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A TIGHTENING BALANCING ACT

Economic Implications of Zambia's Balance of Payments Performance

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Table of Contents

Executive Summary

International trade and investment are primary drivers of globalization, international trade and development. In 2014, Zambia's trade openness – in terms of total monetary flows on all export and import transactions combined – was estimated at 79.6% of GDP while the total (cumulative) stock on inward FDI was 66.5% of GDP. The recent economic headwinds in Zambia and abroad motivated this review of the country's external position relative to the rest of the world. This paper highlights the changes in the balance of payments (BOP), a key tool for monitoring Zambia's economic performance vis-à-vis the rest of the world.

The balance of payments shows the Zambia's financial transactions with other countries in the world, recoding the flows of money into and out of the economy through a number of payments accounts. Checking the economy's balance of payments position offers useful insights about its external sector's health. In a sense, the monetary flows through the balance of payments reflect Zambia's net dependency on the rest of the world.

The context of the analysis in the paper is the economic malaise of 2015. The paper thus demonstrates that the economic debacle of 2015 is not an unfamiliar experience for Zambia. It draws on the country's economic recent history, identifying parallels between the past and the present. It seeks to offer guidance to policy-makers, towards fostering foster effective and reliable responses to the external balance challenges. Particularly, the paper analyses the fundamental elements of Zambia's balance of payments, describing their recent behaviour and highlighting some of the main drivers of imbalances in the different payments accounts. It recommends measures for correcting some of the imbalance in the balance of payments, seeking to contribute to the improvement of the external sector's performance.

Main Observations

The report observes that the causes of fluctuations in Zambia's balance of payments are both demand-driven and supply-driven and largely emanate from the country's current account. This is because the monetary transactions in Zambia's current account amounted to an annual average of 76.9% of the sum total of all balance of payments transactions done between 2009 and 2015. In turn, we present the demand-side and supply-side factors responsible for the fluctuations in external balances between 2009 and 2015.

Demand-side causes:

- ***Robust domestic growth and persistently high import demand,*** particularly urban demand for finished consumer imports. These can be resolved through import demand management trade policies (incentives and regulations) to curb the high levels of imports and relieve the monetary outflows from the current account.
- ***A recession abroad particularly the slowdown in China***, which pushed down global copper prices and reduced Zambia's copper export earnings, further deepened the trade and current account deficits. Unfortunately, Zambia has little within its control to influence a higher Chinese or global demand for copper.
- ***Overvalued currency*** reflective of past interferences in the foreign exchange market aimed at "strengthening" the Kwacha. A strong (or more precisely, overvalued) currency makes it relatively cheap to import and relatively expensive (uncompetitive) to export, thus simultaneously encouraging imports and discouraging exports. This eventually leads to a trade deficit and ultimately a current count deficit.
- ***Speculation on Zambian currency*** as a consequence of overvaluation. Consistent information sharing with the public is crucial for managing market expectations and preventing adverse expectations from forming and filtering through to the current account and further deepening the deficit.
- ***Government's fiscal stance***. The lack of fiscal discipline in Zambia and the resultant mounting fiscal deficit have been important causes of balance of payments imbalances, both historically and in recent times. In light of the economic challenges the economy faces, the policy response has been to maintain consumption expenditure underpinned by an unrelenting appetite to support infrastructure development and public administration expansion resulting in a fiscal deficit (which is now projected to reach 10% of GDP by 2016) financed by heavy borrowing and debt accumulation on commercial high interest rate terms.

Supply-side causes:

- These include: high labour costs; resources depletion; low quality and unreliable production; low factor productivity; low investment; and high or rising levels of inflation.

Recommendations

Having observed the above-mentioned challenges in the balance of payments, we recommend recourse to the following policy and strategic measures:

- ***Applying protectionist measures*** through import tariff increases, quota restrictions and private producer subsidies (or "bailouts") (though highly unpopular among multilateral institutions) are feasible temporary policy response options for Zambia during an external balances crisis.

- *A range of supply-side policy responses* are feasible options for Zambia currently, but the country has already been pursing these policies mainly in terms of infrastructure projects. The success of such policies in contributing towards addressing the balance of payments crisis will critically depend on reprogramming them as long-term strategic economic restructuring undertakings.
- *Maintaining the flexible competitive exchange rate, thus allowing the Kwacha to depreciate* and find its long-run equilibrium is another feasible policy option, but this too is already being pursued in Zambia to a large degree given the liberalized exchange rates. However, there are many pressures (both economic and political) on the central bank to intervene more substantively in long-term exchange rate determination. The authorities should hold fast to short-term, volatility smoothening interventions only, but should also ensure the timely dissemination of information and sensitization of the public; this will help to manage market expectations, dispel uncertainty, and relieve anxieties with respect to the currency.
- Seeking balance of payments support from the IMF is another policy option for Zambia.

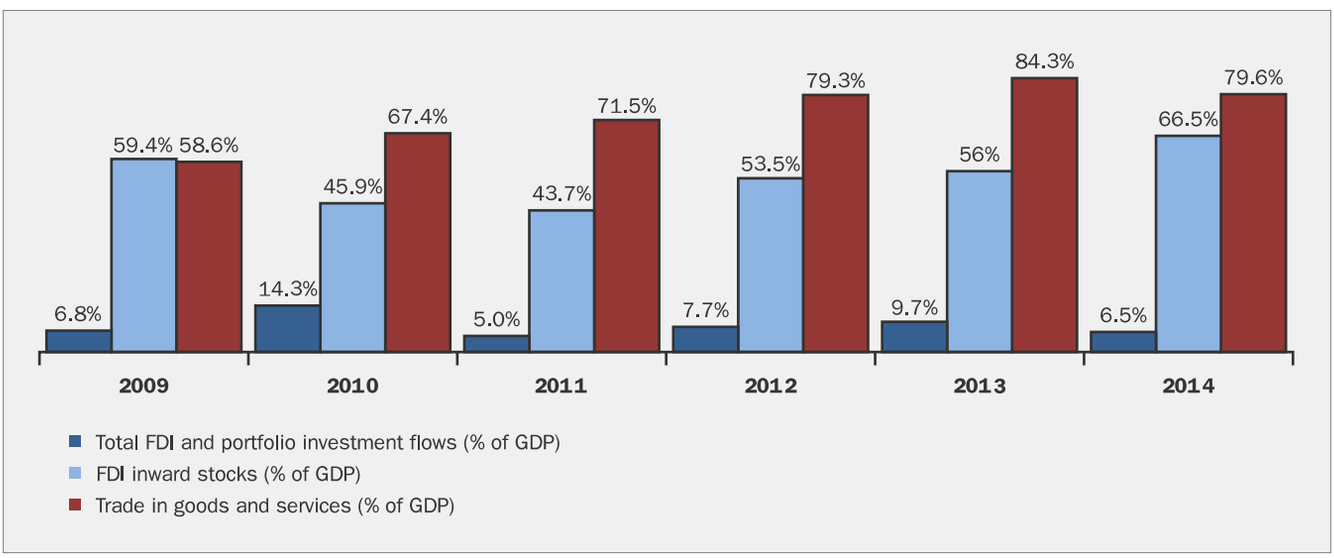
Ultimately, the policy responses that Zambia will pursue are a political choice. Given that the responses are all difficult and come with heavy and costly trade-offs, it is not inconceivable that the country may opt to do nothing in terms of explicit external sector economic management. Policy-makers may opt to sit back and let the economy "ride-out" any storms or external imbalance.

1. Introduction

International trade and investment are primary drivers of globalization, international trade and development. They are "big business" globally. For instance in 2014, world trade was estimated at US$37.9 trillion or 48% of global gross domestic product (GDP) while the total stock of global foreign direct investment (FDI) was 32.8% of GDP (UNCTAD database).

Trade and international investment flows between Zambia and her trading and investment partners are also sizable relative to the extent of the country's economic activity. In 2014, the economy's trade openness (defined as the total monetary flows on all export and import transactions combined) was estimated at 79.6% of GDP. Although the year's total inward and outward flows of FDI and portfolio investment had declined to 6.5% of GDP, the cumulative total stock of inward FDI was a sizeable 66.5% of GDP (Figure 1.1).

Figure 1.1: Trade flows and FDI stocks and flows



Source: Constructed from BOZ BOP tables and UNCTAD data

Although these summary statistics reflect the size and importance of trade and investment to Zambia, by themselves they do not provide a comprehensive picture about the performance of Zambia's external economy. More informative insights can be gleaned through an assessment of the balance of payments (BOP).

Formally, Zambia's balance of payments shows the country's financial transactions with other countries in the world. It records the inflows and outflows of money into and out of the economy through a number of balance of payments accounts. Checking the economy's balance of payments position offers useful insights about its external sector's health. In a sense, the monetary flows through the balance of payments reflect Zambia's net dependency on the rest of the world. In very simplistic terms, this can be explained as follows: if Zambia experiences greater net monetary outflows, this must be because the economy is paying for goods and services from abroad, repaying external debts or making similar other payment transactions. The net outflow must then be because, on aggregate, Zambia depends more on other countries to supply goods and services, provide credit financing and so on than the other countries depend on Zambia to supply these elements to them. As such, Zambia will run various forms of external deficits, a sign of a relatively weak external balance position.

This paper explains the fundamental elements of Zambia's balance of payments, describing their recent behaviours and highlighting some of the main drivers of imbalances in the different accounts of the balance of payments. The paper recommends measures for correcting some of the imbalance in balance of payments towards improving external sector performance.

The rest of the paper is organized as follows: Section 2 explains the standard balance of payments format; Section 3 describes the causes of a current account deficit in the Zambia context; Section 4 highlights in what sense Zambia may be falling into a deepening current account deficit and consequently, an emerging balance of payments crisis; Section 5 highlights the possible policy interventions that might be pursued to address key problems with external balances; and Section 6 closes the paper with a conclusion.

2. Standard Balance of Payments Format

Generally, the countries of the world use the international monetary system to keep track of how their trade and investments flows interact with each other in the global economy. This system was established over time to ensure a stable, coordinated and smooth running global system of exchange rates and international payments amongst the countries of the world. Its main custodian is the International Monetary Fund (IMF), established in July 1944. Since 1944, the IMF's primary purpose has been to ensure the stability of the international monetary system – the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. The Fund's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability (http://www.imf.org/external/about.htm).

In order to carry out its monitoring mandate, the IMF encourages its member States, including Zambia, to maintain and report on their respective monetary inflows and outflows. This data is generally captured in a Standard Balance of Payments format[1], which is usually maintained by the monetary authorities (central bank) of the country.

In Zambia, the Bank of Zambia maintains the country's balance of payments accounts. Generically, the balance of payments has three main accounts. These are summarized in turn, drawing definitional examples from Zambia's balance of payments tables.

2.1 Current Account

The current account captures the monetary transactions for goods and services as well as for incomes and unilateral transfers. Specifically, the current account comprises of the following (see also, Table 1.1):

(i) The goods trade balance (monetary transaction on merchandise exports less monetary transaction on merchandise imports);
(ii) The balance for trade in services (which jointly with the goods trade balance comprises the overall trade balance);
(iii) Net income or net primary income in Zambia (e.g., remittances from Zambians living abroad); and

[1]The Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6) is the latest version of the standardized template and it was last updated in November 2013

(iv) Net transfers or net secondary income (e.g., contributions to COMESA, SADC, IMF, World Bank, the United Nations, etc.).

Table 1.1 Zambia current account 2005-2014

Zambia: BoP Table 2005-2014 (in US $ millions)										
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
June 9, 2014									Prel	Proj
Current Account	**-599.2**	**142.8**	**-754.5**	**-1,038.80**	**583.3**	**1,205.50**	**704.7**	**774.1**	**197.6**	**232.3**
Balance on goods	86.1	1,307.00	899.2	407.4	905.7	2,703.70	2,205.60	1,437.10	1,450.70	1,972.70
Exports , f.o.b	2,208.20	3,890.70	4,448.50	4,880.20	4,242.80	7,261.70	8,512.30	9,191.10	10,410.40	10,811.40
Metal sector	1,673.80	3,175.40	3,667.70	4,004.00	3,343.10	6,071.70	6,915.70	6,497.60	7,049.30	7,174.20
Copper	1,515.60	3,029.30	3,406.50	3,687.50	3,179.30	5,767.90	6,659.70	6,294.50	6,911.40	7,040.10
Cobalt	158.2	146.1	261.2	316.5	163.9	303.8	256	203.1	137.9	134.1
Non-traditional	534.3	715.3	780.8	876.2	899.7	1,190.00	1,596.60	2,693.50	3,361.00	3,637.30
Imports, f.o.b	-2,160.70	-2,635.80	-3,610.50	-4,554.30	-3,413.40	-4,709.90	-6,454.20	-7,925.50	-9,195.40	-9,081.40
Metal sector	-357.4	-520.7	-1,059.10	-1,380.50	-866	-1,029.30	-1,567.30	-2,083.70	-2,560.10	-3,145.50
Non-metal sector	-1,803.30	-2,115.10	-2,551.40	-3,173.80	-2,547.40	-3,680.60	-4,887.00	-5,841.90	-6,635.20	-5,935.80
Fertilizer	-69.9	-97.2	-149.1	-164	-197.8	-215.3	-330	-304.3	-382.9	-418.4
Petroleum	-312.1	-454	-493	-815.6	-535.8	-618.1	-530.5	-930.6	-1,082.60	-1,158.20
Others	-1,411.80	-1,532.40	-1,909.30	-2,193.80	-1,813.90	-2,847.20	-4,026.50	-4,606.90	-5,169.70	-4,359.20
Goods Procured in ports by carriers(Bunker Oil)	32	33.6	35.3	37.4	39.6	42	44.5	47.2	50	53.5
Nonmonetary Gold	6.7	18.5	26	44.1	36.6	109.9	103	124.3	185.6	189.1
Services (net)	-197.6	-358.2	-639.6	-606.9	-419.7	-567	-723.6	-783.4	-874.3	-961.3
Services Receipts	273.3	228.9	273.4	299.6	240.9	310.9	374.5	466.3	585.4	623
Services Payments	-470.9	-587.1	-913	-906.5	-660.6	-877.9	-1,098.10	-1,249.70	-1,459.70	-1,584.40
Income Net	-594.8	-1,168.30	-1,544.60	-1,399.30	-418.7	-1,363.00	-1,155.30	-333.5	-767.6	-1,106.40
Income Receipts	12.9	18.4	35.2	29.5	5.5	8.4	11.1	10.1	5.3	5.7
Income Payments	-607.7	-1,186.70	-1,579.80	-1,428.90	-424.2	-1,371.40	-1,166.40	-343.6	-772.9	-1,112.10
Of which: Income on Equity Payments	-461.1	-1,107.00	-1,532.00	-1,346	-265.4	-1,302.70	-1,092.50	-239.2	-652.8	-872.6
Interest payments	-130	-56.9	-13.3	-54.1	-131.2	-39.8	-44.8	-74.1	-91.3	-209.3
General government	-110	-16.9	-13.3	-20.1	-12.7	-9.3	-13.9	-43.6	-59.6	-177
Private sector	-20	-40.1	0	-34	-118.4	-30.5	-30.9	-30.5	-31.7	-32.3
Current Transfers(net)	107	362.2	530.5	560.1	516	431.8	378	453.9	388.9	327.4
Private	-24.1	153.7	227.9	239	211.6	194.4	231.8	265	279	253.4
Official	131.1	208.5	302.6	321.1	304.3	237.4	146.2	188.9	109.9	74
Commodity, SWAP & Global Fund	0	92.2	156	150.1	105.9	89.1	11.9	65	66	30
Budget Grants	131.1	116.3	146.6	171	198.4	148.3	134.3	123.9	43.9	44

While the misnomers in the layperson's use of economic nomenclature are perhaps understandable, in strict technical terms, it is noteworthy that balance of payments deficits and current account deficits are two different things. When people refer to a balance of payments deficit they usually mean a current account deficit and when they refer to a balance of payments crisis they usually mean a crisis in the current account. This misconstrued interchange of terms is probably because the current account – which is dominated by international trade transactions – tends to be the largest component of the overall balance of payments.

2.2 Capital Account

The capital account has become a relatively small part of the balance of payments in most countries, including Zambia. It measures the net flows of international transactions on debt forgiveness, inheritance tax, death duties, sales of tangible assets (e.g., a factory) and intangible assets (e.g., land), transfer of non-financial assets (e.g., intellectual property), and so on.

2.3 Financial Account

The financial account measures flows of capital, both short-term and long-term. This account includes:

(i) Portfolio investment transactions on Government securities (Treasury bill, bonds including the Eurobond, etc.) by investors; this largely represents external borrowing by the public sector. International investors buying into Government securities do not have any direct control or influence over the use of the portfolio investment monies they provide.

(ii) FDI transactions, which reflect long-term investments. The control to utilize FDI remains with the owners of the money, to the extent of the shareholding structures of the investment projects being financed;

In principle, the balance of payments is an accounting balance sheet for international transactions. Like any good balance sheet, the balance of payments includes a standard accounting or balancing item called Net Errors and Omissions. This component is trivial for this analysis.

In a floating exchange rate financial system like Zambia's, a current account deficit must be matched by a surplus on the financial account in order for the balance of payments to remain in balance. For instance, if the country is facing a trade deficit and resultantly a current account deficit, but cannot readily expand its exports (to increases the inflow of foreign currency) or reduce its imports (the slowdown in the outflow of money to honour import payment obligations), then it will inevitably resort to borrowing through portfolio investments or to attracting FDI, although the latter takes relatively longer to influence.

How has Zambia's balance of payments played out in recent times? What have been some of the main underlying reasons or causes for the balance of payments outturns? What are some of the key implications of the current state of play? What can we say about the external economy going forward? These aspects are discussed in the ensuing sections, from a descriptive empirical perspective of Zambia's balance of payments.

3. Causes of a Current Account Deficit

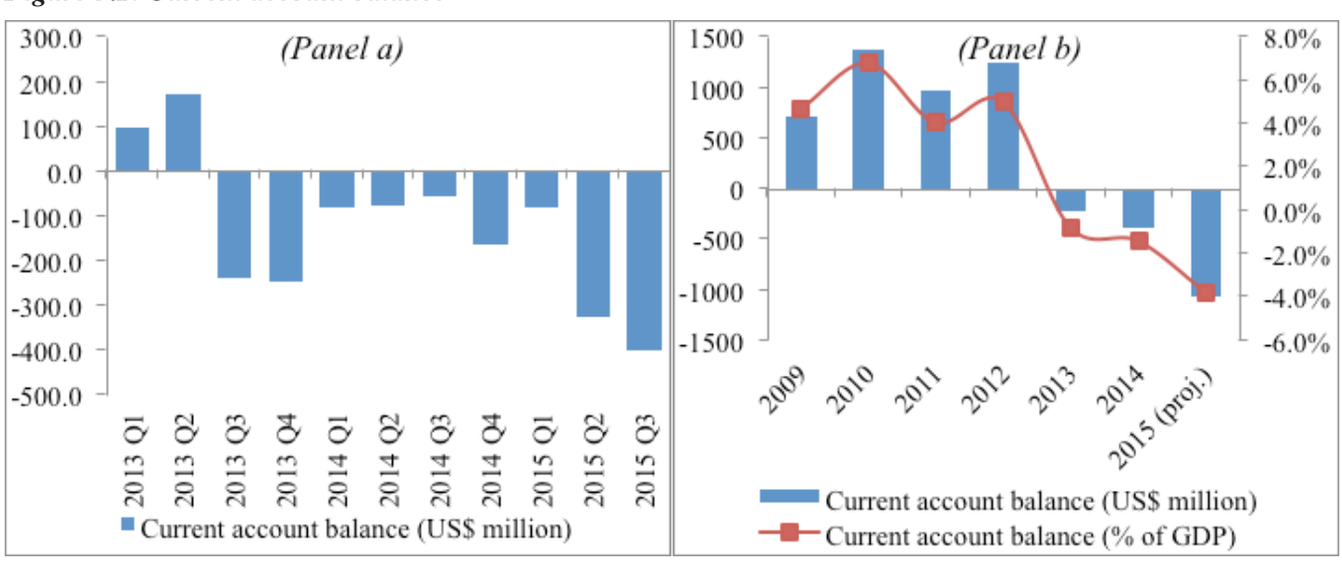
An important sign that an economy's external position is weakening is a deepening imbalance in the current account. Technically, this is measured as the absolute monetary value of the current account deficit (or net position of the current account) or the current account deficit as a share of GDP, which serves as a proxy of the burden of the deficit on aggregate economic activity.

The monetary transactions in Zambia's current account amounted to an annual average of 76.9% of all balance of payments transactions done between 2009 and 2014. These were led by goods (merchandise) trade transactions which accounted for 62.7% of all the balance of payments transactions. Clearly, the happenings in the current account and goods trade account in particular have significant implications for the overall performance of Zambia's external economy.

In 2013, Zambia's current account balance held positive net positions in the first two quarters and then marked deficits in the last two quarters of the year; thereafter, the current account remained in deficit until the close of the third quarter of 2015 (Figure 3.1, Panel a).

On an annual basis, the current account recorded health surpluses averaging 5.1% of GDP between 2009 and 2012. Since 2013, a deepening deficit is observed, which is projected to have reached 3.8% of GDP by the close of 2015 (Panel b). The deepening current account deficit means Zambia's ability to pay for its imports out of its export earnings is declining.

Figure 3.1: Current account balance



Source: Constructed from BOZ BOP tables and IMF WEO data

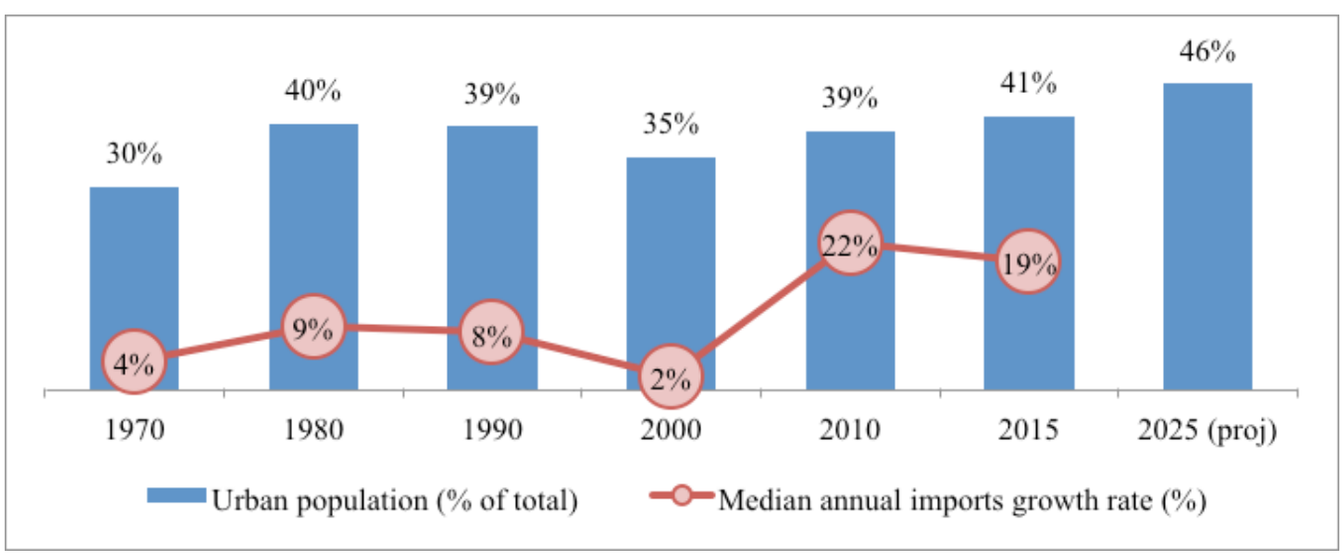
So what has caused Zambia's deepening current account deficit in recent times? In principle, a current account deficit can come from multiple concurrent sources. Some examples are highlighted below, focusing on two broad sources of a current account deficit, namely demand-side factors and supply-side causes. They are non-exhaustive and emphasize those factors that are relevant to the Zambian case.

3.1 Demand-Side Factors

(i) Urbanization and import demand growth

This usually entails that incomes of at least some sub-groups of the population are rising. As incomes increase so do consumption and import propensities, especially among urban middle-class households and small and medium scale enterprises (SMEs). Since exports do not expand as quickly as imports, a trade deficit will usually set in as balance of payments outflows to settle import obligations dominate over export payment receipts. Since trade transactions are the largest part of the current account, a trade deficit implies a current account deficit.

Figure 3.2: Urban population as a share of total population and nominal imports growth



Source: Constructed from UNCTADStats datasets

In the recent slowdown of the Zambian economy (in 2015), consumer goods imports added relatively the largest pressure to the total import bill, particularly after April 2015 (Figure 3.3). The average import bill on consumer imports increased by a remarkable 98%, from ZMW1,145 million per month during January 2014 to April 2015 to ZMW2,267 in May-October 2015. As such, the total imports trend line closely mimicked that of consumer goods imports.

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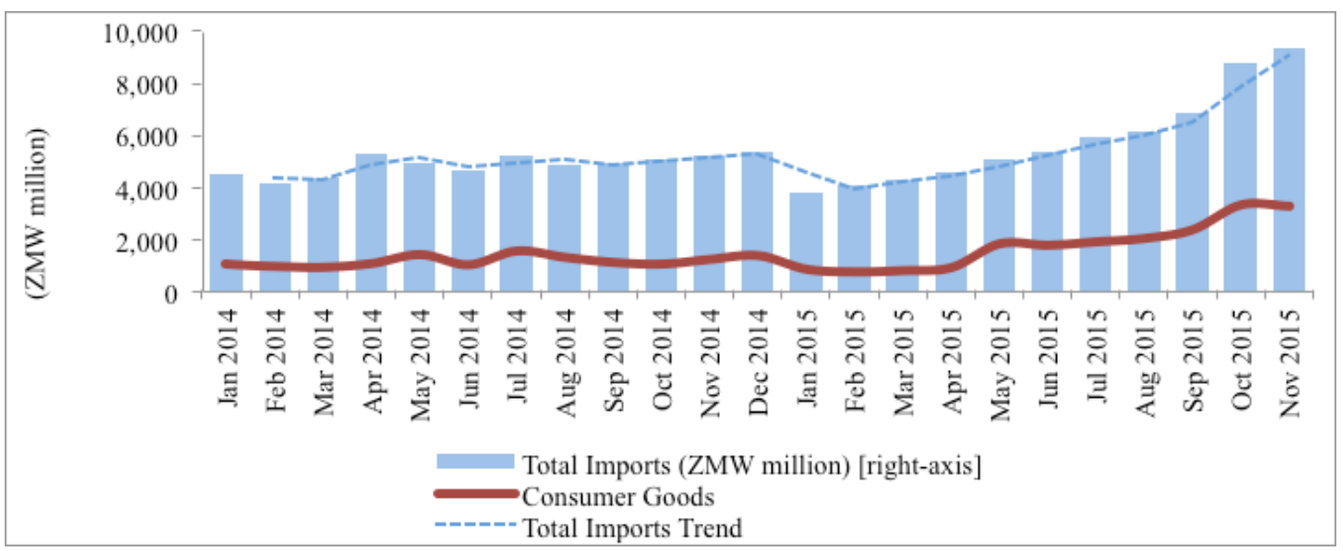
Figure 3.3: Total and consumer imports



Source: Constructed from CSO Monthly Bulletin data

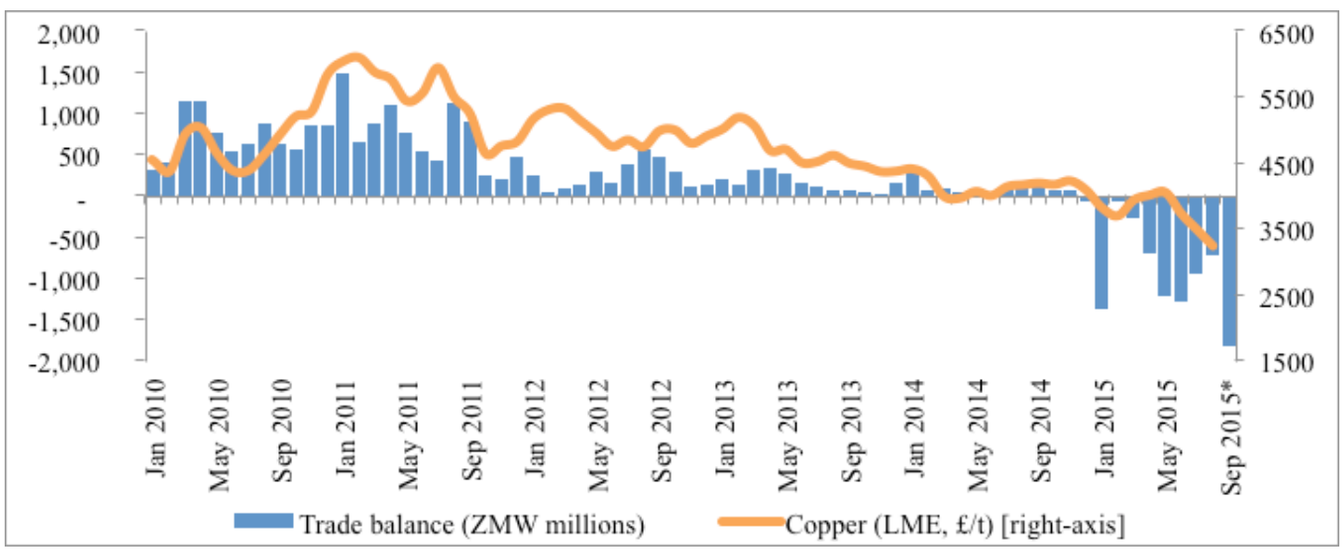
The underlying drivers of the growing consumer goods import bill included the persistently high propensity to consume imported finished goods in spite of a marked depreciation of the Kwacha against major trading currencies. That is, although the cost of importing increased due to the continuously depreciating Kwacha, consumer goods import behavior did not change much; but the last month of the period did see a tapering off of the trend. This lends support to the arguments that urbanization is associated with high importation of consumer goods, which in turn increases imports monetary outflows at a faster rate than monetary inflows from export earnings. Ultimately this contributes to a deepening current account deficit. In the interest of supporting the balance of payments, there is clearly a case for import demand management trade policies.

(ii) Recession Abroad

For a small open economy like Zambia's, a recession in Zambia's main trading partners means that incomes and demand have fallen. As this happens, the demand for Zambian exports also falls. So for instance, as the Chinese economy has slowed down in recent months, its demand for export commodities like Zambian copper has fallen causing the price of the commodity to tumble.

On the Zambian side, the falling copper prices and falling copper exports to China resulted in an increase in Zambia's trade deficit (see Figure 3.4) which in turn contributed to the deepening current account deficit. Unfortunately, Zambia has little within its direct control that would influence higher Chinese or global demand for its copper. Internally, the country only has options to diversify its export portfolio, a supply-side issue that is dealt with later.

Figure 3.4: Zambian trade balance and global copper prices



Source: Constructed from CSO and UNCTAD data

(iii) Overvalued Currency

An exchange rate is said to result in an overvalued currency if it is higher than what is believed to be sustainable or if it is showing strength beyond the economy's full potential performance at a given time. It can be reflective of interferences in the foreign exchange market by the government as a matter of policy or by activities (such as speculation) of other market players which prevent the local currency from trading at its 'true' international value or worth, whatever that may be[2]. Overvalued currencies make it relatively cheap to import and relatively expensive (uncompetitive) to export, thus simultaneously encouraging imports and discouraging exports. This eventually leads to a trade deficit and ultimately a current account deficit.

Once the exchange rate becomes liberalized or market-determined, an overvalued currency should depreciate as a self-correction mechanism. The Zambian Kwacha is a classic example of an overvalued currency since supply of foreign currency has more often than not been outstripped by demand but the central bank periodically intervenes to prevent disruptive adjustments of the exchange rate. This keeps the price of foreign currency low despite the deterioration of terms of trade, depleting reserves and mounting foreign currency expenditure needs such as importation of electricity, fuel and interest repayments on external debt.

[2]It is difficult to determine what the true value of a currency is (or what it should be) and as such, an overvaluation cannot be easily agreed to be the case. Various methods such as the real effective exchange rate (REER) and purchasing power parity (PPP) have been used as ways of finding that true value but these approaches are not perfect.

Normally a currency depreciation in a floating exchange rate regime acts as both an incentive for would-be exporters to increase their export efforts (encouraged by opportunities to earn more Kwacha equivalent from each dollar earned from exports) and a disincentive for importers to reduce imports (given the rising costs of imports under a depreciation). However, notable challenges arise when both importers and exporters face structural constraints that prevent them from changing their behaviours in accordance with the incentives and disincentive (the structural or supply-side constraints are discussed in Section 3.2). For instance, if, other things being equal, importers of finished products cannot find domestic alternatives to substitute the imports with; their high import behaviour will persist despite the higher import costs associated with the depreciation. In this respect, a common solution to a mounting current account deficit is usually to slow down consumer spending on imports, sometimes by deliberately causing a recession or "cooling" of the economy.

(iv) Government's Fiscal Stance

Many accounts have pointed to the lack of fiscal restraint in Zambia and the resultant mounting fiscal deficit as an important cause of balance of payments imbalances, both historically and in recent times. Burton (2016)[3] reports that: "In June 1976, the Zambian government ran out of foreign exchange to pay for imported goods. However, far from being a sudden and unexpected crisis, Zambia's lopsided balance-of-payments had been evident for at least five years. Records in the United National Independence Party's (UNIP) archives show how as early as July 1971, the then-Governor of the Bank of Zambia Valentine Musakanya warned the Finance Ministry of a sharp decline in foreign reserves due, in his view, to various ministries' mismanagement and continued upward revision of budgets. A year later in June 1972, Musakanya claims to have personally warned then-President Kenneth Kaunda of this dangerous, and growing, financial imbalance. Even reports in the international press had by mid-1972 identified a balance-of-payments deficit of USD 295 million (16% of GDP) in Zambia's economy for the 1971/72 financial year".

One of the major structural problems was that the mining sector remained virtually the only source of foreign exchange for the economy (95% as of 1978). In that period, balance of payments deficits and foreign exchange crises became recurring problems brought about by macroeconomic mismanagement. In particular, the Government assumed a position of maintaining consumption expenditure at the post-independence levels seen when world copper prices had been high. The shortage of foreign exchange associated with the external imbalances disrupted production, especially in the manufacturing and mining sectors, since they were heavily dependent on imported inputs. Even worse, the problem of exchange shortages was to some extent self-perpetuating; shortages disrupted mining activities, thereby further reducing foreign exchange earnings (Nash, 1997[4]).

[3]Burton, S. J. (2016) "Unsustainable Consumption Created Zambia's First Balance of Payment Crisis in the 1970s", Economic and Financial Commentary, Vol. 1, Issue 7 February; Lusaka

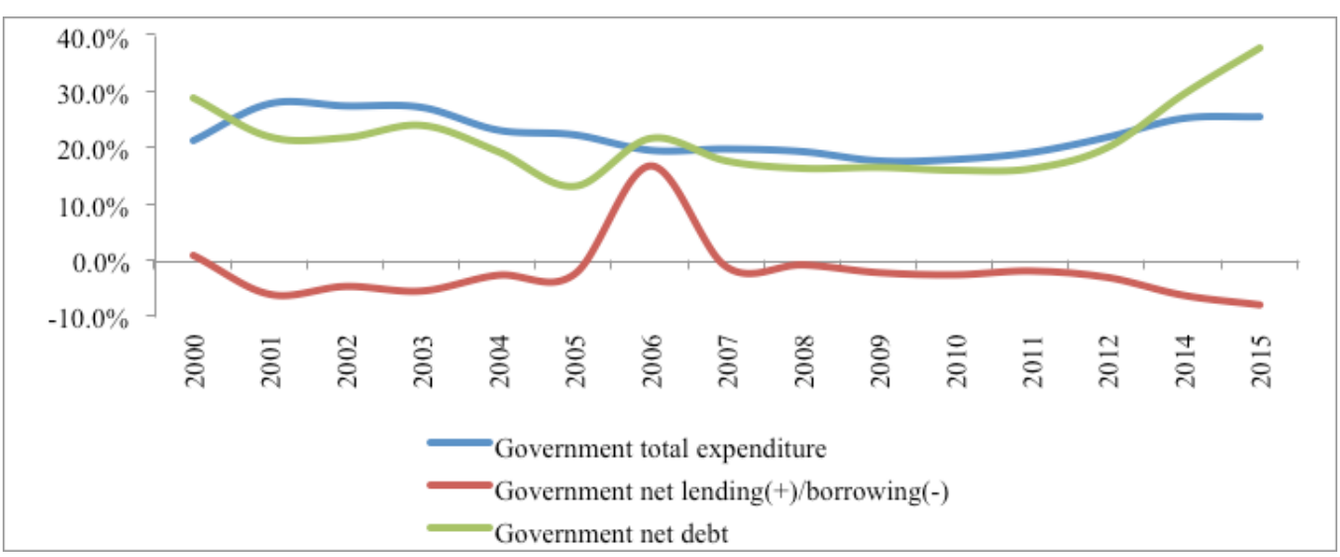
[4]Nash, John (1997) "Zambia", IN John Nash and Faezeh Foroutan (Eds) Trade Policy and Exchange Rate Reform in Sub-Saharan Africa.

The government of the late 1970s diagnosed the basic problem of the country as insufficient investment combined with unfortunate external conditions. No fundamental structural reforms were contemplated. Rather, the government borrowed externally and negotiated several agreements with the IMF to bridge what it viewed as temporary balance of payment shortfalls. These programmes fostered some amount of interim macroeconomic discipline, but this discipline had largely broken down by 1982 when the budget deficit reached 17% of GDP. As such, the domestic policy response to the external shocks of the 1970s was fraught with poor fiscal management, with the Government maintaining high consumption expenditure, maintain a mounting fiscal deficit and resorting to heavy borrowing.

In September 2015, the Bank of Zambia Governor Dr. Denny Kalyalya warned President Edgar Lungu that "Zambia's balance of payments position has deteriorated, reflecting a widening current account deficit... as both traditional and non-traditional exports have declined significantly" and "Imports have declined at a slower pace. As a result, the Kwacha has continued on a depreciating trend". This added pressure for the central bank to occasionally intervene in the foreign exchange market, injecting foreign currency in an attempt to defend the weakening Kwacha and in the process running down foreign reserves.

The fiscal policy response of the Government has been to: maintain consumption expenditure underpinned by an unrelenting appetite to support infrastructure development and public administration expansion; expand the fiscal deficit which is now projected to reach 10% of GDP by 2016; and maintain heavy borrowing and debt accumulation on expensive commercial terms (Figure 3.6). All the key indicators of fiscal performance deteriorated.

Figure 3.6: Selected fiscal policy indicators (% of GDP)



Source: IMF WEO data (Oct 2015 update)

The Government's fiscal response reflects a dichotomous relationship between policymakers and their technical advisors within and outside the Government administration. A Ministry of Finance submission to the Parliamentary Committee on Estimates indicates – that it was becoming increasingly more expensive for Zambia to service its debt repayment obligations and mounting debt that was being contracted to maintain high Government expenditure. Despite this, policy decisions were taken to maintain high consumption expenditure in terms of recurrent spending on fuel subsidies, maize subsidies, electricity importation subsidies, a sizable wage bill and bi-annual interest payments on bonds issued since 2012, among others. Capital expenditures on roads, new district infrastructure and other projects were also unrelentingly maintained as a policy choice.

To make matters more worrisome, the budgetary mismatch between revenue and expenditure has been much too heavily dependent on borrowing to be sustainable. The limited revenue generation options in 2015 created new pressure for debt refinancing at higher interest costs as well as more borrowing. The non-exhaustive (crude and unofficial) list of Cabinet approved external loans in Table 3.1 shows that the Government approved a total external debt contraction level of over US$ 2.7 billion in 2015 alone, with 48% of the external debt being approved in December.

Many observers have questioned the productivity of the mounting debt financing. Similarly, no project feasibility appraisal has been made public thereby raising concern as to whether any socio-economic returns analysis of projects was done. Policymakers have taken borrowing decisions in the absence of a clear base of evidence, and debased all prospects for fiscal consolidation in 2016. Ultimately, partly as a result of a lax fiscal policy, the failing Zambian economy continued to experience a mounting current account deficit.

Table 3.1: Unofficial indication of debt contraction (Cabinet approved external loans), 2015

Date	Source	Amount ($ million)	(% of total)	Purpose
Apr 2015	OPEC Fund for International Development	$14	1%	Water and Sanitation project in Lusaka
Apr 2015	World Bank, African Development Bank	$114	4%	Kariba dam rehabilitation
Jun 2015	African Development Bank	$22.5	1%	Water and Sanitation project in Western Province
July 2015	International Bond Market	$1,250	46%	Infrastructure related projects in roads, energy, education, health, water and transport sectors.
Dec 2015	China	$541	20%	Water and Sanitation projects in Lusaka and Copperbelt
Dec 2015	China	$418	15%	Quality of life project in Lake Tanganyika Basin
Dec 2015	China	$275	10%	Housing construction for security wings
Dec 2015	World Bank	$65	2%	Urban roads in Copperbelt
	TOTAL	$2,700	100%	

Source: Constructed from various media reports

3.2 Supply-Side Causes

The supply-side sources of a current account deficit are sometimes referred to as structural constraints or competitiveness limitations. They are more worrisome causes of a current account deficit than demand-side factors because they are more long term in nature and are therefore more difficult to rectify. Generally, some of the common supply-side causes of a current account deficit include:

(i) High labour costs
(ii) Resources depletion
(iii) Low quality, unreliable production
(iv) Low factor productivity
(v) Low investment
(vi) High levels of inflation

A few examples help to illustrate which factors have been salient in determining the performance of the current account in the Zambian case.

(i) High Unit Labour Costs

High labour wages in Zambia compared to those in competitor economies will, in principle, make it easier for firms in the competitors to produce at lower cost and thus set lower prices on their exports. This gives their exports a significant price advantage, making them more competitive globally than Zambian exports.

Looking at the statutory level of minimum wages as a cursory indicator of labour costs in a country, evidence shows that minimum wages in Zambia are relatively high. From a comparative perspective, Borat et al (2015) find that Zambia's ratio of the minimum wage to the mean wage (Kaitz ratio) is higher than most of its lower middle-income country counterparts. There is also evidence of relatively low wages playing a positive role in the early stages of a country's economic development. For example, Li et al (2012[5]) reveal that after China initiated its economic reforms in 1978, cheap labor played a central role in expanding the economy's participation in world trade as a main driver of growth. At the beginning of China's economic reforms, the annual wage of a Chinese urban worker was relatively low at US$1,004 (before tax, including pensions); and this only rose by 0.1% per year over the next two decades to reach US$1,026 in 1997. After this, the average wage rate was allowed to increase significantly to US$5,487 in 2010. In parallel, minimum wages in China also increased, e.g., from an annual average of US$95.07 in 2004 to US$229.95 in 2015, by 241%. Between the start of the reforms in 1978 and their official end around 1997, China's average real GDP growth rate was 10.1% per annum with a minimum recorded growth of 3.8% during the period. Thus, China took a conscious decision to keep wages low for decades, delaying the wage gratification to its citizens until sustained GDP growth was firmly locked in.

[5]Li, H., L. Li, B. Wu, and Y. Xiong (2012) "The End of Cheap Chinese Labor." Journal of Economic Perspectives, 26(4): 57-74

In striking contrast, Zambia's minimum wages, as set in 2012, was US$140.83 on average. This was only 12 years after the country achieved positive GDP growth. In fact, between the start of Zambia's reforms in 1992 and the time of the minimum wage revision in 2012, the economy's average GDP growth rate was only 4.3% per year, with a minimum of -13.3%[6]. Zambia's wage policy therefore quickly made Zambian labour relatively more expensive even before growth was fully locked in, eroding any chance of export price comparative advantages being formed.

Thus, in this context, as Zambia has continued to import cheap products from lower cost producers like China and simultaneously failed to rapidly expand exports partly due to export price disadvantages underpinned by high labour costs, among other things. This mix has fostered a current account deficit driven by the mounting deficit in the trade account.

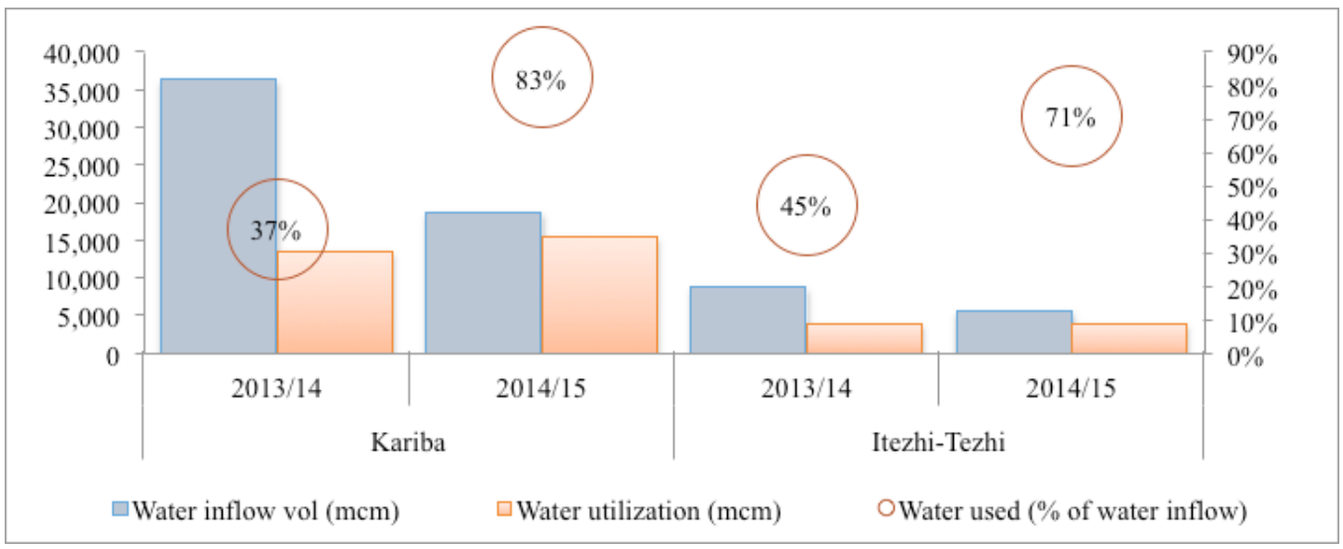
(ii) Resources Depletion

The depletion of resources is another supply-side challenge, which can have far-reaching consequences. A clear example of resource depletion relates to the overuse of water resources in Zambia's main hydropower reservoirs in the first half of 2015. The 2014/2015 rainy season is said to have had lower-than-normal rains. Water inflows into Zambia's main reservoirs for hydroelectric power generation reducing by 35-48% compared to the levels of 2013/2014.

Despite the low water yields, during January and July 2015, the river authorities and national electricity producer ZESCO – who should have been conserving the water resource – depleted about 83% and 71%, respectively, of the water in the Kariba and Itezhi-Tezhi reservoirs (Figure 3.7). In absolute terms, 15.5 billion cubic metres of the water in Kariba was used in the first seven months of 2015 compared to 13.6 billion cubic metres in January-July 2014, which followed a much better rainy season. Similarly, 4.03 billion cubic metres of water were depleted from Itezhi-Tezhi in January-July 2015 compared to 3.9 billion cubic metres in the first seven months of 2014.

[6]Calculated based on IMF WEO data.

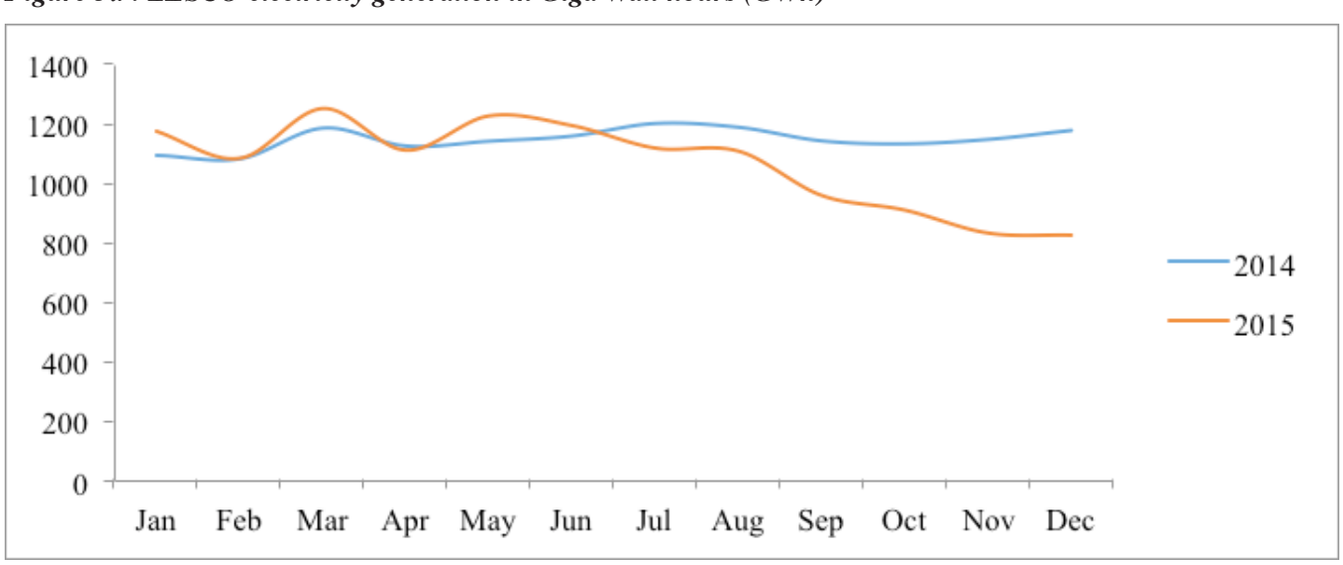
Figure 3.7: Water inflows and water utilization during January to July of each season



Source: Constructed from ZESCO data

By May 2015, Zambia was running very low on water. Electricity production declined dramatically in the second half of 2015 as a result of the costly mistakes in the first half (Figure 3.8). As such, by July 2015, the country had turned from a net exporter to a net importer of electricity. Media reports quoting Government officials as announcing that Zambia would import US$18.2 million worth of electricity per month from about December 2015 onward. This put additional pressure on the import bill, which added to the already deepening current account deficit.

Figure 3.7: ZESCO electricity generation in Giga Watt hours (GWh)



Source: Constructed using ERB Statistical Bulletin data

Compounding the external imbalance problem, the resource depletion, a number of knock-on or confounding effects ensued. Severe power rationing or "load-shedding" was initiated from around June 2015 in an attempt to conserve the remaining water reserves. Production and productivity for export and for the domestic market fell sharply and the cost of production increased, making Zambia's already uncompetitive exports even more so. Crude estimates by local commentators in Zambia suggested that the load-shedding alone reduced industrial productivity in manufacturing and agro-processing by between 30-70% between June and October 2015; it would possibly cost the economy US$4.3 billion in lost GDP by the end of the year, implying a 16% reduction in the estimated end-year nominal GDP.

In turn, the economic malaise meant less tax revenue collection from companies, given their lower performance on turnover and profit. Resultantly, this too added to the mounting fiscal challenges and further constrained the Government's capacity to repay its debts. It also shook investor confidence, particularly with international credit rating agency Moody's downgrading Zambia's B1 rating to B2 in September 2015. All this passed through to the balance of payments as a weakening external position as Zambia spent more abroad (on mounting energy and consumer goods import bills, increasingly more costly debt repayment and so on) than economic players were able to bring into the country as export earnings and capital inward flows.

(iii) Low Quality Goods and Unreliable Production

The preferred quality of a good is determined by consumers, meaning that any producer that would like to increase the chances of selling her goods must understand the quality preference of her would-be consumers. The reliability of production therefore entails matching the supply of given goods with consumer preferences or expectations on quality, timely availability and quantity of good. Usually, modern economies will establish a bureau of standards to technically elaborate and document all the quality standards that reflect the preferences or expectations of consumers in the country. With the advent of globalization aided by a massive expansion of information and communication technologies that have fostered consumers in different parts of the world to readily mimic each other's consumption habits, typically, the standards bureaus have to cross-reference and match local quality standards with international standards.

The standards bureau's other job is to then relay this information about domestic and international quality standards to producers interested to supply goods to the country or to the global economy. This allows producers to improve their awareness about what is expected and thus helps them to improve the reliability of their production in compliance with the consumer preferences and expectations.

In many economies in the world, the standards bureaus have become a cornerstone for export oriented development. They are very well resourced and work jointly with private sector market research and research & development (R&D) companies to decode and document consumer preferences. Billions of US dollars are spent towards tapping into the consumer's psyche with a view to establishing what

consumers want and what they like. Ultimately, this is a key determinant of export performance and thus the balance of payments.

In the recent past Zambia has put forward considerable support to the Zambia Bureau of Standards (ZABS), a statutory national standards body under the Ministry of Commerce Trade and Industry (MCTI). Out of the nine statutory bodies under MCTI, which jointly took up 76.6% and 68.9% of the total MCTI budget head allocation in 2015 and 2016, respectively, ZABS was allocated the largest proportions during both years (Table 3.2).

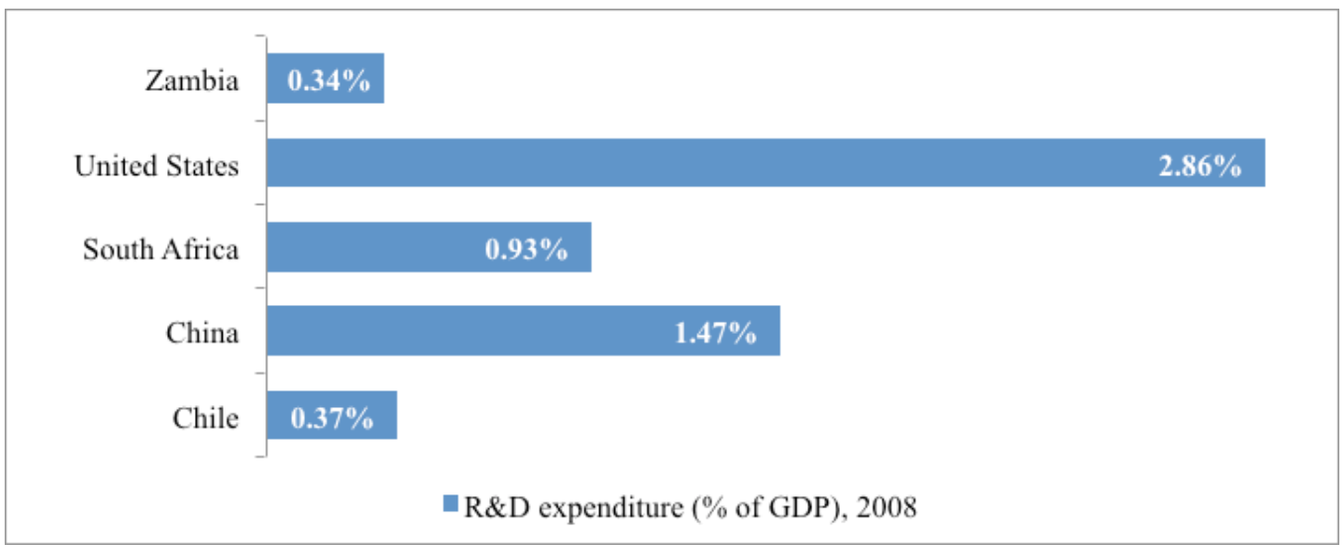
Table 3.2: GRZ Grants to MCTI Statutory Institutions – Operational Activities

	2015		2016	
	ZMW	(% of MCTI Head Total)	ZMW	(% of MCTI Head Total)
1. Business Regulatory Review Agency	2,147,195	0.7%	4,147,195	1.3%
2. Citizens Economic Empowerment	15,000,000	5.2%	14,572,523	4.6%
3. Zambia Bureau of Standards	68,184,540	23.6%	65,757,063	20.7%
4. Zambia Development Agency	22,891,504	7.9%	26,891,504	8.4%
5. Zambia Weights and Measures Agency	21,305,144	7.4%	20,305,144	6.4%
6. Competition and Consumer Tribunal	1,250,000	0.4%	1,250,000	0.4%
7. Competition and Consumer Protection	30,884,400	10.7%	30,456,923	9.6%
8. Kaizen Institute of Zambia	2,000,000	0.7%	2,000,000	0.6%
9. Patents and Companies Registration	57,316,901	19.9%	53,889,424	16.9%
Programmes, Total	***220,979,684***	***76.6%***	***219,269,776***	***68.9%***

Source: Extracted from 2016 Yellow Book, with modifications

However, Zambia still trails considerably far behind other countries in terms of investing in 9research and development (Figure 3.8). The country would have to invest a lot more financial resources, human capital and time/effort into research, development, innovation and technological adaptation, towards producing world-class goods that are highly preferred by domestic and global consumers. This will be critical for the country to expand its export competitiveness and foreign exchange earnings and to improve its external balances.

Figure 3.9: Research and Development Spending, Selected Countries



Source: Constructed from World Bank WDI database

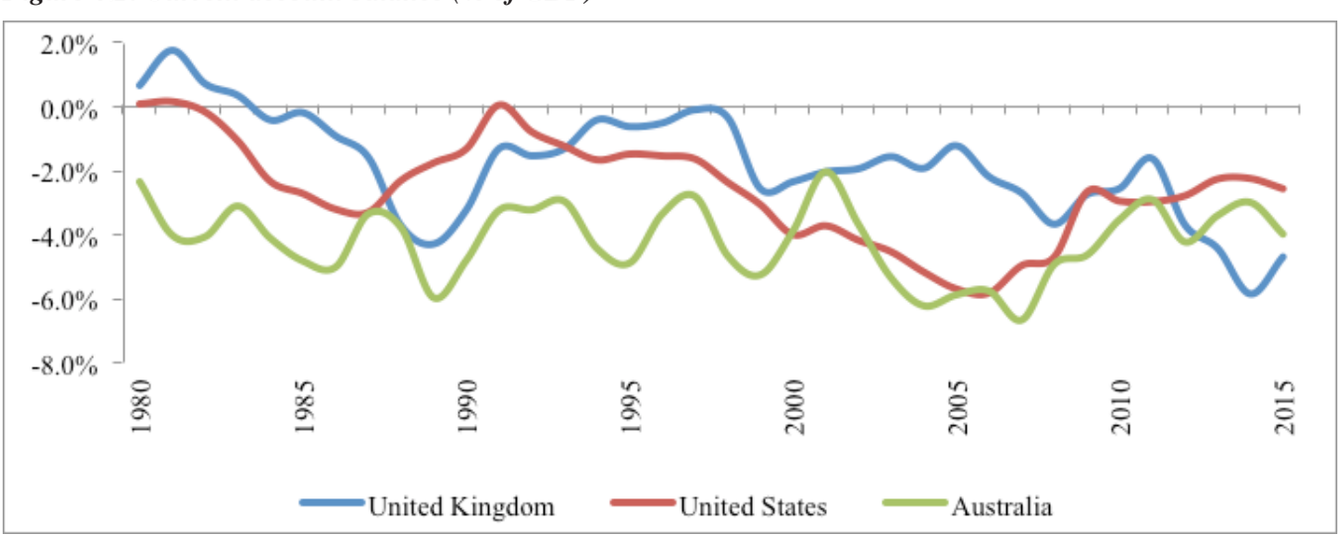
As earlier highlighted, the forgoing examples of supply-side source of current account deficits simply illustrate some of the main long-term causes of Zambia's deepening current account deficit. Additional examples relating to other aspects of supply-side constraints – such as low investment and low productivity – can similarly be presented. However this would provide little additional value-added beyond simply emphasizing that supply-side constraints are long term and therefore relatively more difficult to rectify than demand-side factors. Since the points have already been made, we turn now to a consideration of the conditions under which a weakening current account position becomes a crisis.

4. Mounting Current Account Deficits and Balance of Payments Crisis

A risk associated with a current account deficit is the possibility of the deficit turning into a crisis. A balance of payment crisis is when a country is no longer able to cover its import bills based on its export earnings and/or to service its debt repayment obligations. In this instance, foreign exchange reserves have fallen significantly, the currency has lost a considerable amount of its worth and the country is no longer able to attract sufficient capital inflows to finance the current account deficit; thus, the current account deficit can no longer be sustained. As such, the economy literally falls into insolvency and starts to default on its external payments obligations.

It is important to remember that a current account deficit will not necessarily always lead to balance of payments distress or to a crisis. Australia, the United States, the Unite Kingdom and other advanced economies have maintained current account deficits for prolonged periods (Figure 4.1), but have generally not fallen into balance of payments crises. This is mainly because they have simultaneously pursued domestic policies that ensure market confidence and private sector viability, which in turn have fostered compensatory portfolio investment and FDI inflows into the financial accounts of their balance of payments. Granted, some big economies like Australia, and the United Kingdom have come under increasing balance of payments distress in recent times, with dual positions among the top-5 current account deficit economies and the top-5 deficit net international investment position (IIP) economies in the world in 2014. These developments as well as the policy responses of the countries will be important to watch, particularly in the light of the US Federal Reserve's decision in December 2015 to finally raise interest rates for the first time since the 2008 financial crisis and global recession.

Figure 4.1: Current account balance (% of GDP)



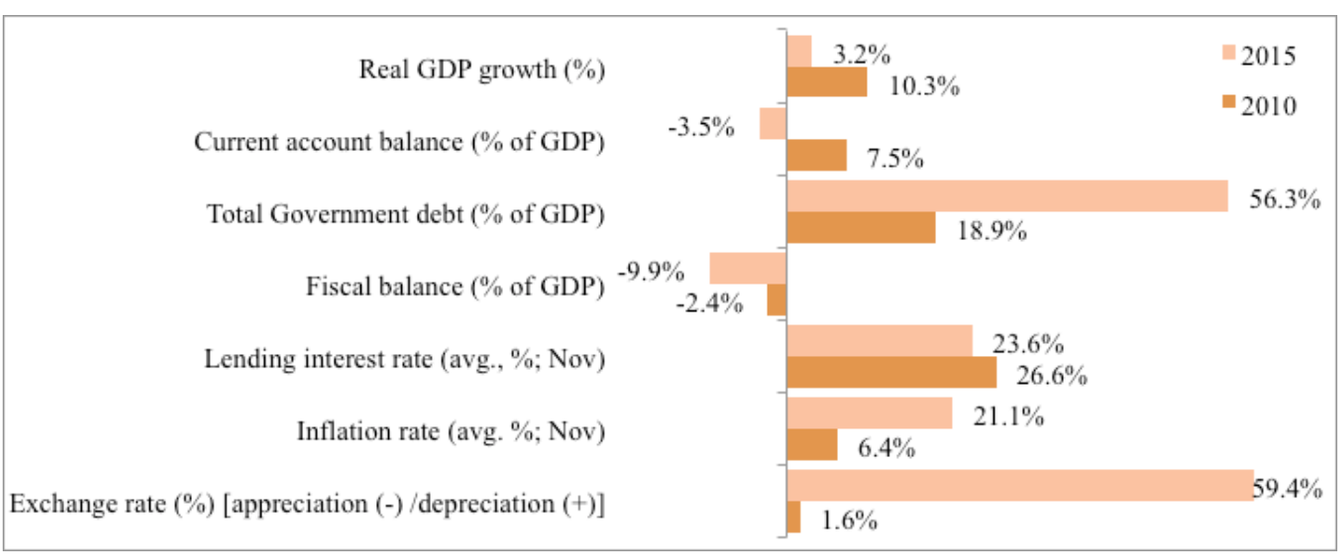
Source: IMF WEO data (Oct 2015 update)

The general point, however, is that a current account deficit need not deteriorate into a crisis; policy interventions can be sought and applied. What is important is to compensate for these deficits by firstly ensuring the deficits are a small part of the total GDP and secondly by establishing an environment for maintaining healthy financial accounts balances, mainly through focus on encouraging FDI, and less reliance on short-term portfolio investments – into Government securities and investments that come as loan financing like the non-concessional Eurobonds – which add to external debt stock. The latter quickly erode financial account health once debt interest repayment obligations start to fall due.

As Zambia experienced the most severe economic downturn in the post-liberalization (post-1991) era and just about all of macroeconomic indicators significantly deteriorated in 2015 (Figure 4.2), concerns began to abound that the country may be falling into a balance of payments crisis. Many stakeholders therefore asked whether Zambia was falling into a balance of payments crisis. The sought insights about what policy measures should it apply in order to rectify the mounting external imbalance.

Firstly Zambia did get to a point of near balance of payments crisis judging by a few press warnings by the Bank of Zambia Governor in September 2015 and the Ministry of Finance in January 2016. Considering that balance of payments crises are typically accompanied by rapid declines in the value of the affected country's currency, the marked fall of the Kwacha seemed, at least for a time, to underlie much bigger problems in balance of payments. More fundamentally, as is typically the case in a balance of payments crisis, Zambia's mounting external imbalances were preceded by large capital inflows into the financial accounts, including through the acquisition of three sovereign (Euro) bond debts (US$750 million in 2012, US$1 billion in 2014 and US$1.25 billion in 2015) and the contraction of other external debts (see, Table 4.1 for examples). The borrowing was initially justified on the basis that the country's bid to sustain and accelerate the rapid economic growth was an imperative. However, it is becoming increasingly more difficult to service the debt as the Kwacha depreciates and obligations denominated in the reserve currency (the US dollar) become more expensive.

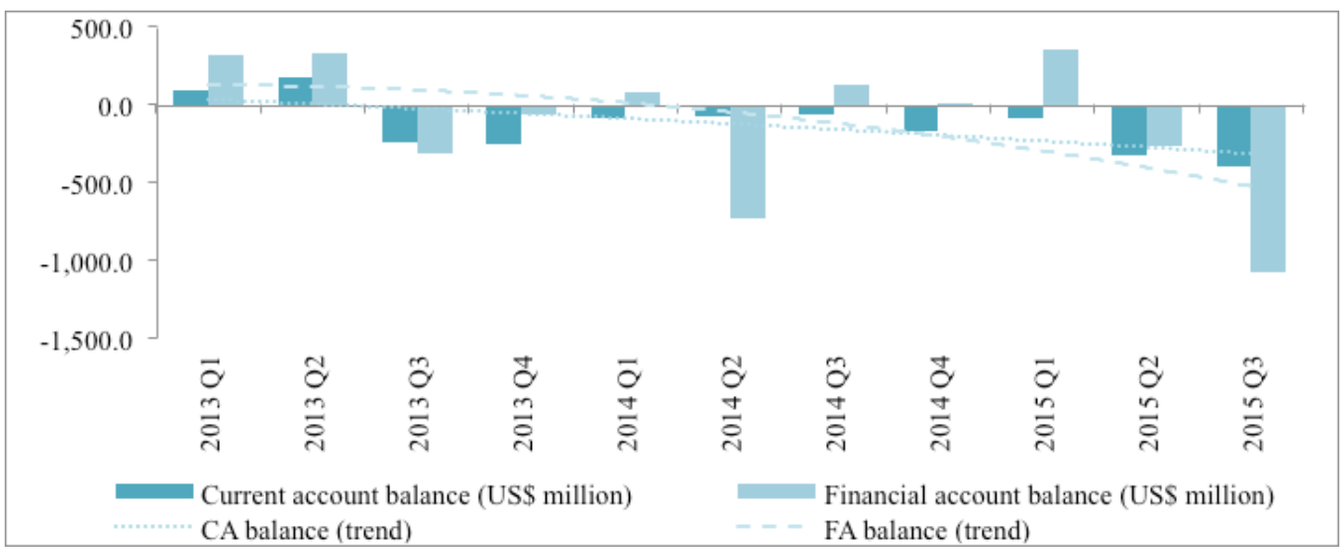
Figure 4.2: Selected macroeconomic performance indicators



Source: Constructed from CSO, BOZ, IMF and MOF data sources

Secondly, in the second half of 2015 a point came when overseas foreign investors and creditors began to worry that the overall excessive debt that their financing was contributing to was becoming unsustainable. The joint effect of interest repayments on external debt and investors pulling out their existing investments saw dramatic monetary outflows from the financial accounts of the balance of payments (Figure 4.3). The net monetary outflow from the financial account reached US$1.1 billion in the third quarter of 2015 alone. The outward bound capital flows readily caused challenges for the Government and for the domestically domiciled firms. The financial gains from various mixes of inbound FDI, portfolio investments and loan holdings were eroded and the inbound flows were reversed.

Figure 4.3: Current account and financial account monetary flows



Source: BOZ BOP Tables

To make things worse, the depreciation of the Kwacha by 36% in the third quarter of 2015 implied that the settlement of foreign currency denominated external payment obligations became more expensive given that firm and public sector revenues are typically derived from domestic sources in Kwacha terms while the external obligations (outbound capital and debt) are denominated in a reserve foreign currency. At the same time that investments were being pulled out of the financial accounts, Zambia partially ran down its foreign reserves trying to support the value of the Kwacha.

Although international reserves depleted intermittently, they did not run down completely. In fact, the monetary authorities managed to defend the external reserves position. However, after the July 2015 Eurobond injection, few options for foreign currency inflows emerged during the year. The economy drifted precariously close to a point of current account crisis in 2015, but a full-blown crisis did not occur.

5. Policy Options in the Wake of Severe External Imbalances

Once a balance of payments crisis sets in, policy response options become very limited and difficult to implement, more so because the short-term payments crisis is often underpinned by longer-term structural imbalances in the economy, as earlier explained. The dual presence of a short-term instability and long-term structural rigidities makes it that much harder to decide on and implement the few policy options available to address the external imbalance.

Some of the policy response options that have been posited for managing balance of payment distress include the following:

5.1
Demand Management: Monetary and Fiscal Policy Responses

In an external balances crisis, demand management policy or expenditure-reducing strategy can be used. A country can, for example, raise its interest rates to prevent further declines in the value of its currency and thus reduce the adverse effects of increasingly more expensive foreign currency denominated payment obligations (debts, import bills and capital outflows), which would otherwise happen during a rapid currency depreciation. In the absence of capital controls, the Bank of Zambia, in an attempt to dually curb inflation and defend the Kwacha, raised the policy interest rate from 12.5% to 15.5% in November 2015 and applied a number of other contractionary monetary policy measures. Although these policy responses did not immediately curb the rising inflation, which had increased sharply from 7.3% in August to 19.5% in October and further increased to 21.1% in November, they did work to fairly quickly stabilize the Kwacha at around ZMW11 per US$ by the close of 2015 thus stemming the rapid depreciation. The trade-off of this contractionary stance was that credit to the private sector was also severely constricted, further depressing an already subdued economy.

Since monetary policy was already contractionary, other demand management options essentially would have entailed the application of contractionary fiscal policy (such as reducing government spending and/or raising taxes). Unfortunately, the balance of payments imbalance emerged in Zambia prior to a presidential election year. Policy-makers were therefore unable to muster the will to undertake short-term policy reforms such as expenditure-cutting or tax revenue–raising measures to address the external payments imbalance. The political risks of becoming socially unpopular so close to an election were just too great for any real fiscal adjustments to be initiated

5.2 Protectionist Trade Measures

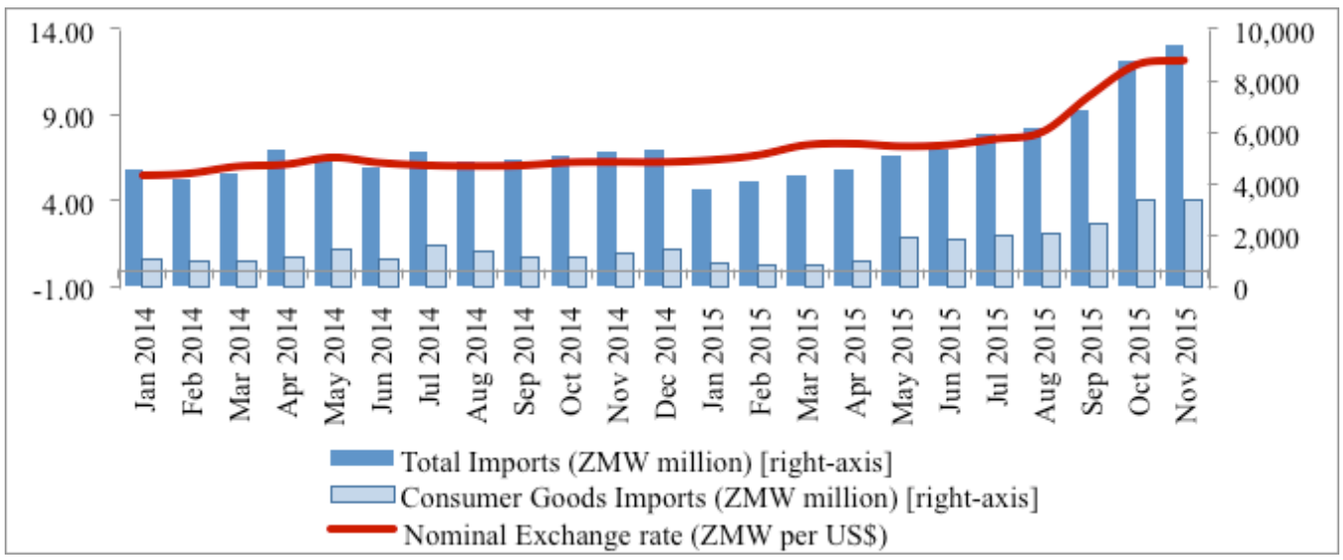
Protectionist trade measures are economic policies that restrain or reduce trade between countries. They include tariffs on imported and/or exported goods and services, restrictive quotas and a variety of other government regulations designed to prevent free international trade. Proponents of protectionism believe that such measures allow fair competition between imports and goods and services produced domestically; they protect the businesses and workers within a country by restricting or regulating imports from foreign nations.

Generally, such measures face strong international opposition, notably the World Trade Organization (WTO). They are generally highly unpopular among the multilateral institutions. The WTO believes that global free trade remains one of the most important engines of national, regional and global growth. "The relevance of trade to global growth has been confirmed by the experiences of many countries, particularly in Asia. In the aftermath of the crisis in 2008 it was, after all, the Asian economies that led global growth by continuing to keep their markets open and using trade as a policy instrument for recovery". Furthermore, WTO believes that actions to the contrary – closing markets, erecting barriers and promoting protectionism [tariff, quota and other trade barriers] – could have had an adverse impact on the global economy.

Irrespective of whether one is a proponent or an opponent of protectionism, it remains true that in a time of balance of payments crisis, protectionist trade measures can help to manage the problem. As was earlier seen, imports are the most significant contributor to a current account deficit. Thus, if economic agents cannot be influenced indirectly through economic adjustment mechanisms such as a depreciating exchange rate, then direct regulations might be an imperative.

In Zambia, imports were sensitive to the depreciation of the Kwacha even through importing became increasingly more expensive as the local currency lost value. Notice the sharp growth in the volume of both total and consumer imports in Figure 5.1 despite the rapid depreciation of the Kwacha after August 2015. It may be necessary to force a reduction in imports, through temporary trade restraints. For selected imported goods particularly non-essentials, tariff escalation will be an effective option for reducing demand while for those that are highly price inelastic, quotas could be more appropriate. Rapid analysis of the broad economic (functional) classifications of Zambia's imports and their respective price elasticities of demand will be necessary in order to establish where tariffs and quotas will be most appropriate. As Figure 5.1 indicates, the kwacha-dollar exchange rates show a co-movement with imports so that as imports increased (relative to exports), the exchange rate was also on the upswing (i.e., depreciating). However this does not go to say that the inelastic import demand caused the depreciation or vis-a-versa.

Figure 5.1: Recent monthly trends in imports and the nominal exchange rate



Source: Constructed from CSO and BOZ data

Another protectionist trade measure will be to offer bailout packages or subsidies to selected domestic producers, particularly those producing for export and earning foreign exchange for the country as well as those producing strategic import substitutes. Subsidies to the private sector – though outlawed by the WTO – are better for development in the long term than consumption subsidies on fuel, electricity, food reserves and so on. However, they may come with many costs: These including:

- The WTO, to which Zambia is a member, using legal recourse to take the country to task in accordance with international trade laws;
- Retaliation by trade partners, including using legal actions through the regional economic communities (COMESA and SADC) that Zambia is a member of;
- Goods shortages and imported inflation if domestic substitutes for some of the restrained imports cannot be made immediately available; and
- Domestic producers becoming lazy perpetual "infants" under trade protection.

In weighing the costs of protectionism against the benefits it is important to recognize that most of these costs can be mitigated through careful research and planning. Ultimately, protectionism is a feasible temporary policy response option for Zambia during the external balances problem.

5.3 Supply-Side Policy Measures

Supply-side policy responses for Zambia would include business and competitiveness reforms that improve the productive capacity, efficiency, ease of doing business and competitiveness of the private sector. A variety of specific options include policies that improve the availability, quality and price competitiveness of factor inputs (labour, capital, technology, energy, transportation, telecommunication, finance and other services, etc.). For instance, in relation to labour, programmes on wage management,

education, skills development and knowhow accumulation come to mind. As a long term structural policy measure, it would help to consciously delay wage increases until the economy has demonstrated sustained real growth rates. To improve the availability of credit and term financing and to attract foreign, cross-border and domestic investments, policies for industrial reorganization, investment and trade are viable options; but they typically take time to yield results.

These supply-side policy measures address a balance of payments challenge by revitalizing and enhancing the productive capacity of the economy, particularly the private sector's efficiency, vibrancy and profitability. That is, they create a stable business environment in which private firms can operate efficiently, effectively and productively, ultimately fostering economic growth. With greater efficiency, productivity and outputs, domestic tax revenues are enhanced over time, creating scope for the domestic economy to readily honour external payment obligations, which have a bearing on the balance of payments.

However, these measures are expensive, take long periods of time and offer no guarantee of compelling the private sector to act. For instance road infrastructure development, a popular undertaking in Zambia, is very expensive and time consuming, and it may or may not yield the desired supply response that policy-makers hope for. Typically, this will only happen if the private sector – as the main targeted user of roads – can be nurtured and "nudged" in complementary (private sector development) ways to improve other aspects of its supply responses. This might be through various structural policy interventions such as the provision of public information and knowledge through public financing of research and development. It would be through investment in complementary infrastructure like storage facilities, warehousing and other housing infrastructure, energy infrastructure, cold-chain facilities, telecommunication infrastructure and so forth. Indeed, structural policies have a key role to play in fostering entrepreneurship, knowhow and experience, market coordination and organization, market intelligence, and other soft-infrastructure aspects.

Zambia was already on a path of massive infrastructure development when the recent macroeconomic instability of 2015 emerged. The mood of policy-makers seems to be that of maintaining the high fiscal spending on infrastructure projects during the crisis, even if it means massive external borrowing (recall Table 3.1). Their success in contributing towards addressing the crisis will critically depend on the private sector supply-side responses, which the projects will actually foster. As such, in order for the infrastructure investments to yield economic returns, the Government will now have to think seriously about strategies for galvanizing the private sector and spurring it to take the export and domestic production opportunities.

5.4
Maintaining a Flexible Currency and Allowing Depreciation

Maintaining a flexible local currency and allowing it to depreciate to its competitive long-run equilibrium relative to the reserve currency or major trading currencies is another policy response option during a balance of payments problem. To some extent, Zambia has pursued this policy, with the Bank of Zambia avoiding excessive interferences in the foreign exchange market. However, in line with its mandate to promote price stability, the central bank has occasionally been forced to intervene in the financial markets in order to smoothen out adverse short-term fluctuations.

As earlier indicated, the losers in a free-float foreign exchange policy scenario would be importers and those holding foreign currency denominated debt, particularly the Government in the Zambian case. At the aggregate level, the costs of the currency depreciation may be partially offset by the gains to winners – export producers and domestic producers of import substitutes – if the winners can readily make supply-side adjustments in response to the opportunities to export more or to supply more to the domestic market.

If robust supply-side responses can be fostered through complementary supply-side reform measures (recall Section 5.3), then some of losers in the currency depreciation like the Government can later raise domestic taxes and earn more domestic revenue to settle their external obligations. Thus, as a policy option, allowing the currency to depreciate cannot be conceived as a stand-alone policy otherwise it will be ineffective. Taken together with supply-side policies, it can support the balance of payments, but over relatively long time horizons in tandem with the supply-side policies.

5.5 Seeking External Assistance as an Option

Another policy option during a balance of payments crisis is to seek external assistance from the international community as Ghana did when it obtained US$918 million support from the International Monetary fund (IMF) in 2015. On the multilateral front, the IMF is perhaps the first-line option for external imbalance stresses. It was established with the main purpose of ensuring the stability of the international monetary system, a system of exchange rates and international payments that enables countries and their economic agents to transact internationally. The IMF's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability. As such, the IMF keeps track of how the trade and investments flows of all economies interact within the global economy, its monetary system ensuring a stable, coordinated and smooth running set of global processes of exchange rates and international payments.

Recognizing that even the best economic policies cannot completely eradicate instability or avert crises, if a member country faces a balance of payment crisis, the IMF can provide financial assistance to support policy programs that will correct underlying macroeconomic problems, limit disruption to both the domestic and the global economy, and help restore confidence, stability, and growth. The

IMF also offers precautionary credit lines for countries with sound economic fundamentals for crisis prevention.

Zambia became a member of the IMF in 1965 and secured its first balance of payments lending support arrangement from the IMF around 1973. It therefore has had a long history with the IMF, having benefited from various arrangements for nearly 40 years, between 1972 and 2011. The latest financial (lending) arrangements between the IMF and Zambia expired in 2011, although some loan repayments are still scheduled until 2020.

With Zambia's economic situation pointing to a dire need for the authorities to approach the IMF regarding an economic recovery programme, the authorities finally took the inevitable decision. In February 2016, the Cabinet authorized the Minister of Finance to engage the IMF and negotiate an economic programme within 2016. However, with 2016 being an election year, the negotiation of an IMF-supported programme was deferred to early 2017.

Other multilateral aid and bilateral aid programmes are feasible options for cushioning the effects of the economic malaise. However, these options are not available for direct balance of payments or fiscal support. This is because all external financing arrangements meant for direct budget support or balances of payments support get their signal from the IMF as the lead multilateral institution on financial matters. Therefore, other than social, infrastructural and other sectoral projects and programmes that are directly controlled by respective donors, external programmes and projects would only be established subsequent to an IMF-supported programme.

6. Conclusion

This paper sought to explain the fundamental elements of Zambia's balance of payments. It gleaned insights into the performance of Zambia's external economy through an assessment of the accounts of the balance of payments. It described the recent outturns in the balance of payments and highlighted some of the main drivers of imbalances in the different accounts. The paper explored a number of policy options that are relevant for Zambia, towards addressing the emerging balance of payments imbalances.

We observed that the most dominant account of Zambia's balance of payments is the current account. The monetary transactions in current account amounted to an annual average of 76.9% of the sum total of all balance of payments transactions done between 2009 and 2014. These transactions were led by merchandise goods trade transactions which were 62.7% of all external payments transactions. The current account—the trade balances in particular—is the key indicator of the performance of Zambia's external economy.

Since 2013, a deepening current account deficit is observed, which closed 2015 at minus 3.8% of GDP. The deepening deficit means Zambia is become increasingly less able to pay for its imports out of its export earnings. The causes of the deepening current account deficit in recent times are therefore important to explore and understand. On the demand-side, some of the main observed sources of the current account deficit include the following:

- *Robust domestic growth and persistently high import demand, particularly urban demand* for finished consumer imports. The solutions to this were seen as import demand management trade policies (incentives and regulations), to curb the high levels of public and private importation and relieve the outflows from the current account. Contractionary fiscal and monetary policies were also discussed.

- *A recession abroad* particularly the slowdown in China, which pushed down global copper prices and reduced Zambia's copper export earnings, and further deepened the trade and current account deficits. Unfortunately, Zambia has little within

- *Adverse currency speculation*, which, in the absence of public information and sensitization with the public in the past (1993-2011) helped the authorities to manage market expectations and anxieties. Consistent information sharing with the public is crucial for managing market expectations and preventing adverse expectations from forming and filtering through to the CA as a deepening deficit.

On the other hand, some of the common supply-side causes of a current account deficit include: high labour costs; resources depletion; low quality and unreliable production; low factor productivity; low investment; and high or rising inflation. For example, Zambia is a relatively high-wage economy, which has led to uncompetitive production and exports. A specific long term structural policy measure would be to consciously delay wage increases until the economy has demonstrated sustained real growth. Another specific structural measure policy would be to improve resource management to avert resource depletions.

From the country's recent balance of payments performance, the writing on the wall is that Zambia is on the verge of a full-blown balance of payments crisis. With its reserves fast depleting and few options for foreign currency inflows, the economy is now a precarious position where it faces increasing risks of default on payment obligations on debt, outbound investments and imports are not farfetched. Some of the feasible options available for Zambia for managing the balance of payments challenges include:

- *Temporary and selective protectionist measures:* this could be through selective import tariff increases that are applied on non-essential classes of goods; enhanced public procurement management to curb public sector import propensities, especially the affinity for top-of-the-range, high-end off road (4X4) motor vehicles for public service officials who work predominantly in urban Zambia; quota restrictions on strategic goods with domestic substitution potentials; and private producer subsidies. All these are feasible temporary policy response options for Zambia during the current external balances crisis, which can even justified to the WTO in relations to various safeguards for economies in distress at that level (but the case for this would have to be clearly and empirically elaborated);
- *IMP balance of payment support:* Seeking balance of payments support from the IMF is another policy option for Zambia, and movement towards establishing an IMF-supported programme has already begun with the authorities having invited the engagement. Of course, the programme will most likely include conditions of fiscal adjustments and fiscal discipline. As such, the Government should mount a well-informed, empirical negotiating position to safeguard high-priority and sensitive domestic interests.
- *A range of supply-side policy responses* are feasible option for Zambia currently, but the country has already been pursing some of these policies mainly as infrastructure projects. The success of such policies in contributing towards addressing the balance of payments challenges will critically depend on reprogramming them as long-term economic restructuring policies and undertakings.
- *Maintaining the flexible and competitive Kwacha* that is allowed to depreciate and find its long-run equilibrium is another feasible policy option.

These recommendations are put forward as policy options that the authorities can explore, further elaborate and apply. Ultimately however, the policy options that Zambia will adopt, if any and the actions it will pursue are political choices. This paper offers insights with which policy-makers and politicians can make informed decisions.

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