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Economic Distress and the Inevitability of an Economic Recovery Programme

Executive Summary

Zambia is emerging from a major economic downturn. The copper price collapse, electricity shortages, huge fall in the value of the Kwacha and high inflation in 2015 left the economy stalling. *Growth in 2015 was 2.9% and possibly 3.4% in 2016, significantly below the long-term average rate of 6.9%*. The downturn was compounded by a tightening of monetary policy which made it harder for businesses to borrow, and by a continuation of expansionary fiscal policies which increased the budget deficit and Government debt. Because the scale of the challenge was so significant, the Government announced it would launch Zambia Plus, a home-grown recovery programme to put the economy back on track.

A credible recovery programme will be essential to instill fiscal discipline, create conditions for growth, and support poverty reduction. A failure to the programme will result in significant adverse consequences for the economy and Zambian households. Without Zambia Plus, the budget deficit (measured as a percentage of GDP) is likely to continue performing worse than the authorities' targets. Thus, the overall debt level will keep growing, possibly reaching an average of 58.6% of GDP over 2017-2021, up from an average of 23.3% over 2007-2014. More debt will mean a bigger budget taken to meet debt servicing obligations. For instance, *in 2017 alone the Government allocated almost ¼ of the budget to debt servicing and arrears payments.* This is the equivalent of over K15 billion that could otherwise be spent on tackling poverty or supporting growth.

The current path is unsustainable, and the consequences of failing to act are likely to be felt hardest by the poor, who already bear the brunt. Analysis of the 2015 Budget reveals that when the economic downturn set in the most significant underspends were on social cash transfers, the economic empowerment fund and the public service pension fund. So, *the absence of Zambia Plus will do bigger and longer lasting damage to the lives of poor Zambians than will the few challenges of the programme*.

Achieving recovery will not come easy. Zambia's growth is forecast to remain modest, around 4.3% on average over 2017 and 2018. This will severely constrain the economy's ability to generate revenue to support domestic spending, and

whilst copper prices are rising lessons from history suggest it would be unwise to pin recovery on such a volatile commodity. To ease pressure on domestic revenues and smooth the path to recovery, a strong case exists to leverage new financing. The option to look to the international markets bears high risks of unsustainable debt. Fitch Ratings recently indicated that despite some economic improvements the outlook for investment in Zambia remains negative so that borrowing is likely to remain quite expensive. *Realistically, using the markets to find sufficient affordable financing is not an option for Zambia*.

Given this, there is a strong case to seek support from the IMF. Zambia faces total external debt repayments of US$1.36 billion over the next two years. Coincidently, Zambia is eligible to access up to US$1.3 billion interest-free financing from the IMF. *Utilizing this funding toward external debt servicing would secure fiscal space for Zambia to maintain spending on priority social protection and infrastructure programmes, thus smoothing the recovery.* The IMF also brings other benefits; notably signaling that Zambia has a clear recovery programme and is open for business will ease conditions for accessing finance.

The case for an IMF-supported Zambia Plus is overwhelming. However, success will require more than a clear well-funded programme. *To ensure that recovery stays on track and policies to support growth, reduce poverty and reduce spending are implemented on time, the programme must also be underpinned by strong, rational and accountable institutions and policy-makers, backed by social and political restraint*.

1. Why a Recovery Programme is Essential for Zambia

This policy insights paper explains why the economic recovery programme dubbed Zambia Plus will be absolutely essential for Zambia from 2017 onward. The paper highlights the scale of the challenge of Zambia's 2015/2016 economic downturn, which necessitated the Zambia Plus recovery programme. It recounts the main sources of the downturn, and explains some of its main implications. Finally, it explores the would-be consequences of inaction or inability to establish and execute a credible economic recovery programme, and posits some essential policy, social and institutional adjustment that would be required for a successful recovery programme.

In principle, an economic recovery programme is a specific, structured, time-bound and contextual intervention that seeks to reverse an episode or period of economic instability, growth stagnation and/or decline. As explained in more detail below, Zambia's economic recovery programme is underpinned by an economic environment characterized by lax fiscal governance, intermittent external shocks and interim macroeconomic instabilities in the economy. As such, in order to incorporate the domestic context correctly the Zambia Plus recovery programme needs to be Zambian led, and needs to address problems unique to Zambia. The programme will need to focus on bringing Zambia's public finances into balance and the Government will need to bring forward plans showing how a combination of spending rationalization and reductions, and revenue base expansion will be achieved. However, the recovery plan needs to go further, and be underpinned by policies that reprioritize spending on policies to deliver growth and social protection, and creating strong, accountable institutions to oversee and implement these policies.

The paper thus argues that *Zambia urgently needs to establish the economic recovery programme as one that fosters strong macroeconomic management and economic restructuring, reliable infrastructure provision (particularly electricity), an improved climate for private investments and robust social protection measures for the poor and vulnerable; all underpinned by strong political stewardship, social and political restraint, strong institutions and a highly professional cadre of policy-makers. The paper further argues that significant benefits would be secured from seeking an IMF-supported programme to augment Zambia Plus, and that the consequences of inaction could include significant financing and fiscal discipline in the medium to long term, with possibilities of further hardships for Zambians, particularly the poor.*

2. Scale and Sources of the Economic Downturn

After achieving 15 years of sustained economic growth that average at 6.9% per year over 1999-2014, in 2015, Zambia's real growth rate slowed down markedly to 2.9% (CSO, 2016). In 2016, growth was expected to remain modest at about 3.4%.

Interestingly, even over the period when the growth record had been impressive, Zambia's challenges to create decent formal jobs and to reduce poverty and inequality persisted. For instance, the Labour Force Surveys indicate that formal sector employment grew by an average of 5.7% per year between 2012-2014 (from 847,420 to 944,200), well short of the annual average employment growth rate of 15.6% that would be needed to create the politically envisioned one million decent new formal sector jobs between 2015 and 2019.

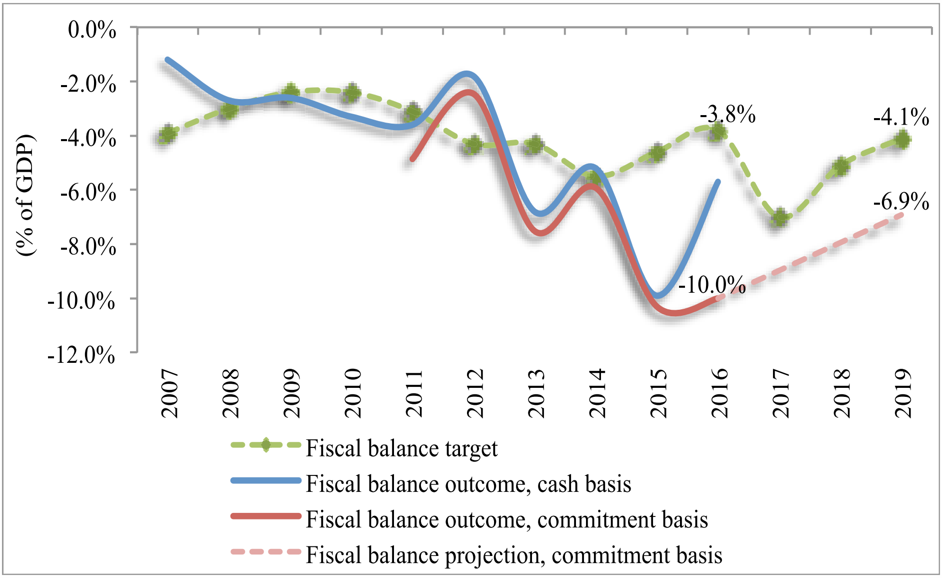
Concurrently, despite the sustained growth of the last decade and a half, rural poverty remained persistently high, falling by only 6 percentage points (from 83% to 77%) between 1998 and 2015. Zambia's inability to reduce poverty placed increasing social and political pressure on the Government to maintain unsustainably high levels of fiscal spending during 2011-2016.

The year 2015 was a critical turning point for Zambia. Initial evidence points to two broad sources of the 2015 economic downturn, namely: a number of external shocks; and a few fundamental *domestic policy misalignments and failures*. On the external front, three shocks are noteworthy:

- In 2015, international copper prices, which had been steadily declining since 2011, fell dramatically by about 35% and ushered is mounting current account deficits of 3.5% of GDP and 4.5% of GDP in 2015 and 2016, respectively.
- In July 2015, severe electricity shortages set in due to reduced water levels in Zambia's main reservoirs for hydroelectric power generation during the 2014/2015 rainy season and considerable overuse of the meagre water resources in the first half of 2015; reportedly reducing industrial productivity in manufacturing and agro-processing by between 30-70% between June and October 2015 and resulting in an estimated nominal GDP loss of US$4.3 billion in by the end of 2015.
- From September 2015, relative price stabilities set in as the Kwacha collapsed, depreciating by 26% in nominal terms in that month (and by 60% on average during the year); and as the inflation rate increased from 7.7% in September to 21.1% by December, underpinned by a strong pass-through effect from the exchange rate depreciation (or so-called imported inflation).

As these external shocks occurred, the domestic policy response was twofold and was generally misaligned. On the one hand, monetary policy, which had remained fairly conservative since 2011, was tightened further through several policy measures. On the other hand, fiscal policy, which

Figure 3.1: Fiscal balance targets, outcomes and projections



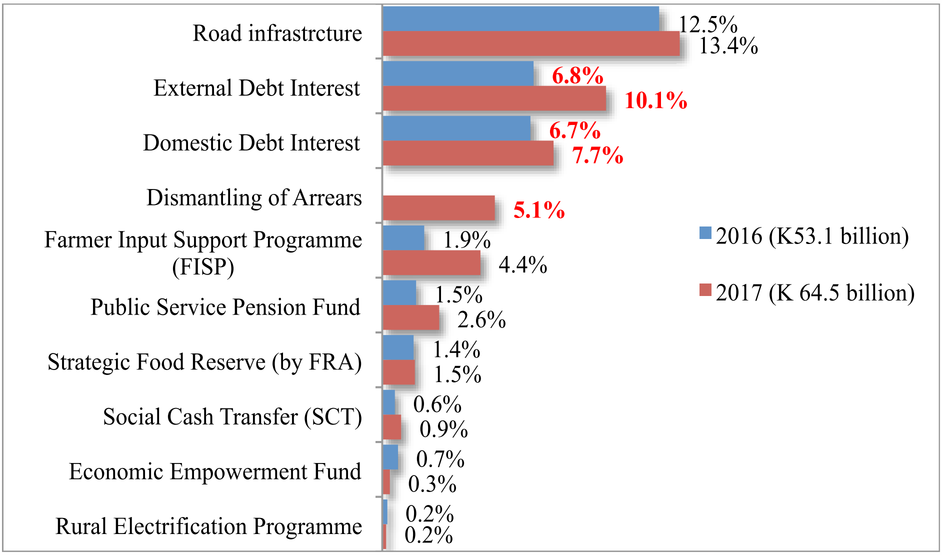
Source: Ministry of Finance Annual Economics reports (and ZIPAR on projection) was quite loose over 2011–2014 remained expansionary, with very few adjustments in the wake of the crisis.

The economic downturn and the policy responses it elicited are a stark indication that without a deliberate and well-planned economic recovery agenda that understands and effectively addresses the challenges and hard choices confronting the economy, prospects for achieving growth, income redistribution, social protection and poverty reduction will remain quite low. That is, should Zambia fail to establish a credible recovery programme or fail to take the decisive actions of the programme (including reaching out to the international community for external support) it faces high risks of adverse consequences.

3. Possible Consequences of Inaction Going Forward

The main potential consequence of inaction will include the continuation of high budget deficits (wide differences between the Government's income or fiscal revenue and its expenditure), leading to growing overall government debt levels. Many Zambians will remember or know about our problems with debt in the past. These caused widespread economic hardship. Definite warning signs have now emerged that the government's deficits and debt have grown to problematic levels again. Since 2009, Zambia's fiscal balances continuously failed to stay within their targeted levels, except

Figure 3.2: Budgetary allocations (% of total budget), by selected function

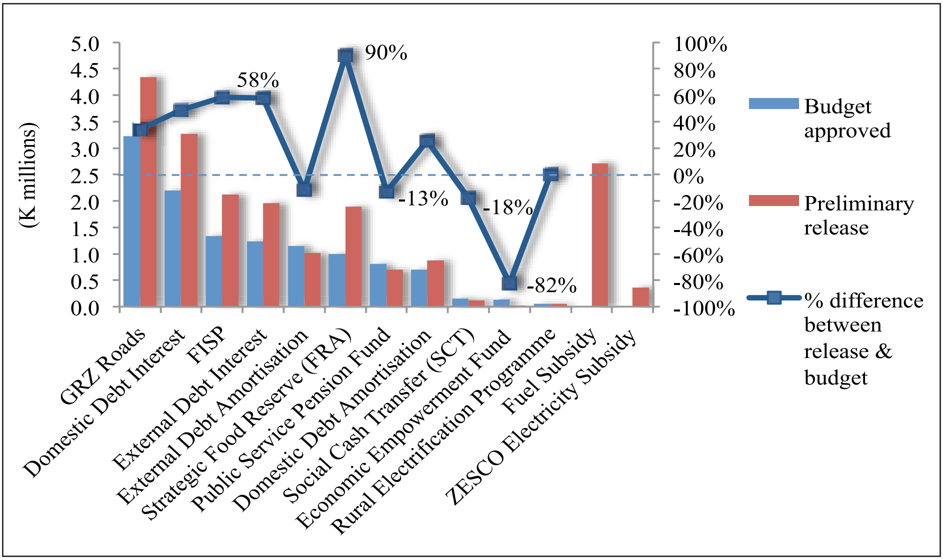


Source: Minister of Finance Budget Speeches in 2012 (Figure 3.1). In 2015 and 2016, the fiscal deficit was markedly deeper than in other years. The deficit was particularly deep on a commitment basis (including arrears on pension and contractor vendor payments). Thus, *if Zambia does not establish a credible economic recovery programme that instills fiscal discipline, the fiscal deficit (on commitment basis) can be expected to remain far below the targeted outcome going forward*.

We project that in the absence of Zambia Plus the current commitments-based fiscal deficit would close 2019 at 6.9% of GDP against the preliminary Ministry of Finance target of 4.1% of GDP (calculated on a cash basis and assuming Zambia Plus). Maintaining a deep fiscal deficit in the long-term is not sustainable; it will create pressure for more borrowing to finance the deep deficit. Zambia cannot afford to continue down this path because its mounting debt overhang is already placing a huge repayment burden on the Zambian people and further fiscal indiscipline will add to this burden. According to the IMF's Fiscal Monitor, over 2007-2014, the annual average debt-to-GDP ratio was 23.3% and over 2015-2021 it is projected at about 58.6% per annum on average. As a result of the heavy debt overhang, as of 2017, the budgetary allocations to (external and domestic) debt service repayments and dismantling of arrears have escalated to an extent where they jointly account for a staggering 23% of the total National Budget (Figure 3.2).

The debt service burden means Zambia will use nearly ¼ of its national resources to cover its obligations in 2017. This is equivalent to each man, woman and child that makes up the 16.4 million persons in the Zambian population paying K896 or equivalently, a family of six paying

Figure 3.3: budget allocations, releases and over-/under-spending, by selected items



Source: constructed from Ministry of Finance, Annual Economic Report 2015

K5,391 to debt service. This is a huge burden considering that in 2015, 54.4% of Zambia's inhabitants were poor and could not afford the minimum annual consumption basket – K2,568 (or K214 per month) – needed to keep a family of six above the income poverty threshold. The debt burden that Zambia has assumed will limit the amount of public resources that can be dedicated to poverty reduction and economic growth.

Fiscal fitness, however, goes beyond the mechanics of mobilizing more revenue and reducing public spending to within planned levels. The Government also needs to make sure spending policies are consistently applied and spending is focused on the right areas to support their stated objectives; overspends, unclear budget allocations and sudden policy changes are all signs of weak fiscal management that can all contribute to significant fiscal imbalances.

The forgoing has been the case in Zambia. The recent fiscal performance has resulted in expenditure tending to go off-track when economic conditions have worsened. Looking back at the difficult year of 2015, overspending was typically realized on statutory budget items (debt interest payment and debt amortization) and major Government projects and programmes. The highest levels of over-expenditure in 2015 were on Strategic Food Reserves (SFR) under the Food Reserve Agency (FRA), which saw expenditure that was 90% over budget (Figure 3.3). This was followed in joint second by external debt interest payments and Farmer Input Support Programme (FISP), which each experienced 58% over-expenditures. The overspending on strategic food reserves was due to a false alarm in 2015 that the then looming regional foods shortage would adversely affect Zambia while the over-expenditures on external debt repayments and to a lesser extent, on FISP were both largely because of the depreciation of the Kwacha during the year. Massive overspending on fuel and electricity subsidies was also experienced mainly because these items had not been budgeted for in 2015 and readily became large deficit financed items during the year.

Conversely, the three budget items that experienced the deepest spending cuts in the same year (2015) were the Economic Empowerment Fund (spending of 82% below budget), Social Cash Transfer (18% below budget) and Public Service Pension Fund (13% below budget). Therefore, in 2015, the risks of significant underspending were realized in relation to social protection and socio-economic empowerment programmes. The evidence shows that to date *the poor suffered more in the absence of fiscal discipline, an indication that a failure to restore fiscal discipline will most likely see this group suffer even more*.

In the absence of the Zambia Plus programme, prospects for restoring fiscal discipline and fitness will be limited, judging by the country's fiscal performance in the recent past. This will result in more and more of the country's wealth being used to service debt or be wasted in non-priority areas, rather than support economic growth, social protection and the improvement of the lives of Zambians. Inaction may do greater and longer lasting damage to the lives of ordinary Zambians than a recovery plan. A strong case therefore exists for establishing a credible home-grown recovery programme.

4. Is the IMF Relevant to Zambia Plus?

Zambia's real GDP growth may remain subdued in the near-term, around 4.3% on average over 2017-2018 according to the Ministry of Finance. This will limit the economy's ability to generate fiscal revenue based on domestic economic activity, and although copper prices are rising lessons from Zambia's past show it would be unwise to gamble the country's economic future on potential revenue streams from a highly volatile commodity.

Given this, an injection of external financing to augment the domestic resource mobilization will be required for a feasible and sustainable recovery programme. Granted, options to seek

Box 4.1: Purpose of IMF lending facilities

Today, IMF lending serves three main purposes:

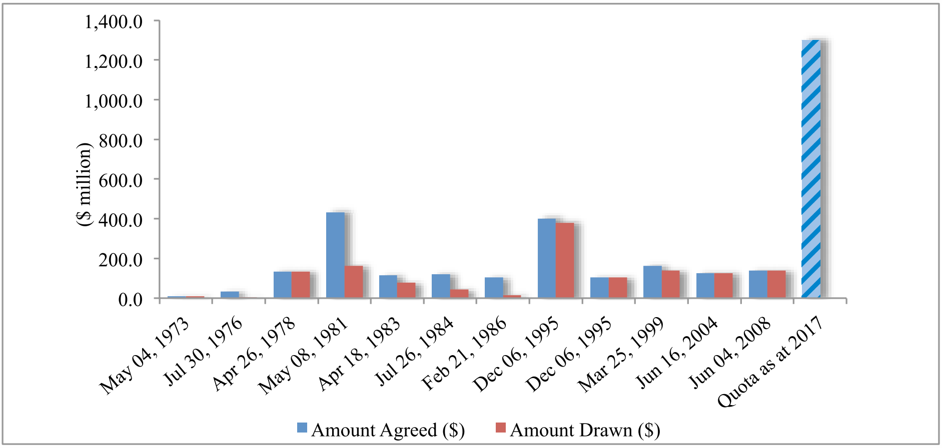
First, it can smooth adjustment to various shocks, helping a member country avoid disruptive economic adjustment or sovereign default, something that would be extremely costly, both for the country itself and possibly for other countries through economic and financial ripple effects (known as contagion).

Second, IMF programs can help unlock other financing, acting as a catalyst for other lenders. This is because the program can serve as a signal that the country has adopted sound policies, reinforcing policy credibility and increasing investors' confidence.

Third, IMF lending can help prevent crisis. The experience is clear: capital account crises typically inflict substantial costs on countries themselves and on other countries through contagion. The best way to deal with capital account problems is to nip them in the bud before they develop into a full-blown crisis.

Source: IMF (http://www.imf.org/external/about/lending.htm)

Figure 4.1: Zambia's history of IMF lending arrangements (1973-2008) and current quota



Note: the Quota as at 2017 is not an agreed amount; that is what Zambia is eligible to borrow.
Source: constructed from IMF data and information (http://www.imf.org/external/np/fin/tad/extarr2.aspx?memberKey1=1080&date1key=2017-01-31)

funding from the open market exist, but these will be expensive and could result in long-term spending challenges as a result of high interest charges. This is underlined by the recent Fitch Ratings investment report, which gives Zambia a "negative outlook" for investment. It highlights the risk that this outlook deteriorates if there is "a sustained inability to access external sources of financing, as might occur with the failure to successfully negotiate an IMF programme*".* This suggests that accessing financing on the open market would be costly for Zambia, and a cheaper option would be to seek aid support directly from the IMF and subsequently from cooperating partners and foreign investors as they gain more and more confidence that an IMF-endorsed Zambia Plus is fostering recovery. *Thus, the IMF will be a key element for unlocking international resources for Zambia, both directly and indirectly.*

In general, IMF support to an economic recovery programme like Zambia Plus offers three main benefits, namely: (financial) relief to the Balance of Payments (BOP) in the wake of external shocks or imbalances; technical assistance and advice for economic adjustment and recovery; and a signal to the international community (cooperating partners and foreign investors) that the country is serious about economic management, thus unlocking new streams of external financing (see also, Box 4.1).

The financial support offered by the IMF is much needed to tackle the growing balance of payments challenge Zambia faces. In 2017 alone Zambia expects to expend K6.5 billion (or $680.3 million) in external debt interest payments (Figure 3.2). Assuming no additional external repayment obligations or shocks (like the massive exchange rate depreciation in 2015) emerge in 2018 so that Zambia faces the same external debt service requirements, over the two years (2017-2018) Zambia will need $1.36 billion. According to the IMF, Zambia, as its member, is eligible to a quota of about US$1.3 billion, which would be extended through one of various lending arrangements of the IMF. *The quota would cover 96% of the two-year external debt service payments that the country will require; without this Zambia would need to meet these payments from domestic revenue. IMF support will therefore secure fiscal space for Zambia to maintain spending on priority infrastructure, economic productive capacity building and social protection programmes*.

However, the $1.3 billion would be a significantly larger agreed amount than any programme amount Zambia has accessed in its past relationships with the IMF (Figure 4.1). The IMF would therefore want to be convinced that the fiscal space to Zambia will not be wasted but properly used, based on an underpinning 'fiscal discipline framework"; it would require a credible economic recovery programme before it can agree to a lending arrangement.

This means improving transparency and accountability of institutions, with the technical support of the IMF, enabling timely and accurate reporting and monitoring of spending patterns. To do this Zambia must embrace the IMF's co-monitoring of the programme to demonstrate that recovery is on track. This will lend credibility to the Government's programme. This external monitoring of the success of fiscal management will serve two purposes, to help leverage greater support from the cooperating partners and help to abate (social and political) pressure on the Government to go off budget. *The external funding from the IMF will be jeopardized if Zambia cannot establish an economic recovery programme that is transparent and over which the Government can be held to account*.

Finally, IMF funding may also bring indirect benefits to Zambia. Whilst there have been recent improvements in accessing capital to support investment, this still remains a significant challenge to Zambian companies and is a barrier to economic growth. *An IMF endorsed, Zambian led, recovery programme will send a clear and credible signal that Zambia is open to investment, and will create more opportunities to access relatively more affordable finance on the international market, thus reducing domestic borrowing costs.*

5. Necessary Adjustments and Institutional Reforms for a Successful Programme

A successful recovery programme needs to balance prudent monetary policy, fiscal discipline and prioritize spending on policies to deliver growth and social protection. Zambia has started down this path. For example, monetary policy was tightened in 2015 in order to contain inflationary pressures and to address the exchange rate volatility. Other adjustments, particularly those on the fiscal side, are only just being undertaken in 2017. An example is the reduction of domestic borrowing, which is already resulting in the decline of yield rates on Government securities. The weighted average Treasury bill yield rate declined from 24.2% in September 2016 to 19.5% in February 2016 and the weighted average Government bond yield rate dropped from 25.2% in September 2016 to 20.6% in February 2017 (www.boz.zm).

Continued fiscal and monetary adjustments will be necessary in order to consolidate the relative stability that has been achieved in the recent past. Stability is a pre-condition for fostering productivity, diversification and economic growth. However, in order to improve the growth prospects, Zambia would have to also initiate complementary structural, business and institutional reforms. The country will also have to pay close attention to promoting poverty and inequality reduction, through mechanism for gradually but persistent and effective transferring of economic resource to disadvantaged groups and areas.

Establishing the right political economy, underpinned by institutions, social and political culture will require programmes and initiatives for coaching the Zambian society, institutional and political systems, towards changing the general psyche, attitudes and culture. Thus, significant improvements in economic management will need to be fostered through the re-establishment of *strong institutions* insulated from undue influences of political patronage and a return to rational, well-informed and evidence-based policy-making.

Second, in order to foster institutional strengthening and evidence-based policy formulation and execution against a credible recovery programme, the general public and political interests will have to be coached to exercise restraint in the amount of pressure they exert on institutions and policy-makers. Strong stewardship from the Head of State will be critical in order to support the efforts of the Ministry of Finance and the Cabinet Office to re-establish adherence to fiscal rules and foster overall public sector professionalism. This step will be critical for rebuilding strong institutions for economic management.

In summary, *a combination of strong institutions and policy-makers together with social and political restraint will be required to ensure the recovery plan come to fruition.* Without these changes to Zambia's governance environment, there is little chance that the country will actually identify and address its core recovery challenges and constraints and build for a successful future.

6. Conclusion

Ultimately, the main message of this paper is that an IMF-supported economic recovery programme is an absolute necessity for Zambia. The main consequences of any inaction or inability to establish Zambia Plus would include a continuation of fiscal slippages, mounting deficits and debts with concurrent external imbalances. The sizable (direct and indirect) external resources that are anticipated to augment domestic resources and create fiscal space would also be forfeited in the absence of a credible economic recovery programme. Without Zambia Plus, the continued social and economic hardships for Zambians will fall disproportionately more on the poor and vulnerable members of the society.

Zambia Plus is therefore urgently required towards re-establishing strong macroeconomic management and economic restructuring. It will be a critical framework for fostering the reliable provision of infrastructure services like electricity, improving the climate for private investments and business, and bolstering social protection programmes for the poor and vulnerable. The programme should be underpinned by strong high-level stewardship, social and political restraint, and strong institutions and policy-makers. It should be supported by a well thought-out and well negotiated IMF aid package, which will support the re-instillation of fiscal discipline and unlock addition external resources.

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