators during the power crisis and often firms' rent is indexed to the US$, which has therefore increased as the kwacha has lost value.

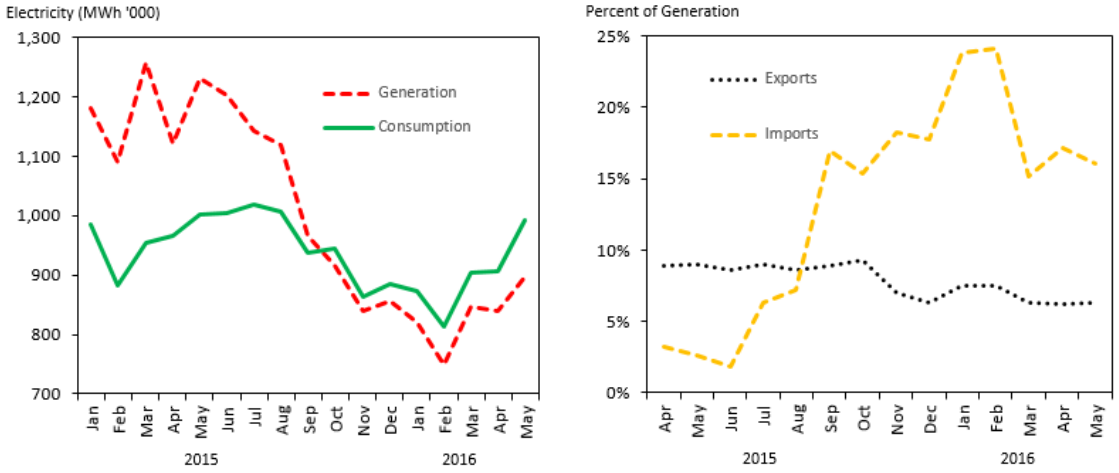
There have also been large shifts in the prices of particular food items and goods. The CSO reports that between April 2015 and April 2016, national average prices for the following goods has increased by over 30%: Roller mealie meal (30%); maize grain (35%); tomatoes (114%); onions (38%); dried beans (30%); sugar (35%); table salt (37%); and hammer mill charges (45%).[11]

Source: World Bank (2016) 'Beating the Slowdown: Making Every Kwacha Count, 7th Economic Brief, June 2016, Lusaka.

Shock 2: Power shortages.

23. Almost all (95%) of Zambia's installed generation capacity comes from hydropower[12]. As a result, electricity supply is highly dependent on the water levels in the main reservoirs. In recent years, generation capacity has become insufficient to meet consumer demand (figure 6). The low rainfall in 2015 exacerbated the existing power deficit by contributing to lower water levels in the reservoirs. This in turn meant that the majority of consumers experienced extensive power shortages in 2015 (at least 8 hours per day on a rotational basis), which in turn increased the cost of doing business and dampened growth. A recent study suggests that in 2015, the losses to the agriculture sector arising from the power shortages amounted to 1.6% of GDP[13].

Figure 6: Power

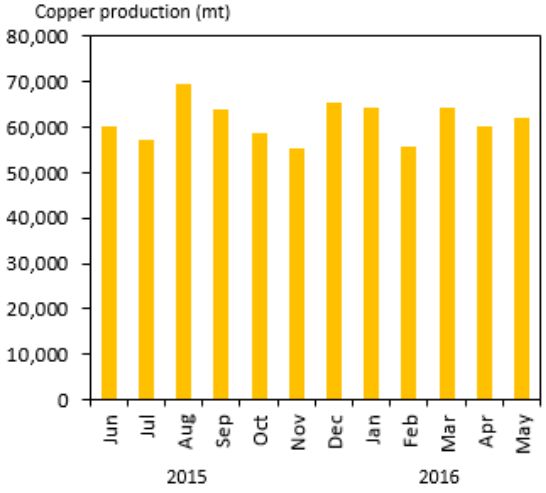


Source: Ministry of Finance.

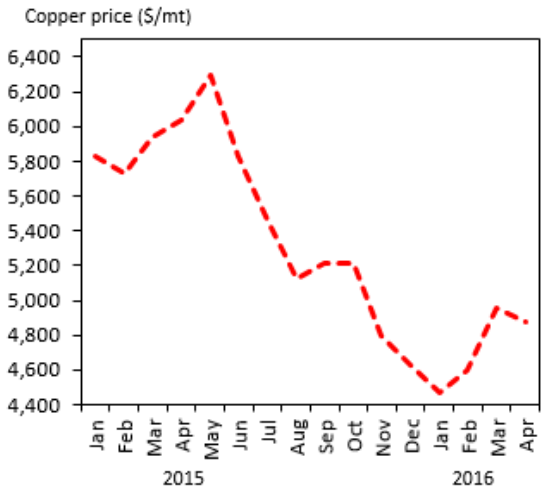
Shock 3: Copper mining downturn.

24. Copper prices fell sharply in 2015, losing almost 30% of their value over the course of the year, in line with slower growth in China and a decline in global commodity prices (figure 7). Zambia's copper production was also affected by uncertainty over the mining tax and royalty regime, and the power shortages, leading to mine closures (7,700 jobs lost) and delayed investments[14]. Overall, the value of copper exports fell by US$2.4 billion or 31% in 2015, contributing to a current account deficit of 3.5% of GDP. Given that copper accounts for over two-thirds of Zambia's exports, this decline created significant depreciation pressures on the kwacha.

Figure 7: Copper Mining



Source: Ministry of Finance.

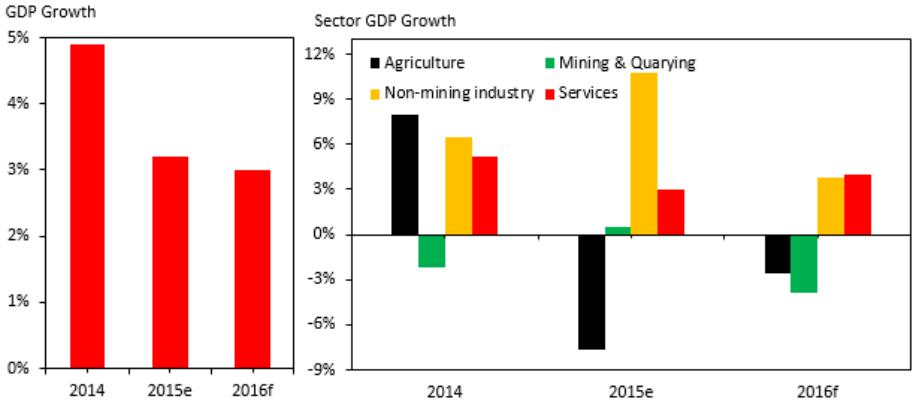


Source: World Bank Commodity Prices.

25. These shocks contributed to real GDP growth slowing to an estimated 3.2% in 2015, meaning that it only grew marginally on a per capita basis, as agricultural production fell and mining output was stagnant. The decline in agricultural output and stagnation in mining was partially compensated for by growth in services and a large increase in the construction sector driven by a 30% increase in

public investments. However, due to their relatively small size in the economy as a whole, growth in these sectors was insufficient to offset the shocks to agriculture and mining in full (figure 8).

Figure 8: Real GDP Growth 2014 – 2016



Source: Ministry of Finance and World Bank. Note: e = estimate; f = World Bank forecast.

D. The Macro-Fiscal Impact of the Shocks

Exchange rate and inflation

26. The kwacha lost a third of its value against the dollar in the first half of 2015 (January to June), as the decline in copper prices combined with a general strengthening of the dollar against emerging market exchange rates to weaken the domestic currency (figure 9, box 3). Foreign interest in emerging market investments waned as investors moved back from a 'search for yield' towards the US economy and safer asset classes. For Zambia, this was evidenced by increasing spreads on its Eurobonds and reduced foreign holdings of domestic securities, along with kwacha depreciation.

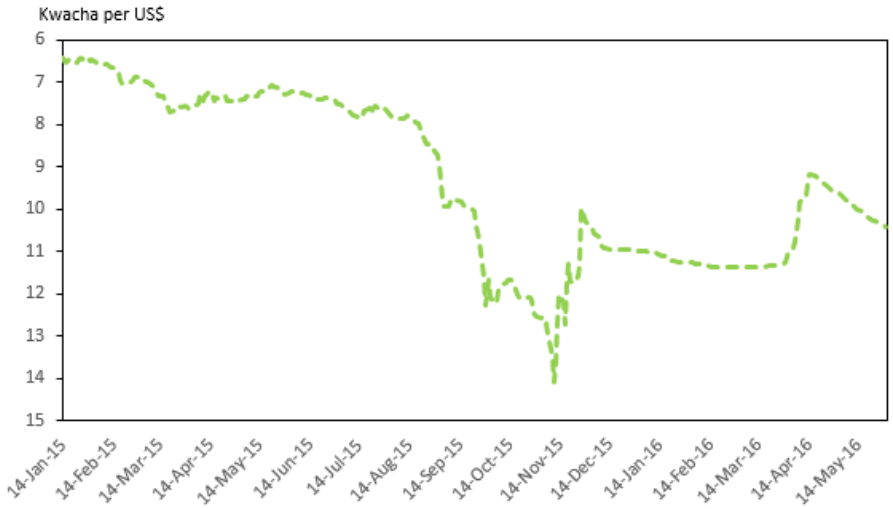
27. Pressure on the kwacha accelerated in the third quarter (July to September), as the currency lost a further third of its value against the dollar in just three months, bringing the cumulative loss of value of the currency by end September to 47% since the start of the year. The second half of 2015 was characterized by extreme exchange rate volatility[15]. Panic was evident in the foreign-exchange market with single-day depreciations on a few occasions exceeding 5%.

28. The pressure and volatility continued into the fourth quarter. By November 10, 2015, the exchange rate reached ZMW 14.1 per US$, representing a 54% loss in value since the start of the year. However, by the end of the month it had recovered to ZMW 10.3 per US$, an appreciation of 27% in 19 days, following an aggressive tightening of monetary policy by the Bank of Zambia. Furthermore, the Bank of Zambia had adjusted the rules governing foreign exchange trading to dampen market speculation and volatility, increased interest rates, and intervened repeatedly to supply foreign exchange to the market.

29. Between December 2015 and end-March 2016, the exchange rate was more stable, fluctuating between ZMW 10.3 and ZMW 11.4 per US$. The kwacha then appreciated by 18% between end-March and mid-April 2016, as the demand for the US$ eased as firms made their annual tax payments. By mid-April 2016, this trend reversed and the kwacha began to depreciate

against the US$ again and reached ZMW 10.4 per US$ at the end of May 2016. An overall depreciation of 62% was recorded between the start of 2015 and end-May 2016.

Figure 9: Exchange Rate 2015-16



Source: Bank of Zambia.

30. The rapid depreciation of the kwacha in the third quarter of 2015 fed through into higher inflation in the fourth quarter, as the cost of imported goods increased. Between January and September, month-on-month inflation averaged 0.7% per month, while annual inflation averaged 7.3%. In October, prices jumped up by 6.2% in a month, and then increased by a further 5% in November. By the end of November, annual inflation stood at 19.5%. Price increases for food items were more acute, given the additional impact of the poor rains earlier in the year, and so annual food price inflation stood at 23.4% (figure 5).

31. As the currency stabilised mid-way through the fourth quarter, price pressures also eased somewhat. The monthly inflation rate fell to 2% in December. Overall, by the end of the 2015, prices were 21.1% higher than the previous year.

32. In 2016, monthly inflation continued to decline, and by March it had fallen below 1%. It then stayed below this level for the remainder of the first half of the year. However, annual inflation remained in double digits until August 2016, as the effects of the price increases in the fourth quarter of 2015 continued to impact on the base.

Box 3: Factors Affecting the Kwacha

There are six important factors to understand when making an assessment of the behavior of the kwacha.

i. The first is global and concerns global copper prices. As copper prices fall, the kwacha typically depreciates and as copper prices rise, it typically appreciates.
ii. The second is also global and reflects the relative strength of the US$ against other currencies. The US$ has strengthened against other currencies since early 2014, following the expectation that the Federal Reserve would increase interest rates (a move they made in December 2015).
iii. The third is a domestic factor and concerns Zambia's foreign exchange markets being 'thin' (i.e. there are often times of low demand), and so relatively small purchases of foreign currency can move the exchange rate considerably.
iv. The fourth factor relates to government regulation and control of the market via the central bank. The Bank of Zambia intervenes in the market and also closely monitors the trading of foreign currency. The market can also move when the government makes large payments (for example when capital project payments are due).
v. Lastly, seasonal factors can impact on the rate. A good example is when monthly and annual tax payments are due: firms will need to move from US$ positions to kwacha in order to meet their tax obligations.

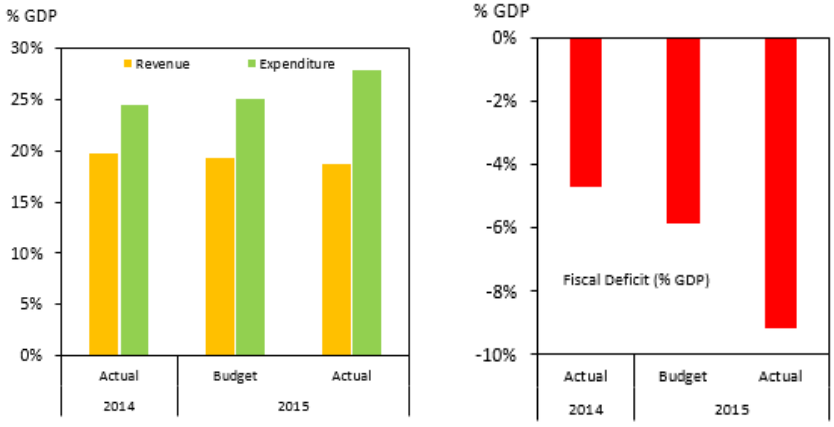
Furthermore, it is also important to note that a weak kwacha does not necessarily mean a weak economy and vice-versa. For example, an appreciating kwacha makes Zambian exports more expensive and imports relatively cheaper. Since many inputs for producing domestic goods are imported, when the currency depreciates production costs rise for many firms. What is important however is the stability of the exchange rate which helps with making sound investment and business decisions.

Source: World Bank (2016) 'Beating the Slowdown: Making Every Kwacha Count, 7th Economic Brief, June 2016, Lusaka.

Further fiscal pressure

33. The economic shocks experienced in 2015 combined to weaken public finances by lowering revenues and increasing expenditures (figure 10, table 1). Actual revenue collections amounted to 18.5% of GDP, compared to a budget estimate of 18.9%. In absolute terms, the shortfall amounted to ZMW 1.05 billion. Key drivers for the shortfall in revenues included lower than anticipated mineral royalties from copper production, and lower than anticipated import duties, as the depreciation of the kwacha lowered import demand.

Figure 10: Budget Performance



Source: Ministry of Finance.

Table 1: Fiscal Summary (% GDP)

	2014	2015		
	Actual	Budget	Actual	% point Deviation
Revenue and Grants	19.7%	19.6%	18.7%	-0.9%
Domestic Revenue	18.9%	18.9%	18.5%	-0.4%
Grants	0.8%	0.7%	0.2%	-0.5%
Expenditure	24.4%	24.2%	28.1%	3.9%
OW Wages and salaries	9.5%	9.0%	8.8%	-0.2%
Goods and services	3.0%	3.4%	2.8%	-0.6%
Interest payments	2.2%	1.9%	2.8%	1.0%
Social benefits	0.4%	0.5%	0.5%	-0.1%
Subsidies	2.0%	1.3%	3.9%	2.6%
Public investment	5.3%	5.7%	7.0%	1.2%
Fiscal Deficit	-4.7%	-4.6%	-9.4%	-4.8%
Financing	5.9%	5.1%	10.0%	4.9%
Domestic Financing	0.7%	2.2%	1.8%	-0.4%
External Financing	5.2%	3.0%	8.2%	5.3%

Source: Ministry of Finance. Note: 'budget' excludes any supplementary.

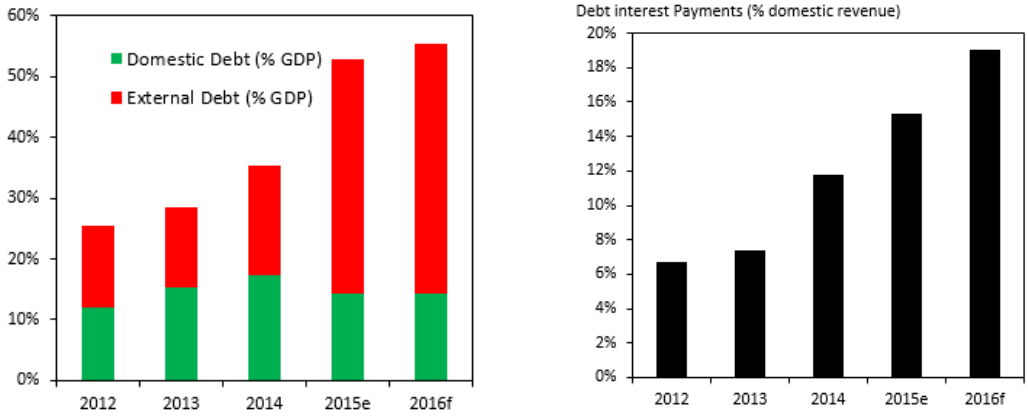
34. Expenditures amounted to 28.1% of GDP, compared to a budget estimate of 25.2%. In absolute terms, the increase amounted to ZMW 5.02 billion. Exchange rate depreciation was a key driver of expenditure increases, as it increased the cost of dollar-denominated expenditures and the interest cost of external debt in the local currency. The main areas in which expenditure increased in 2015 (with the amount by which it increased indicated in brackets) were:

- ***Fuel subsidies (ZMW 2.6 billion, not budgeted for);*** the depreciation of the exchange rate increased the cost of Government's fuel purchases, yet the domestic pump prices at which fuel (mainly petrol and diesel) sold to the consumer remained unchanged, thus creating a subsidy cost to Government.
- ***Emergency power (ZMW 0.4 billion, not budgeted for);*** Government tried to ease the power shortages by purchasing expensive diesel-generated power which was sold to consumers at a subsidised rate.
- ***Interest costs on debt (ZMW 1.9 billion, 52% above budget);*** interest costs on debts denominated in foreign exchange rose as the kwacha depreciated, while interest costs on domestic debts rose on account of increased interest rates as the Bank of Zambia tried to contain rising prices.
- ***Farm inputs and grain purchase subsidies (ZMW 4.0 billion, partly budget for);*** the cost of Government's purchase of farm inputs rose as the exchange rate depreciated, while the cost of the subsidies it provided to grain farmers to enable them to sell their grain at a below-market rate rose in line with rising prices.

35. Lower revenues and increased expenditures meant that the 2015 fiscal deficit increased to 9.4% of GDP as compared to the budget target of 4.6%[16]. The increased deficit was financed by proceeds from a third Eurobond (US$ 1.25 billion) issued in July 2015, a net issuance of domestic securities amounting to ZMW1.9 billion over the course of the year and ZMW 0.6billion in bridge financing from the Bank of Zambia. Even then, Government continued to accumulate arrears, estimated at 2.1% of GDP at the end of 2015.

36. The legislation specifies nominal ceilings for external and domestic debt, so to permit the unbudgeted issuance of the 2015 Eurobond, Government asked Parliament in June 2015 to approve the raising of the external debt ceiling from ZMW 20 billion to ZMW 35 billion[17]. This increase was equivalent to 19% of 2015 GDP. The Eurobond issuance coupled with the exchange rate depreciation led to the debt to GDP ratio reaching 53.4% in 2015, up from 20.6% of GDP in 2011 and 35.2% in 2014. This rapid growth in indebtedness has raised concerns about debt sustainability especially as the portfolio has become much less concessional and more exposed to foreign exchange risk. Furthermore, interest payments are expected to use up over 18% of domestic revenues in 2016, crowding out other expenditure commitments (figure 11).

Figure 11: Debt and Interest Payments



Source: Ministry of Finance.

37. Government data for 2016 indicates that the fiscal pressures experienced in 2015 are persisting[18]. Revenue performance has not improved, as economic activity remains subdued and mining royalties remain low, while the cost of subsidies and interest payments continue to drive up the fiscal deficit. Subsidies on fuel, power, grain and farm inputs are estimated at over US$1.1 billion in 2016 (more than twice the budget level), unless Government takes action to increase the cost to the consumer. New sources of external financing are limited and demand for domestic securities is subdued, reflecting tight market conditions for domestic commercial banks and reduced interest from foreign investors. Government is therefore highly constrained in its ability to maintain current subsidy levels while catering for debt repayment obligations, and there has been pressure on the Bank of Zambia to provide bridging loans for Government to finance its commitments.

E. Managing the Impact of the Shocks

38. The Bank of Zambia took repeated action to reduce inflation and stabilise the currency, particularly in the second half of 2015 as pressures increased. These actions focused on tightening domestic liquidity (making it harder for Commercial Banks to lend and more expensive for the private sector to borrow) and improving the supply of dollars in the domestic financial market. By reducing the potential for credit growth and limiting further deterioration in the domestic currency, these actions sought to dampen future price increases.

39. Measures implemented by the Bank of Zambia to tighten monetary conditions included:

i. ***Increasing the reserve requirements of Commercial Banks*** from 14% to 18% (up from 8% in February 2014); this served to reduce the amount of funds available to them for lending, dampening credit growth which could otherwise feed into inflation).

ii. ***Raising the policy interest rate*** from 12.5% to 15.5%, and removing caps on Commercial Bank lending rates; this served to increase the cost of borrowing, in turn reducing the momentum for credit growth.

iii. ***Intervening in the foreign exchange market to support the kwacha*** by selling US$615 million of reserves in the last four months of 2015 and narrowing spread margins; this served to reduce the pace of exchange rate depreciation, while tightening domestic liquidity[19].

iv. ***Selling domestic securities;*** this served to reduce the funds available to Commercial Banks for private sector lending.

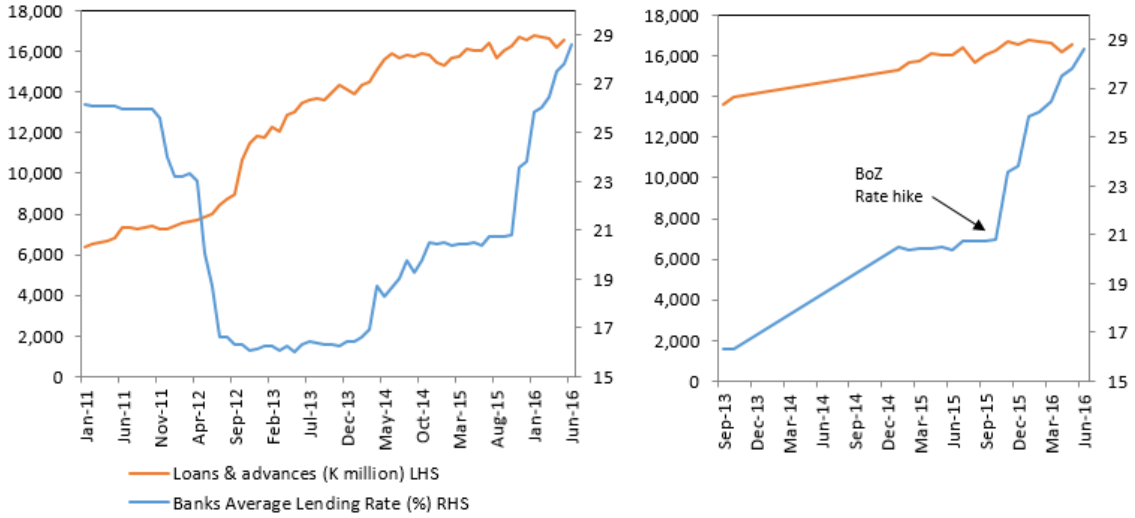
v. ***Raising the cost and restricting Commercial Bank access to overnight lending;*** this also acted as a break on exchange rate speculation and credit growth as large firms became less able to get overdrafts to react to shifts in the exchange rate, and also meant that Commercial Banks needed to be more conservative so they could cover their positions.

40. The Bank of Zambia's actions helped stabilise the kwacha and dampen the domestic price momentum. The kwacha regained value against the dollar from its lows of November 2015, as noted above, but has remained somewhat volatile in 2016, reflecting continuing market uncertainty about the economic recovery and very thin markets characterised by a limited number and volume of inter-bank foreign exchange transactions.

41. However, by making it more difficult and more expensive for the private sector to access credit, the Bank of Zambia's stabilisation actions come at a cost to future economic recovery. In particular, tighter liquidity conditions have caused commercial bank lending rates to rise significantly, with the average rate reaching 28.9% in June 2016[20] (figure 12). Such high lending rates are unaffordable for many businesses, and although bank capitalization levels are high, the percentage of non-performing loans has risen from 5.5% in 2014 to just under 9% in June 2016. Kwacha-denominated credit to the private sector only grew by 8.4% in 2015, reflecting both the tightening liquidity conditions and increasing cost of borrowing, and did not increase at all in the first five months of 2016. Total credit including foreign exchange loans actually fell by 1% across the same period. Real growth in the non-mining sectors of the economy is only forecast to be 3.5% in 2016[21]. Overall, economic growth in 2016 is forecast at 2.9%, which is slightly below the estimated 2015

level of 3.2%. Further, the Bank of Zambia in implementing these measures departing from its operational framework, making its actions harder to predict in the future.

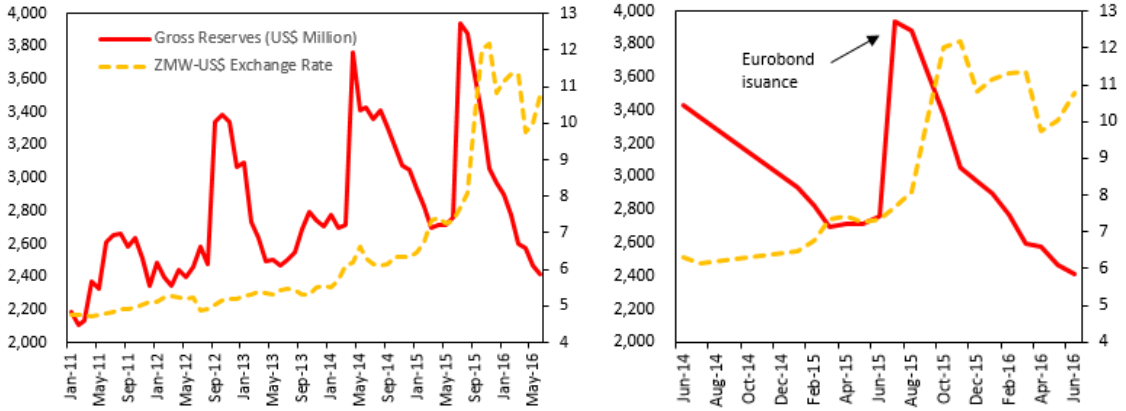
Figure 12: Commercial Banks Lending and Rates



Source: Bank of Zambia.

42. The challenge the Bank of Zambia has faced is that Government did not reduce spending in light of the 2015 shocks. Instead, as noted in the previous section, spending increased, as Government sought to offset power shortfalls and maintain subsidised prices for fuel, grain and farm inputs. Since emergency power and fuel is imported, Government's demand for foreign exchange also increased considerably, placing additional pressure on the kwacha and Bank of Zambia reserves (figure 13).

Figure 14: Reserves



Source: Bank of Zambia.

43. Bank of Zambia data indicates that Government purchases of foreign exchange for purposes other than debt servicing amounted to US$ 355 million in the second half of 2015, as compared to US$10 million in the second half of 2014. In the absence of spending restraint in the public sector, the Bank of Zambia had no option but to place the burden of price and exchange rate stabilisation on the private sector, by making access to credit more expensive and reducing its overall availability.

In effect, publically-financed consumption subsidies were prioritised at the expense of private sector growth.

F. The Value of Co-ordinating Fiscal and Monetary Policy

44. Zambia was not well positioned to manage the economic impact of the 2015 shocks, in spite of ten years of strong growth. Greater Government investment in economic diversification during the growth years would arguably have strengthened the broader economy's ability to withstand a downturn in the mining sector, thus potentially limiting the subsequent shock to the balance of payments and the exchange rate. Timely investments in economic infrastructure, particularly power production capacity, would have helped avoid power shortages, limiting the subsequent costs to Government of emergency power and the adverse impact on private sector productivity.

45. Government increased indebtedness and expanded consumption spending, rather than using the growth years to build fiscal resilience, particularly from 2011 onwards. Consumption expenditures, financed by non-concessional borrowing, increased almost as rapidly as investment. Efforts to increase revenues from the mining sector only occurred once commodity prices had started falling. Thus when revenues were adversely impacted by the 2015 shocks, and the cost of expenditures and debt servicing denominated in foreign exchange rose, Government had no fiscal reserves or stabilisation funds to draw on to compensate for the lost revenue or to finance the increased costs. Instead, it was faced with the choice of cutting spending or increasing borrowing.

46. Government did not cut spending to maintain its fiscal balance in the face of revenue and exchange rate shocks in 2015. Instead, it allowed spending and debt to rise further as it absorbed the increasing cost of fuel, maize and power subsidies. By maintaining high spending, the Government provided some kind of cushion to the downturn, but in a poorly targeted way. At the same time, its loose fiscal policy served to exacerbate the impact of the economic shocks on the private sector, as higher Government spending added to domestic price, interest rate and currency pressures.

47. Fiscal restraint on the part of Government, through reduced public subsidies (box 4), would have contributed to a one-off increase in prices for specific consumers. In particular, fuel and electricity consumers, farmers accessing Government-supported inputs, and consumers accessing maize at below-market prices would all have felt the effects through increased business costs and/or lower disposable income. The outcry that resulted from Government's attempt to increase the cost of electricity in December 2015 demonstrates that unwinding subsidies can be a politically challenging undertaking.

Box 4: Subsidies

Fuel: Zambia shifted from having some of the highest fuel prices in Africa (and globally) in the mid-2000s to lower prices in 2008, supported by direct government subsidies and reduced taxation. Following vibrant consultation and debate in 2012, the fuel subsidy was removed in April 2013. However, as no adjustments were made to fuel pump prices despite the rapid depreciation of the kwacha in 2015, the fuel subsidies returned. Between September 2015 and March 2016, the fuel subsidy is estimated at US$ 36 million per month. While higher fuel prices do feed into higher transport costs for the poor, the largest beneficiary of this subsidy are higher income and vehicle-owning households[22].

Electricity: Insufficient investment in electricity generation and a lack of diversified sources of electricity production have

led to an electricity deficit. A growing shortfall in supply was exacerbated in 2015 by a reduction in hydroelectric generation due to low water levels at the country's main reservoirs. Government increased the extent of rolling black-outs (load-shedding) to at least 8 hours per day on a rotational basis for the majority of its household, and commercial and industrial consumers. And although they are not subject to rotational load-shedding, ZESCO requested the mining industry to curtail its load by 30%. To keep the supply at this reduced the level, Government increased the importation of power from GW(h) 2.6 in March 2015 to GW(h) 157 in December 2015, and to a peak of GW(h) 207 in January 2016 at great expense to the Treasury. The price of imported power ranged from USc 6.5KWh (from Mozambique) to USc 16.5-18.8 Kwh from emergency power producers (Aggreko and Karpower), leaving the Ministry of Finance with an unbudgeted bill for an estimated US$235 million in 2016.[23]

Food/ Agriculture: The Farmers Input Support Program (FISP) and Food Reserve Agency (FRA) are Zambia's two main agriculture subsidies. FISP was launched during the 2002/2003 season to provide maize seed and fertilizer to small scale maize farmers. The FRA was created by the Food Reserve Act of 1995, Cap 225 of the Laws of Zambia. The common goals of both are to improve food security, farmers' incomes, and the participation of the private sector in agriculture, both at inputs supply and output marketing levels. Between 2008 and 2015, Government spending on FISP was on average 91% above what was budgeted for per annum, while FRA was 158%. The issue with agriculture subsidies is not that they exists (agriculture subsidies can be an important poverty reduction tool), but is linked to the poor fiscal planning associated with them, and that in their current form, they are insufficiently targeted to the poor and can undermine incentives for producers of maize.

48. However, fiscal restraint would have eased macroeconomic management of the 2015 shocks, by reducing pressure on the kwacha, lowering broader inflationary tendencies, and increasing the scope for more affordable private sector credit.

49. The first round effects of fiscal restraint would have been:

i. ***Lower Government demand for foreign exchange;*** if Government had instigated more cost-reflective pricing for fuel, emergency power and farm inputs, the requirement for foreign exchange to pay for subsidised imports would have been lower. Total Government purchases of foreign exchange for purposes other than debt servicing amounted to US$423 million in 2015, as compared to US$14 million 2014.

ii. ***Lower fiscal restraint would have helped Government injections of money into the domestic market;*** if Government had cut domestic spending in line with the fall in revenues, the increase in domestic liquidity (i.e. money creation) arising from its fiscal operations would have been lower. Government liquidity injections in 2015 amounted to ZMW 11 billion, almost twice the level of 2014, where they amounted to ZMW 6.8 billion.[24]

iii. ***Less need for costly external borrowing;*** as Government's deficit would have been smaller. Government's outturn budget deficit in 2015 amounted to ZMW18 billion, as compared to a programmed deficit of ZMW 9.5 billion. If Government had cut spending during 2015 to remain within its programmed budget deficit, it would have not needed to make a third Eurobond issuance.

50. Fiscal restraint could in turn have been expected to lead to:

i. ***Reduced pressure on the kwacha,*** with lower exchange rate pass through effects to inflation and less requirement for Bank of Zambia to sell foreign exchange to stabilise the currency.

ii. ***Less need for Bank of Zambia to issue domestic securities and raise interest rates in order to tighten domestic liquidity conditions,*** with positive knock-on effects for the availability of private sector credit at more affordable rates.

iii. ***Reduced fiscal cost of debt service,*** as Government would have been paying lower interest rates on a lower volume of debt, and, for debts denominated in foreign exchange, at a less depreciated exchange rate.

iv. ***A better Bank of Zambia reserve position,*** as Government demand for foreign exchange would have been lower, as would Bank of Zambia's need to sell foreign exchange to the market to ease pressure on the kwacha.

v. ***Lower risk of future sovereign debt distress,*** as Government would not have increased its indebtedness to finance additional spending, while, for debts denominated in foreign exchange, there would be a greater potential for Bank of Zambia reserves to service future repayments at a less depreciated exchange rate.

51. The overall outcome of a better co-ordinated fiscal and monetary policy could be expected to be a more stable and conducive environment for private investment, with less pressure on prices, lower borrowing costs and greater access to credit. A recent investor perceptions survey revealed that many enterprises consider current Government fiscal policy to have a negative effect on their operations, with the size of the Government budget deficit being cited as the single most negative factor. In addition, high levels of inflation, high lending rates and exchange rate depreciation were all cited as reducing market confidence in investing in Zambia.

52. Better co-ordination between fiscal and monetary policy could also be expected to have a short-run positive effect on the current account balance, helping offset some of the immediate impacts of falling copper output and copper prices on the economy by dampening exchange rate pressures. Recent cross-country evidence for sub-Saharan Africa confirms that fiscal deficits are associated with a deterioration in the current account balance[25]. However, in the long-run, the key to achieving a trade surplus lies in promoting non-traditional exports and supporting a business environment where more intermediate goods are produced in Zambia, rather than relying on imports.

G. Ideas to Boost Economic Recovery and Improve Market Confidence

53. Zambia currently faces an unsustainable fiscal outlook. The economy has been badly affected by the triple shocks of 2015 (copper downturn, poor harvest, power shortages). The shocks have in turn reduced Government revenues. At the same time, public spending has risen as Government has sought to subsidise rising fuel, power and maize prices and the cost of servicing debt has increased. The fiscal deficit is now at historically high levels, and accessing financing to maintain this deficit is becoming increasingly difficult and costly. Zambia faces a real and rising risk of debt distress in the coming decade, particularly if it has to rely on non-concessional and commercial debt to plug budget deficits stretched by growing recurrent expenditure.

54. The burden of macroeconomic stabilisation has fallen on the private sector. Rising Government spending has exacerbated the price and exchange rate pressures associated with the 2015 economic shocks. The monetary policy actions taken to reduce inflation and stabilise the plummeting exchange rate have been effective, but are not conducive to a growth-led recovery. The cost of borrowing has increased, while the availability of private sector credit has shrunk. The proportion of non-performing bank loans rose towards 10% in the first half of 2016, and economic also remained subdued.[26]

55. Government urgently needs to reduce its fiscal deficit to alleviate the immediate pressure it is placing on monetary policy and to boost prospects for economic recovery. The alternative passive approach of waiting for copper prices to improve would only serve to perpetuate the 'boom and bust' cycle that Zambia has experienced to date, and would be a missed opportunity to encourage economic diversification, which is essential to long-term economic and fiscal sustainability. By reducing the size of the fiscal deficit, Government will create space for increased levels of private sector financing and investment, including in non-copper sectors of the economy.

56. Options for deficit reduction include revenue mobilisation and expenditure cuts. In the short-term, given current economic constraints, the burden will need to fall on expenditure, and particularly, subsidies for fuel, emergency power, maize and farm inputs. Renewed efforts need to be made to move towards more cost-reflective pricing, accompanied by a clear articulation by political leaders of the advantages to the economy as a whole of lower public spending on subsidies. Efforts are also needed to protect the poor during any transition from subsidies prices via social transfers[27].

57. What remains critical is that any reduction in the fiscal deficit is planned and managed carefully. A disorderly and incomplete adjustment will not restore market confidence. A too severe or too quick adjustment will undermine growth.

I. Coordinated fiscal and monetary policy, with fiscal restraint

58. Government needs to commit itself to a sustainable alignment of fiscal and monetary policy in the medium-term. In the past decade, Government failed to take advantage of an unprecedented period of growth to consolidate its fiscal position and boost its resilience to future revenue shocks.

59. Government should develop fiscal rules, backed by Parliament, to guide the level of fiscal deficit that is compatible with macroeconomic stability. These rules could also be used to help insulate public spending against cyclical volatility; for example by requiring reserves to be boosted in periods of high growth, so that targeted spending can be maintained in a downturn without placing undue pressure on monetary policy. Global experience has shown that fiscal rules are only successful when there is genuine commitment to fiscal discipline; without commitment, means will always found to bypass or change a rule.

60. In Zambia, building political understanding and consensus on the need to co-ordinate fiscal and monetary policy, and the risks of failing to do so, is essential. Commitment to fiscal discipline is needed before any fiscal rules or debt ceilings can be effective. Political commitment to fiscal discipline could be framed through the development and submission to Parliament of a *Charter of Fiscal Responsibility*, setting out Government's objectives for fiscal policy in the coming five years. The objectives of the Charter could then guide the formulation, approval and execution of the national budget on an annual basis. Such an approach would provide the necessary pathway for political understanding of and adherence to fiscal and borrowing rules, which would in turn strengthen Government's fiscal credibility, with positive knock-on effects for investor confidence.

II. Coordinated fiscal and debt management

61. The Government's debt issuance and management strategy of the past five years has been opportunistic, as reflected in the issuance of the 2012 and 2014 Eurobonds that took advantage of lower Zambian debt levels, a good economic growth record and a global search for yield that led to increased interest in African countries' sovereign debt. However, increasing debt levels and debt servicing costs (as a result of the issues mentioned earlier and the depreciation of the kwacha), and revenue shortfalls in 2015 helped support a decision for a third bond despite the higher cost of borrowing. The only constraint on over-borrowing is the debt ceiling, but as recent increases have shown, it can be swiftly lifted ahead of any borrowing, and therefore has no real meaning at present.

62. Better coordinated fiscal policy and debt management would help move forward from this opportunistic and ad hoc stance, to one that properly considers issues of debt sustainability, the specific risks related to the type of borrowing, the cost of repayment, and crucially, to one that ensures that there are clear links between planned borrowing and planned expenditures. Debt decisions should be guided by a debt strategy that is incorporated in the fiscal charter and reflected in the budget. This will lead to better investment and improved debt sustainability compared to the recent off-the-cuff borrowing decisions. Four key measures are: (i) issuance of a debt strategy; (ii) resetting of an appropriate debt ceiling; (iii) issuance of quarterly debt reports; and (iv) better coordination between Government debt managers and staff engaged in spending and investment decisions.

III. More efficient public spending

63. The content of public spending also matters. One of the shortcomings of fiscal policy in the past five years has been that recurrent spending has been allowed to grow almost as rapidly as investment spending[28]. Relatively more public expenditure needs to be invested in areas that can support economic diversification and future growth prospects. Government may also be able to justify a higher level of deficit if the expenditures being financed are explicitly targeted towards growth investments, for example increased power production capacity.

64. Efforts are needed to ensure that any under-utilized resources are reallocated to where they can have a greater impact, and greater focus is needed on protecting and supporting the poorest households via better public expenditure. It may not be politically feasible to eliminate subsidies quickly, and in some areas (for example agriculture), they may have a valid role if they can be better targeted to the poor.

65. In some areas (such as encouraging agriculture or supporting the poorest households), there is a better case for subsidies than for fuel or electricity for example. Where subsidies are provided, Government should introduce rules that govern their public provision; for example better targeting of beneficiaries so that subsidies only focus on the poorest members of society, as well as setting caps on the amount of subsidies that can be provided. It also needs to ensure that the benefits of growth are distributed more inclusively than has been the case in the past decade. Any reduction or removal of subsidies should be accompanied by measures to protect the poor during the transition. One of the key means of doing so is by scaling up the Government's Social Cash Transfer system.

IV. More efficient revenue collection

66. Going forward, Government needs to make sustained efforts to improve domestic revenue mobilisation. This will help shift some of the recent reliance on external borrowing—and Government—to a more sustainable footing. Domestic revenues can be boosted by broadening the tax base and ensuring the continuity of revenue administration reforms. Especially those that further support the recent introduction of electronic filling and payment, which have helped improve efficiency and enhanced transparency. Key revenue areas to explore relate to the mining sector and efforts to ensure the legislation governing transfer pricing is strengthened, so that illicit transfers are minimised. Furthermore, a framework for the granting of tax incentives should be put in place and published to ensure that revenue opportunities are not wasted where companies would have invested despite the incentives.

Acronyms

CSO	Central Statistics Office
FDI	Foreign Direct Investment
FISP	Farmers Input Support Program
FRA	Food Reserve Agency
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Country
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiative
VAT	Value Added Tax
WDI	World Development Indicators

End Notes

[1] World Bank (2016), 'Africa's Pulse', April 2016 edition.
[2] Based on numbers reported by the CSO on 28 April 2016; for further information see: Central Statistics Office (2016) '2015 Living Conditions Monitoring Survey: Key Findings', Central Statistics Office, Lusaka Zambia.
[3] For an in-depth review of economic management in the 1990's and prior see Hill and McPherson (2004) and World Bank (1998).
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[10] IMF Article IV, May 2015.
[11] Central Statistical Office (2016), 'Monthly Bulletin', April 2016.
[12] World Bank (2015), 'Powering the Zambian Economy', 6th Economic Brief (December 2015).
[13] IAPRI (2016), 'The Impact of Power Rationing on Zambia's Agricultural Sector, Working Paper.
[14] World Bank (2015), 'Powering the Zambian Economy', 6th Economic Brief (December 2015).
[15] Bank of Zambia (2016), 2015 Annual Report, p.18.
[16] The difference between the fiscal deficit including and excluding grants narrows from 2014 as grants fall to below 1 percentage point of GDP and to 0.3% of GDP in 2015.
[17] The debt ceiling is covered in the new Constitution and General Loans (Guarantee) Act. This ceiling was put in place to help prevent over-borrowing and strengthen Parliaments' accountability role regarding national debt.
[18] 'Monthly Economic Indicators (MEIs)' (January to May 2016)', Ministry of Finance, Lusaka.
[19] Bank of Zambia data: statistics fortnightly.
[20] Bank of Zambia data: statistics fortnightly.
[21] World Bank Macro-Poverty Outlook, April 2016.
[22] World Bank (2016), 'Beating the Slowdown: Making Every Kwacha Count', 7th Economic Brief (July 2016).
[23] World Bank (2015), 'Powering the Zambian Economy', 6th Economic Brief (December 2015).
[24] Calculated from Bank of Zambia data: statistics fortnightly and Ministry of Finance Monthly Economic Indicators.
[25] World Bank (2016a), 'Africa's Pulse', April 2016 edition.
[26] Government reported in August 2016 that in the first half of 2016 VAT receipts were 20.3% below target.
[27] World Bank (2016) 'Beating the Slowdown: Making Every Kwacha Count, 7th Economic Brief, June 2016, Lusaka.
[28] Between 2010 and 2015 current expenditure increased by 42%. In real terms while public investment increased by 71% (albeit from a much lower base).