THE SEQUENCING OF ECONOMIC REFORMS: LESSONS FROM ZAMBIA

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ABSTRACT

Many development economists believe that there is, or ought to be, an optimal sequence of policy reforms for countries that are in the process of structural adjustment. There are now many theoretical approaches to economic policy and/or economic growth which allow the derivation of optimal paths of growth and development. Sequencing theory is meant to provide optimal transition paths for adjusting economies.

There is, however, no theoretical basis for deriving optimal sequences of reform. If reform succeeds, it will change the structure of an economy. Thus, it is impossible to derive any reform path which has been optimally sequenced in advance. (The “Lucas critique” takes on another guise.)

This paper examines the history of economic reform in Zambia to determine whether “optimal”, or even “sub-optimal”, sequencing has been important in the design of policy reform. The results are consistent with a growing literature which suggests that economies undergoing economic reform follow a variety of adjustment paths, none of which were optimally determined in advance.

The results reconfirm that the general idea that economic reform is an adaptive, eclectic, process which succeeds though continual monitoring, review, and revision of policies. Some sequencing of policies can always be shown to have occurred after the fact. What cannot be shown is that sequencing is an important element in determining the outcome of policy reform.

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1. Introduction

This essay examines Zambia's experience with economic adjustment to highlight lessons about the sequencing of policy reforms. Concern about this issue among development economists results from the presumption that there is, or ought to be, an "optimal" or "sub-optimal" path to reform.[1] Zambia's experience, however, adds further weight to the mounting evidence that such paths do not exist.[2]

For many years, Zambia was a chronic non-reformer. Over the period 1976 to 1991, the Kaunda government adopted seven donor-supported adjustment programmes. Each programme comprised policy measures designed to reduce the economy's internal and external imbalances and restore the conditions for sustainable growth. Each was abandoned, reinforcing Zambia's economic decline.

With the restoration of multi-party democracy and the change of government in October 1991, Zambia adopted a structural adjustment programme (dubbed the "New Economic Recovery Programme") which, with minor hitches, has been implemented ever since.[3] Indeed, towards the end of 1995, Zambia expects to complete a Rights Accumulation Programme with the International Monetary Fund (IMF) and begin an arrangement under the Enhanced Structural Adjustment Facility.[4] This will be a major step in normalising relations with the international financial community.

Economic reform is meant to fundamentally alter a country's growth prospects. In principle, reform is <u>not</u> primarily a means of satisfying external creditors. But, because of Zambia's poor credit standing, a practical pre-condition for the resumption of sustained growth is for Zambia to re-establish a reputation for responsible financial behaviour.[5]

A major objective of Zambia's reform programme has been to gain regular access to international finance. Due to the debt overhang, Zambia cannot finance its economic imbalances independently of donor support. This has constrained the timing and direction of economic reform. Indeed, an over-riding consideration in framing the adjustment package has been to adopt a set of measures which the international community accepts as being credible and sustainable. The sequence of reforms within that package has been an incidental consideration.

The essay is arranged as follows. Section 2 briefly discusses what the sequencing argument implies. Section 3 reviews Zambia's economic performance up to October 1991. Section 4 examines the policy reforms which have been implemented since then. Section 5 derives lessons about the sequencing of reforms based on Zambia's experience. Section 6 considers some outstanding questions related to sequencing and outlines a "pragmatic" approach to policy change. Section 7 has concluding comments. Four annexes expand on points raised in the text.

2. The Sequencing of Economic Reforms

Arguments that policy reforms have to be sequenced have arisen only recently.[6] The main focus of research has been to establish the existence of sequences of policy reforms, variously described as "proper", "optimal", "sub-optimal", "appropriate", "right", or "correct"[7], which developing countries should follow to move their economies from instability and decline to sustainable growth paths.[8] (Annex A give examples of sequences from the literature.)

When viewed in broader terms, policy sequencing is a sub-set of the more general problem of how economies achieve (or return to) particular growth paths. This problem (which is surveyed in Annex B) has a rich history dating from the earliest theories of growth and development.

At the outset, it should be understood that some sequencing of policy reform is required. All relevant policies cannot be changed at the same time without producing chaos.[9] Moreover, there are limits to the capacity of any government to administer policy change.[10] Thus, actions have to be spread out or "phased".[11] Time is also needed to monitor the outcomes of the changes being made.[12]

Similarly, it is now well understood that economic adjustment requires numerous complementary changes. All economies consist of inter-linked markets, institutions, and organisations. Changing one policy at a time, in such a setting, is ineffective and often counterproductive.[13]

Since neither of the extreme positions, i.e., change everything at once or one thing at a time, has any practical relevance, there would appear to be a broad field over which sequencing could apply. The basic sequencing argument is that there is (or ought to be) a widely applicable, clearly identifiable, set of policy and institutional changes which, if implemented in a pre-determined order, will "optimise" the pace and direction of economic reform.[14] Accordingly, the literature makes frequent reference to the need for "correct" sequences and (so-called) "mistakes" in sequencing are highlighted. In fact, in some areas such as those related to trade, finance, institutional development, and the role of stabilisation in structural adjustment, the literature is often dogmatic.[15]

Moreover, comparative analysis typically shows that certain sequences of policy changes (especially those which emphasise fiscal prudence) have helped a large number of countries achieve (or return) to sustainable growth paths. Since growth and reform are such amorphous concepts, all countries which have grown or reformed, in some sense, will have "got the sequences right" even if by happenstance or accident.

The basic issue, however, is not what happened; it is what will happen. Proponents of sequencing assert that there are optimal sequences that can be planned in advance. Verifying this proposition is difficult.

As an empirical matter, different countries might follow similar sequences of policy reforms which are shown, after the fact, to have "worked". Yet, this does not imply that the sequences are "optimal" or, even, "correct".

Three other objections can be raised. First, optimal policy sequencing lacks a theoretical foundation. Second, differences in access to financing across countries can significantly modify the timing of policy adjustment. Each country's policy sequence is, therefore, path-dependent. Third, reforming governments in Africa have so little credibility, that attempts to implement a "planned" sequence of policy changes will more frequently generate skepticism rather than consensus. "Planning" in Africa as undertaken by governments has almost invariably aggravated the economic decline. That is, even before it is attempted, such a "planned" approach to reform is unlikely to succeed.

a. <u>The Theoretical Foundation of Sequencing</u>

One problem with the idea that there is an "optimal" sequence of policy reforms is that it has no theoretical foundation. If such a foundation were to be developed, it would be derived within a dynamic programming (or optimal control) framework. The objectives of reform would be clearly specified (in a measurable way); there would be information on the initial structure of the economy; and the time paths of the various constraints on the economy would be known. The policy variables, or instruments of reform, would also be known.

In principle, such a multi-dimensional, dynamic model would yield a series of "optimal continuations" which balance the relative costs and benefits of changing the instruments (i.e., implementing specific policies) at different points along the adjustment path. The optimal sequence of reforms would be the ordered set of changes in the instruments at each point along this path.[16]

Such a model is subject to several difficulties. First, establishing reasonable initial conditions is a monumental task, especially in Africa where economic reform involves the return of collapsing economies to stable, sustainable growth paths. Economic collapse in Africa has led to the reduction in income, employment, and output as well as the degeneration of key institutions, such as the central bank, budget office, and judiciary. The full extent of the deterioration becomes evident only after reform is underway.[17]

Second, there is often lack of agreement on the key policies which are crucial to reform. Many African countries have now been operating under donor-sponsored programmes for more than a decade. These programmes generally have similar objectives, such as the reduction of external and internal imbalances and the promotion of economic growth. However, serious differences of opinion remain over how these objectives should be pursued. At one extreme, there have been advocates of the "big bang" type of reforms (such as those adopted in Poland, The Gambia, Argentina, and Bolivia). Other countries (such as Russia, Senegal, Hungary, and Zimbabwe) have followed more gradual approaches. Detailed comparisons of these approaches show that the scope, pace and quantitative criteria applicable to the major policies -- privatisation, civil service reform, financial liberalisation, debt rationalisation, and trade, tax, and exchange rate reforms -- which are designed to restore economic balance have varied widely by country.[18] For countries which depend heavily on external support, the situation has been complicated further by shifting views about the relevance of these factors as more is learned about economic reform and the priorities of the international financial community change.[19]

And third, since economic reform and adjustment are designed to change the underlying structure of the economy, the basic parameters of any dynamic model used to derive the sequence of reforms would change at every point along the adjustment path[20] making it impossible to determine the phasing of reform in advance. That is, economic reform is path-dependent.[21]

Lacking such a theoretical foundation, analysts have no formal basis for determining in advance whether particular sequences of policy changes are "optimal", or even "right". Comparative studies across developing countries may highlight what has worked in specific instances. These studies, however, do not reveal what is "optimal"; whether the same sequence of policy changes would work elsewhere; or how particular sequences of policy reforms emerge from different economic circumstances.[22]

Some examples help make the point. Socialism "worked" in the former Soviet Union (FSU) for seven decades. Few people now believe that it provided an optimal development trajectory. Despite being widely copied, Soviet-style socialism failed completely in Africa.[23] The removal of all capital controls by Indonesia in the early 1970's contradicts the argument, derived from the "Southern Cone" experience, that trade liberalisation requires a series of steps leading to the elimination of capital controls. In Indonesia, trade reforms followed the opening of the capital account.[24] The adoption of a "cash budget" by Bolivia, Argentina, and Zambia is evidence that significant structural reform (of the budget process) can precede stabilisation. Finally, changes underway in Russia are demonstrating that structural reform through privatisation and the reform of State-Owned Enterprises is yet another path to stabilisation.[25]

b. Financing versus Adjustment

Differences in the availability of financing also undermine the view that policies can be optimally sequenced.[26] Economic imbalances can persist only as long as they can be (implicitly or explicitly) financed.[27] When financing exists, governments have considerable scope with respect to the timing and types of reforms they implement. Even partial funding can change the profile of adjustment significantly.

Such situations regularly arise during the implementation of donor-supported adjustment programmes. The compelling issue for many African countries has been to maintain donor support rather than fundamentally reform the economy. For that, the reforms being implemented need to show some results. There is nothing to guarantee that the "optimal" effort will be made. Indeed, the literature on the politics of economic reform makes it clear that maintaining commitment to reform or "ownership" (as some call it) is a major problem.[28]

When financing is available, it requires a responsible, far-sighted, and perhaps even brave government (such as Korea in the early 1980s) to force an economy to adjust.[29] Certainly no African country has ever used adjustment as a strategic option. All have waited until financing has been severely restricted (or even cut) before adjusting. Even then, most countries have seen adjustment only as a means of forestalling complete collapse. The practical significance of policy sequencing in these cases has been minimal.[30]

c. Planning and Sequencing of Reforms

There is a major practical difficulty with the idea that an optimal (or "correct") sequence of reforms can be implemented. Sequencing has overtones of planning, control and direction that have failed dismally in Africa. An important lesson of the last two decades of "directed development" has been that State intervention itself is often the problem. Based on principles derived from welfare economics, it used to be accepted that the State had a role in overcoming market "failures". In Africa, bitter experience has shown that market mechanisms with all their deficiencies, are often far more effective and efficient in promoting growth and development than the directives which emerge from (bloated) government bureaucracies.[31] Since sequencing implies more structured intervention (e.g., maintain capital controls while gradually easing trade restrictions), the African public have reason to be skeptical that governments have the ability to optimally sequence key economic policy changes.

An important goal of economic reform is to normalise the economic role of the State. But, by the time most governments initiate reform, they have lost credibility. Further intervention, even to ensure that reforms occur in the "appropriate" sequence, does nothing for government credibility. In practice, the so-called "re-invention of the State" cannot be promoted by further intervention by bureaucrats whose track record is already poor. Almost invariably, such attempts will undermine confidence and further delay reform.[32] Thus, during the initial stages, even sensible policy reforms (i.e., reforms which are designed to minimise economic imbalances) may have the opposite effect.[33]

The main way in which a (weak) government can regain credibility and begin to exert some influence over the course of economic events is by selective disengagement from the economy. This involves the removal of controls on markets and resource allocation, the withdrawal of the State from commercial activity, and the redirection of public resources to areas (infrastructure, education, and health) that are public responsibilities. In these matters, sequencing is of second (or lower order) importance. Restoring credibility does not critically depend on sequencing; it requires tangible evidence that government intervention has diminished.

d. Overview

For both theoretical and practical reasons, policy makers have no need to concern themselves with the "optimal" sequencing of reforms. Some phasing of reform is inevitable. The basic issue is whether the phasing adopted represents the "next best step" for the country involved.

Zambia's experience provides a useful case study of how, for almost two decades, this basic idea was ignored. Section 3 deals with period prior to 1991 when a series of reform programmes were adopted and discarded. Section 4 considers the period after 1991 during which reform has been sustained.

3. Zambia 1976 to 1991: Reform Abandoned Often

The reluctance of the Kaunda government to promote economic reform is well-known.[34] During the two decades of one-party rule (1972 to 1991) Zambia experienced an economic catastrophe. An inept, irresponsible government, which received too much support, too uncritically, and for too long from the international community,[35] systematically ruined the economy.

Some international comparisons help illustrate the point. In 1960, Zambia's per capita income was higher than South Korea's. In 1974, Thailand's per capita income was less than Zambia's. Now, South Korea's per capita income is eighteen times higher and Thailand's per capita income is three and a half times higher than Zambia's.

From the end of WWII to 1974, Zambia saved and invested in excess of 30 percent of GDP. Average per capita income grew at close to 4 percent per annum. This was one of the best growth performances in the world.[36] From 1975 to 1991, Zambia's savings rate collapsed and the average investment rate, although inflated by foreign aid, external borrowing, and the accumulation of arrears, fell below 20 percent of GDP. During this period, Zambia's average per capita income declined by 2.5 percent per annum. For developing countries which avoided disasters such as civil wars and coups,[37] this was the worst performance in the world.

Data in Tables 1, 2, and 3 place the movements of key macroeconomic aggregates in context. Inflation was high, the currency underwent massive devaluation, and there was a sharp decline in real per capita income. The budget deficit was large. The money supply and the dollar value of foreign debt grew rapidly. Mining production and exports declined, and domestic savings fell.

Domestic saving was positive (mainly due to the surpluses of parastatal organisations). But, the saving rate was only a fraction of what it had been. From the mid-1970's onwards, Zambia ceased being a country which generated large amounts of saving and investment; consumption, both public and private, dominated national expenditure.

The key datum is the budget deficit. The combination of large deficits and declining real per capita output was especially destructive. The Government was borrowing resources abroad that it could not repay. It was also printing money in an attempt to gain control over a diminishing supply of real domestic resources. This behaviour, which has been a common cause of economic collapse in Africa, Latin America and the economies in transition, reflects a fundamental misunderstanding of the difference between finance capital and real capital (see Annex C). Zambia's leaders behaved as though the two were the same.

When large deficits continue over such long periods, economic collapse is inevitable.[38] What happened in Zambia is no surprise. The puzzle is why the government, with the consequences of its inaction so visible and so destructive, continued to reject economic reform.[39]

Table 1: Zambia: Exchange Rate, Money, Prices and Output.

	Exchange Rate (K/$)	Reserve Money (K mn)	Domestic Credit (K mn)	Broad Money (K mn)	Consumer Prices (1985 = 100)	Real GDP ($) (1985 Prices)
1965	1.400	33.1	-46.4	107.5	10.2	1374.0
1966	1.400	42.0	-19.2	145.3	11.3	1419.0
1967	1.400	51.5	27.7	169.4	11.9	1517.0
1968	1.400	63.1	53.4	218.7	13.1	1556.2
1969	1.400	92.6	-6.3	281.5	13.5	1605.5
1970	1.400	137.1	-26.7	355.6	13.8	1730.4
1971	1.400	89.2	191.9	318.5	14.7	1748.9
1972	1.399	105.8	287.0	341.1	15.4	1910.1
1973	1.554	138.8	347.9	410.8	16.4	1891.7
1974	1.554	128.2	386.1	440.7	17.7	2019.2
1975	1.554	183.2	697.0	493.7	19.5	1966.6
1976	1.260	231.9	918.9	623.5	23.2	2018.6
1977	1.316	228.7	1204.3	698.7	27.8	1986.4
1978	1.270	240.6	1440.0	639.4	32.3	1997.8
1979	1.285	252.2	1588.6	832.2	35.4	1937.0
1980	1.245	287.2	1863.2	907.1	39.6	1995.8
1981	1.133	334.5	2260.8	978.7	44.7	2118.9
1982	1.076	386.7	2910.0	1309.3	50.8	2059.3
1983	0.662	440.7	3180.3	1454.2	60.7	2018.8
1984	0.454	518.5	3554.0	1703.8	72.9	2006.5
1985	0.175	634.4	4223.4	2101.8	100.0	2044.5
1986	0.079	1718.5	5834.3	4061.8	154.0	2059.3
1987	0.125	2417.6	7047.3	6265.6	224.3	2114.3
1988	0.100	4832.2	9619.0	10125.8	346.9	2247.1
1989	0.046	6587.9	15327.8	16727.5	793.5	2224.2
1990	0.023	11606.6	19059.4	27389.7	1674.4	2213.6
1991	0.011	21837.2	55227.5	48327.0	3224.9	2212.7
1992	0.003	36659.5	57427.0	96170.0	9588.9	2136.5
1993	0.002	87475.0	89540.0	199266.0	27718.0	2312.0
1994	0.001	149045.0	125145.0	299540.0	42209.0	2160.2

Sources: Source: IFS Yearbook, IFS Monthly Issues 1992-1995
Bank of Zambia Monthly Economic Indicators
Ministry of Finance Macroeconomic Indicators

Table 2: Zambia: Exports, Employment, Mining Production, and Debt

Year	Exports f.o.b ($ mn)	Formal Employment ('000)	Mining Employment ('000)	Mining Production (1985=100)	Deposits Abroad * (US $ mn)	External Debt ($ mn)
1965	527	296	52	136		155
1966	691	324	55	117		157
1967	654	344	55	122		195
1968	759	354	51	133		210
1969	1073	328	56	151		247
1970	1001	343	58	140		654
1971	1226	366	58	131		689
1972	758	368	61	143		758
1973	1144	373	62	140		823
1974	1407	385	65	146		957
1975	810	393	65	133		1353
1976	1037	369	64	145		1525
1977	896	370	65	135		2341
1978	856	367	61	136		2585
1979	1373	374	62	116		3047
1980	1298	379	63	125		3266
1981	1079	374	61	114		3633
1982	1024	366	60	121	230	3709
1983	836	364	57	118	240	3805
1984	652	365	58	108	210	3826
1985	784	362	57	100	360	4639
1986	517	361	59	86	280	5700
1987	873	366	57	84	360	6508
1988	1179	369	57	86	400	6709
1989	1407	372	56	85	420	6873
1990	1263	377	57	83	420	6600
1991	1082	360	59	75	440	7190
1992	1104	349	59	82	420	6986
1993	987	339	57	94	420	6361
1994	1067	339	53	90	400	6236

Source: IFS Yearbook, IFS Monthly Issues 1992-1995
Ministry of Finance Macroeconomic Indicators.
* Cross border deposits in foreign Banks by Zambians.

Table 3: Zambia: Inflation, Investment, Savings and Interest Rates

Year	Rate of Inflation (% p.a.)	Gross Dom. Investment (% GDP)	Gross Dom. Savings (% GDP)	Change in Real GDP/cap (% p.a.)	Treasury Bill (% p.a.)	Interest Rate Diff. Zambia/UK *	
1965	8.1	24.3	39.9	21.7	3.5	-4.7	60
1966	10.2	28.9	43.1	-6.0	3.8	-7.8	57
1967	5.0	30.8	37.0	3.0	4.4	-3.3	63
1968	10.8	32.4	39.3	3.7	4.5	-8.0	61
1969	2.4	18.1	51.4	1.3	3.5	0.7	49
1970	2.7	29.6	43.2	0.4	2.4	2.0	57
1971	6.0	37.3	35.2	-3.3	3.3	3.0	65
1972	5.1	35.3	36.9	5.7	4.3	1.6	63
1973	6.5	29.2	45.0	-3.9	3.9	-1.3	55
1974	8.1	36.4	45.9	3.3	4.0	2.3	54
1975	10.1	40.5	21.0	-5.5	4.0	11.0	79
1976	18.8	23.8	28.9	1.0	4.2	-4.5	71
1977	19.8	24.7	22.1	-7.6	4.4	-2.5	78
1978	16.3	23.9	20.5	-2.6	4.4	-8.0	80
1979	9.7	14.1	23.1	-3.8	4.4	-1.2	77
1980	11.6	23.3	19.3	2.3	4.5	-0.8	81
1981	13.0	19.3	6.8	0.5	5.8	-5.6	93
1982	13.6	16.8	7.9	-5.7	6.0	-11.4	92
1983	19.6	13.8	12.6	-4.9	7.5	-19.2	87
1984	20.0	14.7	18.5	-3.5	7.7	-18.6	82
1985	37.3	14.9	15.4	-2.7	13.2	-26.9	85
1986	54.0	23.8	22.6	-2.9	24.3	-42.9	77
1987	45.6	13.9	15.0	-2.7	16.5	-37.7	85
1988	54.7	11.4	16.2	-25.7	15.2	-46.8	84
1989	128.7	9.9	14.5	18.0	30.5	-115.6	86
1990	111.0	15.4	14.7	-9.0	30.5	-82.9	85
1991	92.6	13.5	11.6	-12.5	39.0	-59.1	88
1992	197.0	14.0	2.2	7.6	47.0	-148.6	98
1993	189.0	10.3	4.8	26.6	124.0	-97.0	95
1994	52.3	9.2	6.4	-33.5	78.4	13.5	94

Source: IFS Yearbook, IFS Monthly Issues 1992-1995
Ministry of Finance Macroeconomic Indicators
* Difference in equivalent Real Treasury Bill Rates, UK and Zambia

The answer is rooted in Zambia's economic history. Zambia's economy had benefitted from the buoyant world demand for copper together with expanding mine production during the first decade of independence (1964 to 1974). High rates of private investment and large public investments in infrastructure led to the rapid expansion of the economy's productive base. Foreign debt was low and domestic savings were high. Bolstered by conservative fiscal and monetary policies, per capita incomes grew rapidly.

Formal planning started in Zambia at independence. The First National Development Plan (1966-1970) was based on the "Seers Mission Report"[40] which had proposed a major increase in government involvement in the economy to help expand infrastructure, promote agriculture, and direct more resources into regional development.

Government involvement was also seen as a way of reducing the large African/non-African income inequalities.[41] The newly-independent government sought to ameliorate them as quickly as possible. Having "surplus" resources seemed to provide a solution.

Independence had swept away restrictions on political activity and other social constraints (such as pass laws). The effects of the "industrial colour-bar" which had prevented Africans from holding managerial and senior technical positions was dealt with by the "Zambianisation" of employment.[42]

A less tractable issue was the concentrated ownership of productive assets. The solution chosen was nationalisation. Beginning in 1968, the State took over most of the major productive assets in the country (except banking and commercial farming). This process was essentially complete by 1975 when President Kaunda delivered the so-called "watershed speech".[43]

Yet, while Zambia was seeking economic independence through State control, the political system became increasingly authoritarian. Indeed, only eight years after Zambians had rid themselves of one form of political repression, another was forced on them. In 1972, under the guise of promoting a One Party Participatory Democracy, the United National Independence Party (UNIP) declared itself to be the only legal party.

The stage was set for disaster. Indeed, 1975 <u>was</u> the "watershed" year for Zambia, but not in the way its leaders intended. Due to the collapse of the world copper price in late 1974, Zambia's combined budget and balance of payments deficit shifted by the equivalent of 55 percent of GDP in the space of one year.[44] Zambia responded to this shock by financing the imbalances rather than adjusting.

Another reason why reform could be postponed was the general absence of accountability. Much has been written about the politics of economic adjustment in Zambia, most of it devoted to who did what to whom, when, and with what support.[45] Economic performance was never a high political priority. Indeed, Kaunda and UNIP were highly successful in convincing most Zambians that their economic problems were primarily the result of external factors.[46]

This was politically astute, but it only part of the story. External events were important, but none of them required the government to run such large budget deficits for so long, or to borrow excessively abroad. Similarly, external factors do not explain why the government allowed vital economic institutions, such as the central bank, the Budget Office, and the revenue departments -- which at one time were among the best in Africa -- to collapse.

The outcome was the steady dissipation of the economy's wealth-creating capacity. Politically, Kaunda's version of "personalised rule" destroyed most vestiges of accountable governance.[47] Socially, ideals that were once widely shared were abandoned along with any effective concern for the poor[48]. And, economically, the ability and willingness of the Zambian population to generate income and accumulate their wealth domestically diminished.

Those who could get their resources out of Zambia did so. As a result, capital flight from the mid-1970's onwards has been estimated to exceed $12 billion.[49] Those who could not shift their resources abroad defended themselves from State action in other ways: tax evasion, the use of parallel markets, currency substitution, smuggling, and by shifting into activities over which the government had little control.

The result was generalised economic decline. The government responded with several attempts at reform. Internationally-supported programmes were undertaken in 1978, 1980, 1981, 1984, 1985, 1989, and 1991 through Stand-By and Structural Adjustment Programmes.[50] None was continued to the point where economic reform could have succeeded.

These failures were costly. The accumulated loss of national income, the large external debt, and the deadweight loss of unutilised and poorly utilised capital run into the billions of dollars.[51]

One positive outcome of the failures was that it triggered a situation where demands for political and economic reform could no longer be resisted. The general public understood what it <u>did not</u> want. This, in turn, helped define what the objectives of economic reform <u>had</u> to be.

Finally, these episodes removed all possibility that any further attempt to finance the economic imbalances would be futile. Zambia's international credit-worthiness had been completely destroyed. In late 1991, when the change in government took place, economic reform had become the only way forward.

4. Zambia 1991 to the Present: Reform Sustained

Why was it that the various attempts at reform were abandoned before the elections of 1991 but, since then, economic reform has been sustained? Five factors seem relevant.

First, when given the opportunity to freely express their choice, Zambian voters overwhelmingly rejected Kaunda and UNIP. The majority of Zambians wanted an end to the economic stagnation and economic mismanagement associated with one-party rule. The 1991 elections gave the new government a mandate for radical economic reform.

Second, the MMD Party comprised many people who, for different reasons, were disenchanted with the unwillingness of the former government to restructure the economy. The Party's Manifesto, which featured prominently in the election campaign is a blueprint for fundamental economic and social change.

Third, the economy was so close to spiralling out of control that the leaders of the new government recognised that economic reform was essential.

Fourth, after many threats, the international donor community had finally "pulled the plug" on Kaunda and UNIP. The new government understood that re-engaging the donors would require a complete change in economic and social policies.

And fifth, just three months after taking office, the failure of the maize harvest created a major emergency. Zambia had no foreign exchange and limited food reserves. Without donor support, a tragedy of unprecedented proportions loomed.[52]

These considerations produced a fundamentally different approach to economic management. The Zambian people wanted change; the new government was publicly committed to economic reform; and the resumption of international support depended upon actions designed to restructure the economy. The return of multi-party democracy also held the prospect of greater public accountability and improved governance.[53]

The first few months of the new government gave every indication that a major shift in policy was underway. The first important change was the elimination of maize meal subsidies. This was followed by the removal of most import restrictions; the abolition of export licenses; a faster rate of crawl in the official exchange rate; the removal of barriers to entry in the financial and insurance markets; and the lifting of interest rate ceilings.

The clearest signal of the government's commitment to reform was the 1992 Budget which sought to sharply reduce the budget deficit. The Budget also outlined the government's approach to privatisation and parastatal reform, announced steps to reform the tax system, devalued the kwacha by 30 percent, and made commitments to reduce inflation, stabilise the economy, and revive growth.

The beginning of 1992 was full of promise. The government had set the groundwork for the resumption of international support and, by "balancing" the budget,[54] it appeared to be taking the steps needed to prevent the fiscal system from further destabilising the economy.

The promise was not realised. By April 1992, the Budget had begun to unravel. The government acceded to the demands by civil servants for wage increases in excess of 100 percent, and it provided operating subsidies to Zambia Airways of approximately $30 million. These extra-budgetary expenditures were in direct contrast with the elimination of maize meal subsidies, which had been presented as a way of easing pressure on the budget. Questions arose about the government's commitment to fairness, equity, and prudent economic management, all of which had been features of the election campaign.

Drought relief added to the budgetary problems. A large budget deficit emerged which was financed by money creation (i.e., borrowing from the Bank of Zambia). Economic instability intensified. Inflation, which had been 111 percent in 1991, was 191 percent in 1992. The exchange rate, which was K64=$1 at the end of 1991, rose to K184=$1 by the end of 1992. Contrary to the government's expectations, the macro-economic situation continued to deteriorate.

The new government had "blown it". It had failed to do the one thing that mattered most: it had not distinguished its approach to economic management from that of its predecessor.

Asset-holders had seen enough. Capital flight and currency substitution, which were already serious, became more pronounced. Consumer and business confidence evaporated, and the general public lost faith in the government's ability to manage the economy. Barely a year old, the new government's economic policies were in deep trouble.

By the third quarter of 1992, senior policy makers began to understand that the main source of economic instability was the budget. Doing something about it was difficult. The data needed for a pro-active approach to economic policy were not available. Most relevant economic information was months out of date and many data were unreliable. As a result, the government's policy responses were mis-directed, delayed, and ineffective. Worse, the basic institutions, such as Budget Office and Bank of Zambia, which were needed to take a lead in turning the economy around, were in disarray.

A further complication was that in early 1992 the government had assured the donor community that it would put more emphasis on the social sectors. With inflation so high and so much of the budget being absorbed by wages and subsidies, real social expenditures were declining.[55]

The government's performance was not easy to explain. Apart from some liberalisation in the area of trade and finance, about the only positive outcome during 1992 was the successful distribution of drought relief.

The basic problem was the lack of budget discipline. This was a direct carry-over from past practices, and reflected poorly on the government. New directions were needed.[56] A concerted effort was made to meet the end-September benchmarks agreed with the IMF. It did not succeed, but it helped identify the measures needed to bring the economy back on track.

In November 1992, the issue of "inflation as the cruelest tax on the poor" was raised. President Chiluba went on record as stating that this tax had to be reduced, and that the government would do whatever was needed to bring inflation under control.

Several initiatives quickly followed. Within the space of two months (December 1992 and January 1993), the exchange rate was unified (by allowing the copper company, ZCCM, to sell at the market rate); the Government put itself on a cash budget; a limit was placed on wage increases[57]; a Treasury Bill tender for the market determination of interest rates was introduced; import and export licenses were removed; and it was announced that all exchange controls would be eliminated.[58] (A chronology of Zambia's economic reforms is given in Annex D.)

A Data Monitoring Committee was established between the Ministry of Finance (MoF) and Bank of Zambia (BoZ). At first this Committee met daily until the relevant data were up-to-date and a system was developed to keep them that way. Once that was completed, the meetings were reduced to three per week. The Committee has overall responsibility for monitoring the day-to-day operations of fiscal and monetary policy and, since January 1993, it has implemented the cash budget.

The introduction of the cash budget prevented government operations from being a separate source of instability.[59] Unfortunately, monetary excesses continued. In the early months of 1993, the government would not allow the price of petroleum products to rise to reflect exchange rate depreciation. As a result, ZIMOIL, the State-owned oil corporation, could not generate the local currency required to purchase foreign exchange to pay for oil imports. The BoZ provided the foreign exchange on credit. This led to a major increase in reserve money.[60]

By late April, BoZ lending to ZIMOIL was stopped and the growth rate of reserve money dropped sharply. Inflation declined. Prices rose by 15 percent in May, 11.6 percent in June, and 2.7 percent in July. They have remained in single figures ever since. Reflecting this decline, nominal interest rates began to fall towards the end of 1993 and the exchange rate stabilised as well.[61]

There have been a few minor bumps since mid-1993, due to donor threats to withdraw support[62] and the run on Meridien BIAO Ltd. in early 1995.[63] Overall stability has been maintained. Indeed, given the extent of the shocks (in December 1993, December 1994, and February 1995) the economy has become remarkably resilient and robust.

Other reforms have been proceeding. These include the gradual privatisation of numerous State-Owned Enterprises, the development of an approach to civil service reform, the retrenchment of thousands of casual daily employees, the repair of basic infrastructure (roads, bridges, airports, schools and hospitals), and the improved flow of supplies and materials to government departments and government-supported institutions.

These measures have been taken as bureaucratic pressures, Parliamentary schedules, and donor conditions determine. An "Action Plan" listing all policies and their progress has been regularly reviewed and updated. Nonetheless, no grand scheme to ensure that these policies are implemented according to a particular sequence has been produced.

Indeed, there is no evidence that senior government officials have ever discussed the need to implement the economic reforms in any particular sequence. Such discussions would have been irrelevant towards the end of 1992. The economic situation was deteriorating so rapidly[64] that something had to be done. Something was done! The government reduced inflation the "old-fashioned" way -- by the brute force control of reserve money. Nothing remotely related to sequencing was involved.[65]

5. Zambia's Experience: Lessons Learned

What lessons does Zambia's experience provide about the sequencing of economic reforms? This section draws answers from the periods before and after the elections of 1991.

a. Reform Efforts Before the 1991 Elections

The following points stand out.

First, the sequence of policies used by the Kaunda government during its several attempts at adjustment was irrelevant. Sequencing might have mattered if the government had been willing to change when the country had the resources needed to finance its adjustment. At the time, however, there was no effective lobby for reform.[66]

Second, the reverse did not apply. There is no evidence that reform was abandoned in Zambia because the policy changes were incorrectly sequenced. The problems were more deep-rooted. Economic reforms were abandoned even when they were working. For example, the foreign exchange auction was successfully allocating the existing supply of foreign exchange. The operations of the auction, however, were not being supported by prudent fiscal and monetary policies.[67] And, the New Economic Recovery Programme, which has been the basis of the MMD government's reforms, was formulated during the Second Republic.

Third, despite the theoretical problems associated with deriving "optimal" policy sequences and using them for cross-country comparisons, the historical record provides a useful basis for developing retrospective scenarios. Such an exercise would start from the premise of "what if" specific sequences of reform had been followed. It would confirm that the lack of sustained reform overwhelmed any potential benefit of changing policies in any specific order.[68]

Fourth, a broader view of the several abandoned reform efforts raises questions about the aid policies of the donor community. Why, for example, did the IMF and World Bank continue lending to Zambia long after the country could not service its debts? What effect (if any) did the regular re-direction of donor emphasis have on the cohesion and consistency of Zambia's economic policies?[69] Were the donors too ambitious in promoting their development agenda? And, why has there been such a rush to implement new initiatives when earlier programmes were incomplete?

It would require another study to examine these questions in detail. Nonetheless, what needs to be explained is how the Kaunda government continued to attract so much donor support despite nonperformance, a long habit of broken promises, and continued economic decline.[70]

b. Reform Efforts Since the 1991 Elections

The experience since the elections of 1991 provides the following lessons about sequencing.

First, the success of the reforms so far has not been due to any well-articulated or well-ordered pattern of policy change. The reforms have succeeded because of the measures taken to stabilise the economy. Beginning in the second half of 1993, economic stability has been imposed and maintained, despite several shocks, through the "cash budget". This is a mechanism for imposing the policy of zero government borrowing from the banking system which was announced as part of the 1992 budget. The government was already committed to maintaining a prudent fiscal policy. However, it took a major structural change in the way the government managed the budget to make that policy effective.[71]

Second, proponents of sequencing stress that the proper ordering of policies is needed to generate and maintain consensus.[72] This presumed advantage was not important in Zambia since the results of the election demonstrated the general desire for reform. The main task for the new government was to restructure the economy as rapidly as possible. Indeed, a major criticism of the MMD Government has been the slow pace of reforms, not the reverse.[73]

Third, a problem for members of the new government has been to establish a sense of direction. Those who opposed President Kaunda knew what they did not want. They were less certain about what they did want. The ambivalence influenced policy implementation, at least initially. For example, the performance of the budget during 1992 showed that the new government had mis-understood the institutional dynamics. It was only after it had repeated many of its predecessor's mistakes, that the government made a radical change in budget policy.

If, upon taking office, the government had carefully formulated an "optimal" sequence of policy reforms, the events of 1992 showed that the sequence would not have worked. That is, in Zambia, the actual sequence of policy reforms could not have been pre-determined. Neither could it have been optimal. From Annex D, it is evident that the only common feature of the reforms is that they have been adaptive (which is a key element in the pragmatic approach to policy reform outlined in the next section).

Fourth, the importance of immediate action on institutional reform cannot be over-emphasised. Indeed, one conclusion from Zambia's experience is that institutional and policy reform should be given the same (high) priority.[74] The weakness of the basic economic institutions has been a major drawback to sustaining policy reform. In the process, Government credibility has suffered. Events in early 1995 are illustrative. The BoZ initially mis-handled the collapse of the Meridien bank. And, due to weaknesses in the Budget Office and indifferent revenue collection efforts, the budget has required a mid-course correction within months of being approved by Parliament.[75]

Fifth, whether or not a pre-determined sequence of policy changes had been agreed in Zambia, that sequence would have been modified due to the resistance of specific interest groups.[76] There are many examples. The BoZ succeeded in delaying the removal of exchange controls. ZIMCO, the parastatal holding company, resisted privatisation. The civil service reforms have been dragged out. And, ZCCM has so far managed to deflect attention from the need for a complete overhaul of its operations.

These examples point to the need to explicitly incorporate strategic considerations into the design of policy reform. The result would be a series of contingent scenarios and <u>not</u> a predetermined sequence of policy changes!

6. Overview of Sequencing

What remains of the argument that policy changes should be optimally sequenced? The evidence from Zambia is consistent with the growing body of research which shows that a wide range of transition paths exist, none of which is necessarily "optimal" or "right". The research also shows that there is no pre-determined package of policy changes which is widely applicable across developing countries.[77]

Notwithstanding this negative conclusion, several points are highlighted by the sequencing issue. I shall discuss these and then describe what could be called a pragmatic (or adaptive) approach to the implementation of economic reform which incorporates some of the key ideas of sequencing.

a. <u>Remaining Questions</u>

Five points would benefit from further study. These are the value of a dynamic sequencing model; the role of confidence; the sequencing of donor aid; sequencing and strategic behaviour; and sectoral level sequencing.

i. Dynamic Sequencing Model

If the economic structure changes as policies are implemented, what is the most appropriate strategy for choosing how to undertake policy reform? By analogy with critical path models or risk analysis, policy makers could formulate a sequence of contingent policy changes. Policy makers would meet periodically to review and re-chart the path of economic reform in light of emerging results.

This approach overcomes the non-optimality of pre-determined sequences of reforms. At each point, policy makers would decide what is the "next best move" to promote the goals of reform.

Having chosen a particular reform path, policy makers would have to allow some time for the changes to take effect. Their subsequent responses would be designed to complement the initial policies, or to remove factors which obstruct those policies.[78]

ii. Confidence versus Sequencing

The role of confidence in the process of economic reform is widely discussed, less well understood, and improperly modelled. The notion of an investor's "option value" is not fully appreciated.[79] Countries such as Zambia which have experienced widespread disruption and decline have to make a special, protracted effort to re-establish confidence. A major problem is that even as policy reform progresses, confidence remains fragile. The perceptions of key economic agents are difficult to coordinate, and they are often subject to sharp changes.[80]

Under these conditions, the chances of implementing particular sequences of reforms will vary enormously. A programme may be "appropriately" sequenced according to some pre-set criteria. But, if the general public believes that reform will not work (or will work only after long delays), the sequence in which the policies are changed will make little difference. By contrast, if confidence is improving, a large number of reforms can be implemented. Moreover, their effects will usually cumulate thereby validating and further reinforcing the improvement in confidence.

The design of any reform programme has to pay detailed attention to the issue of confidence. No blue-print for this exists although in cases of widespread regression (such as Zambia), confidence will only rise when consumers and businesses have reason to believe that the government's capacity for economic damage is diminishing. That typically requires the government to reduce its intervention in the economy and disengage from commercial activities.

With the capacity that now exists for rapid international financial transfers, government policy makers have little room for manoeuvre. By contrast, asset-holders can (and do) regularly re-assess the risks of keeping their assets on-shore. This greatly reduces the scope for governments to initiate economic reform in a structured or phased way. Typically, the government has to take some bold measures to convince the general public that there has been a fundamental break with past policies. In the initial stages, this may require hard-hitting measures such as a cash budget.

Without dramatic action, the general public will not be able to discern whether conditions have changed. Confidence will remain low and, even if the overall policy package had been "optimally" sequenced in some sense, it will have minimal impact.

iii. Sequencing of Donor Aid

The effect of the timing of aid flows has been widely discussed. A common view has been that the efforts to promote reform in developing countries will be undermined unless the donors provide large amounts of aid in a timely manner.[81] In Zambia's case, the non-receipt of donor support has been blamed for the failure of reforms on several occasions.[82]

The timing of aid flows is subject to "moral hazard". If donors provide generous support in advance of reform, developing countries have little incentive to adjust. If they do not provide support, economic reform may fail despite the recipient country's best efforts. Few African countries (including Zambia) have helped in this regard. Too much aid has been provided on the promise of reform which never materialised.[83]

To an increasing extent, donors have resolved the matter by tying their support to performance. African countries used to be highly outspoken about this type of conditionality.[84] For some countries, including Zambia, conditionality is now seen in less negative terms. An increasing number of African countries are recognising that "performance-based" support provides their best opportunity to establish an international reputation for responsible economic management.

Conditional support is unlikely to diminish until African countries regularly promote economic reform on their own and service their external debts.[85] Thus, in practical terms, aid is flowing to countries which demonstrate they can perform.[86] The outstanding issue is whether this system is the most effective approach for helping reforming countries onto sustainable growth paths.

iv. Sequencing and Strategic Behaviour

A suggested advantage of pre-announcing the sequence of policy changes is that it builds consensus for reform.[87] It is presumed that the better the general public is informed about economic reform, the less likely the changes announced by the government will be treated as negative shocks. Too little, however, has been made of the fact that a pre-announced programme of reform provides opponents of reform with pre-determined opportunities for obstruction.

Governments behave strategically with respect to donor aid. Similar behaviour has to be expected of opponents of reform. Since economic reform is designed to change an economy's structure, the interests of some well-entrenched groups will be hurt. The success of economic reform hinges on widely sharing information about the government's goals. Yet, providing the details and time-frame about how the goals will be met is risky, particularly when the reforming government has weak institutions and the economy is unstable.[88]

For example, it is well understood that successful reform depends on the implementation of a comprehensive adjustment package which takes advantage of mutually reinforcing changes. Yet, some elements of the package may not (and often cannot) be implemented as planned. Controlling the <u>public sector</u> deficit is a major element in re-establishing economic stability.

Reducing the governments contribution to this deficit, is relatively "easy". It is much more difficult to reduce the deficits of the State-owned agencies especially, as in Zambia, these agencies had considerable autonomy under the former government. The principals of these organisations, therefore, have the capacity and the incentive to undermine the reform programme. By overspending, they exacerbate instability. They can point to the consequences of government's failure to deal with them -- inflation, devaluation, and rising interest rates -- while playing down their own contribution.[89] Union leaders have similar incentives to undermine reform as well.[90]

As a means of minimising strategic opposition to reform, the government should retain some flexibility in choosing the details and timing of policy reform. A pre-announced schedule of policy changes is too convenient for the opponents of reform. A preferable approach is to announce the general direction of reform, leaving room to adjust the implementation time-table.

v. Sectoral Level Sequencing

Most discussions of sequencing concentrate on macroeconomic aggregates. Since economic reform is multi-dimensional, there are several other levels -- sectoral, institutional, regional -- at which sequencing of policy reform might apply. For example, institutional reform is a vital element in developing the capacity for improved economic management. And, sectoral level liberalisations, such as in agriculture, raise questions about the commitment of government to disengaging from economic activity.

The literature provides no clear guide on patterns or phasing of institutional reform.[91] Reforming governments typically begin with an exceedingly weak institutional base. It is ironical, however, that many governments are being encouraged by aid agencies to set up additional institutions, such as privatisation agencies, revenue boards, "independent" central banks, or stock markets, as mechanisms for promoting and/or accelerating reform.

This frequently has the opposite effect since the conditions which undermined existing institutions are usually not understood. As a result, the new agencies are often ineffective. For example, even with several new departments and a major re-organisation, the Cabinet Office and Establishment Division, Zambia has been unable to effectively promote civil service reform.[92] The Zambia Privatisation Agency has already undergone two reorganisations since it was set up in 1992. It is widely seen to be moving too slowly.[93]

The evidence of successful new institutions is limited. Just as forced-pace institutional development was not a "key" to planned development, forced-pace institutional change is not essential to reform. [94] Making the existing institutions perform better is far more important. In this regard, new institutions, such as the Zambia Privatisation Agency or the Lusaka Stock Exchange, should not be expected to perform effectively for several years. How, then, are they supposed to contribute to reform?

Adding sectoral level details would greatly increase the problems of working out an "optimal" pattern of policy change. Harmonising the relative benefits and costs of different sets of reforms across sectors would be a major undertaking. Working out the details would overwhelm the administrations in most developing countries. In Zambia, the approach has been to press ahead with initiatives in several areas simultaneously with the ultimate objective of moving the whole system forward.

No clear patterns or sectoral sequences are evident as this process unfolds. Zambia is having some notable success in devolving health administration and giving local communities more control over educational spending. Gradual disengagement by the central government from these areas is working. This is not the case in agriculture where the way in which the government is disengaging <u>is</u> the principal problem.[95]

b. <u>A Pragmatic Approach to Policy Change</u>

An evident conclusion of this paper is that it is not possible to derive in advance a sequence of policy changes which constitute an "optimal" or "sub-optimal" time path of economic reform.[96] Based on Zambia's experience there is no basis for inferring that the particular sequence of reforms which were followed were "right" or "proper", or the sequences used in Zambia might apply to other developing countries.

This conclusion about sequencing, however, does not negate some of the practical results which have emerged (and are still emerging) from Zambia's economic reforms. The main goal of the government has been to return the country to a sustainable growth path. Reaching this goal requires a number of identifiable steps, the order of which may vary as circumstances change, and policy implementation, and institutional reform proceed. The steps include:

- bring the macroeconomic data up to date so that that economic policy can be pro-active;
- restore (or impose) budget discipline even if, in the initial stages, it requires a brute force mechanism such as the "cash budget";
- begin removing the restrictions and regulations which provide opportunities for corruption and inhibit enterprise and initiative. This is an important means of using liberalisation and market mechanisms to "level the playing field";
- take positive measures to minimise the losses of the public enterprises by opening their markets to competition, accelerate privatisation, or negotiate management contracts;
- restrain the expansion of the public service either through lay-offs, reorganisation of the civil service, providing wage increases below the rate of inflation, or by having a "hiring freeze";[97]
- reform the tax and revenue system. This will require some updating of the tax code and perhaps a new tax (such as a VAT), but the principal requirement is to boost tax compliance;[98] and
- focus attention on improving infrastructure -- roads, bridges, railways, airports, hospitals, schools, rural storage, water and sanitation systems, garbage disposal and urban drainage. This directly affects welfare; it also reduces the unit operating costs in the public and private sectors.[99]

Taking these measures requires action in all areas of the economy: the budget, monetary policy, the financial system, parastatal management, the control of productive assets, the organisation of the civil service, repair of basic infrastructure, strengthening of economic institutions, and the revamping of social sector programmes. None of the policy changes will unfold neatly. Initial policy reforms will require further action by policy makers.

A key part of this process is that the government recognises the need for timely, decisive, policy responses which build upon (and modify) the affects of earlier policy changes. In the place of a well-ordered sequence of policy changes, this pragmatic approach to economic reform involves regular monitoring and review, and decisive policy responses.[100]

7. Concluding Remarks

Zambia's experience does not support the existence of "optimal" or even "sub-optimal" sequences of policy reforms. Prior to the 1991 elections, Zambia was a chronic non-reformer. Several adjustment programmes were abandoned. Economic decline continued. In retrospect, Zambia's economic performance during that time would have improved dramatically if only <u>some</u> economic reform had been sustained, irrespective of how the policies were sequenced.

The stop-start efforts at reform eroded confidence, created an unserviceable debt burden, and undermined the institutions that could have helped to restructure the economy. In the process, the government lost credibility. By 1991, Zambia had reached the point that a fundamental reorientation of economic policy was the only way forward.

The economic recovery programme introduced after the elections has been dominated by the need to ensure that external support is continued. During the election campaign, the MMD Party promised economic reform and accountability. International agencies are holding the government to these promises. When the government's commitment appears to falter, donor support has been delayed, and even withheld.

Under these circumstances, the optimal sequencing of policy changes has played no substantive role. Indeed, it is difficult to see how sequencing could have assisted Zambia address some of its most pressing problems. A key element, the cash budget, was added <u>after</u> the government had failed to impose budget restraint through conventional means. This mechanism had not been part of any pre-determined pattern of policy reform. Without it, however, the economy would not have stabilised.

An implicit assumption underlying the idea of sequencing is that governments have the capacity to effectively manage the reform process. The extent of economic decline, social deterioration, and institutional regression in African countries over the last two decades makes this assumption questionable. Governments have limited capacity for economic management, especially as they initiate reform. Often the best that governments can do is to piece together a series of overlapping policy changes that steadily reduce the macroeconomic imbalances.

When some improvement is evident and confidence begins to revive, scope may exist for pursuing reform in a less force-paced fashion. However, until this occurs, the government will need to make (and sustain) a large number of policy changes to convince the general public and external agencies that it remains committed to reform.

Economic reform is not an event which can be pre-programmed or "sequenced". It is a process which has to be monitored and managed on a day-to-day basis in a flexible, adaptive way. Progress will be halting; the margins for error are narrow; mistakes will be made; reversals will occur; and delays in policy implementation are inevitable. In working through this process, policy makers cannot simply draw on particular patterns of policies which appear to have worked elsewhere. Guidance about general policy directions are useful; specific sequences are not.

After years of mis-steps and backsliding, Zambia is showing that economic reform is possible. The key to the success so far is that the government and its agencies have remained committed to a credible, comprehensive package of reforms that directly address Zambia's principal economic imbalances. The order, or sequencing of the policy changes has been immaterial. The main lesson from Zambia's experience is successful reform requires sustained policy changes; their sequencing is of little importance.

Annex A

Hypothesised Sequences

The literature contains numerous examples of sequences of policy reforms which various authors suggest that developing countries must follow to ensure that the order of economic reform is "right", "correct", or "optimal". This annex summarises four author's views of what the sequences should be.

a. R. McKinnon <u>The Order of Economic Liberalisation Financial Control in the Transition to a Market Economy</u> (1991)

While McKinnon's book deals with economies in transition, its theme could be broadly applied to African countries as well. Many of these economies are in transition from systems based on pervasive State control and intervention to more market-oriented economies.

McKinnon's introductory chapter is an excellent summary of how he sees the order in which reform has to be undertaken. He makes the following points:

- "fiscal control should precede financial liberalization" (p.4)
- successful reform requires revenue reform
- "Until a full-fledged internal revenue service for collecting taxes from the private sector is put in place, many industrial assets and most natural resources must remain government-owned as revenue sources for the public treasury." (p.5)
- "Second in the order of liberalisation is the opening of the domestic capital market so that depositors receive, and borrowers pay, substantial real (inflation-adjusted) interest rates." (p.6)
- this second step should be done only after the fiscal system is under control. Moreover, the pace of financial liberalisation has to be geared to the success achieved in stabilising the economy.
- the government has to move vigorously to "harden the system of money and credit" (p.6), especially on the "deposit side" (p.7).
- the "credit side" of the banking sector should only be decentralised "cautiously" and the flow of credit is circumscribed "for many years".
- the government must "move quickly" to establish a system of commercial law and enforceable contracts (p.7).
- "After the (successful) liberalization of domestic trade and finance, there is an appropriate pace for the liberalisation of the foreign exchanges. In the balance of international payments, transacting on current account is best liberalized much faster than international capital flows..." (pp.7-8).

- the unification of the exchange rate "...should precede the elimination of centralised controls over who can export and who can import" (p.8)
- trade liberalisation is achieved by shifting from quantitative restrictions to tariffs and the deliberate reduction in the cascading of implicit tariffs (pp.8-9)
- "Free foreign exchange convertibility on capital account is normally the <u>last</u> stage in the optimal order of economic liberalisation" (p.10. Emphasis in original).

b. L. Smith and N. Spooner "The Sequencing of Structural Adjustment Policy Instruments in the Agricultural Sector" (1990)

This paper develops a number of rules for sequencing. Page 6 states that stabilisation has to precede supply-side measures. This, however, is qualified on page 8 when the authors note that "certain structural policies" are essential to stabilisation. They cite a long passage from Williamson (1987) on page 11 about the order in which trade should be liberalised. Since this passage neatly summarises what many believe is a key sequence, I shall repeat it.

> First, liberalise imports of critical inputs especially needed for tradable production. Second, devalue to the point needed to gain and maintain a competitive exchange rate. Third, borrow anything that may be needed to restore full capacity operation of the economy as soon as possible. Fourth, advertise your intention to liberalise imports as circumstances permit, in order to ward off investments in uneconomic import competing industries. Fifth, once the economy is operating at full capacity, use payments improvements to liberalise imports across the board. When you have finished with liberalising imports, start thinking about liberalising the capital account or appreciating the currency."

Citing Edwards (1987), Smith and Spooner add their weight to the view that the final step is liberalisation of the capital account.

In Figure 2 (page 16), there is a step-wise scheme of how economic reform should proceed. The steps are:

1. Decontrol essential imports of inputs.
2. Devalue to maintain [a] competitive exchange rate.
3. [Provide] foreign exchange for critical infrastructure.
4. Reform [the] domestic financial market and start reforms in factor markets.
5. Liberalise [the] agricultural sector.
6. Remove price controls in industry.
7. Trade liberalisation.

8. Liberalise capital markets.

c. The European Commission Study on "The Design of Economic Reforms in the Context of Political Liberalisation -- Findings and Conclusions from the Case Studies" (1994) has a section on the "Implementation or Sequencing of Reforms". It concluded that:

- "There is broad theoretical consensus on how to to sequence economic reforms. In many cases practice does not seem to follow this suggested sequence ...

- Reforms should be phased to maximise short-term supply response and minimise budgetary disruptions."

d. The recent CDR (1995) paper contained a section which focused on problems in the design of reform programs due to sequencing errors. The paper gave five areas where the sequencing of reform had been incorrect. It noted (p.67):

> The sequencing of adjustment reforms has been problematic in at least five respects: increases in producer prices before removal of major bottlenecks in infrastructure; liberalisation of financial markets and increases in real rates of interest before necessary changes in the real economy, in particular some kind of parastatal reform; liberalisation of foreign trade without effective export promotion policies and incentives; deregulation of national markets without measures to promote an effective and competitive private sector; and introduction of cost recovery in public services before measures to ensure availability of inputs and effective services in a transitional period.

By implication, the "right" or "optimal" sequence which, presumably, would have avoided the problems would have been to reverse their sequencing. The report continues:

> These sequencing problems reflect an exaggerated faith in immediate and strong supply response from the private sector. A related design error concerns the assumption that institutions can be changed overnight.[101]

<u>Overview</u> More examples could be cited, particularly from the "Southern Cone" experience. Nonetheless, the above examples clearly provide the essence of the arguments.

Annex B

Historical Background of Sequencing

Many economists have been attracted to the idea that desired social and economic outcomes occur in well-structured phases. A common conclusion has been that moving an economy onto (or returning it to) some desired time path requires an ordered series of policy and/or institutional changes.

Economic reforms are designed to move an economy from imbalance and instability to a stable, sustainable growth path. It is not surprising, therefore, that economists would seek to derive a least cost and/or least-time transition path. Some detailed research has attempted to demonstrate that there are (or ought to be) sequences of policy reforms, variously described as "optimal", "sub-optimal", "appropriate", "right" or "correct", which move economies along this transition path.

The intellectual background for this work is exceedingly rich. The following review is illustrative.

An early example of an approach which implies a specific sequence of policy actions is Say's Law that "supply creates its own demand".[102] Keynes' "theory of effective demand", reverses the causality so that "(effective) demand creates its own supply." The policy implications of Keynesian theory have been debated and refined for more than half a century.[103] This debate has not changed the essence of Keynesian policy namely that the direction taken by any economy which is operating at less than full employment can be modified by measures which change the level of effective demand. Considered at the broadest macro-economic level, this is a sequencing argument.

Perhaps the first attempt by economists to establish general patterns or phases through which economies evolved to some desired final state were the "stages" theories of development[104]. This approach created widespread interest but it was ultimately undermined by the results of Kuznets' monumental work on the structure of modern economic growth[105].

The stages approach was partially responsible for the appeal of "planned" development in the post-WWII era.[106] Proponents of planning argued that if development proceeded through well-defined stages, the public sector, acting in the "national interest", had an obligation to accelerate the process.[107] The apparent success of the centrally planned economies suggested that planning could rapidly raise countries to higher standards of social and economic development. The availability of increasingly powerful programming techniques seemed to provide the means by which planned development could be achieved.

Sequencing was implied in other ways. According to the theory of the "big-push", the multi-dimensional structural barriers to growth could be overcome with a major effort across the whole economy.[108] Other economists identified various "vicious cycles" and "poverty traps" which undermined growth. To escape these cycles/traps, economists advocated the need for a "minimum critical effort", which was typically seen to involve a major increase in investment.[109] But, for investment to rise, there had to be systematic means of reducing population pressure, raising savings, and improving productivity.

Some observers argued that a "big push" demanded too much administrative capacity and too many resources.[110] Emphasis began to shift to the promotion of "leading sectors".[111] This approach, which built on the idea of "forward" and "backward" linkages[112], was an extension of the notion of comparative advantage. If countries were to develop, policy makers had to encourage sectors and sub-sectors which were growing rapidly. Over time, growth would spread throughout the economy via sectoral income, employment, and product linkages.[113] Some economists then noted that the linkages could have negative as well as positive effects.[114] The implication was that policies designed to promote growth (including sequences of policies) would have to take account of potentially adverse spin-offs.[115]

Other work was also relevant. In order to understand the empirical structures of different economies, econometricians devised many new approaches to solving systems of equations. There was considerable debate about the relationships among variables within these systems. A key question was the degree of simultaneity involved. One view was that economies could be organised and understood as sequential systems.[116] This led to the "causal chain" theory which treats economic processes as a series of distinct and well-ordered steps.[117]

The theory of "optimal economic policy" was an attempt to derive a fully consistent set of policy options based on the known structure of the economy and policy-makers' preferences.[118] A policy model consisted of a set of structural relations and identities linking policy variables, i.e., the "instruments", which could be controlled[119] to the "targets", which policymakers wished to influence.[120] Economic policy was "optimal" when the (sequence of) changes in the instruments yielded the desired increments in the targets.

The theory of "optimal economic growth" was an implicit policy model.[121] It assumed that a properly regulated (or planned) society would wish to maximise its consumption (or some other index of welfare) over time. The solution of the model yielded the time-path of the instruments needed to optimally raise the rate of savings and investment so as to achieve the consumption (or welfare) goals.

All of these approaches have been widely debated. The stages idea faded[122]; the "leading sector" approach became one of several strategies for promoting growth[123]; there was no clear agreement on how to determine the "minimum" effort which was "critical" for growth[124], optimising models proved to be too restrictive as a guide to practical policies[125], and due to "bureaucratic failures" planning lost its appeal.[126]

Research began to shift from stages and phases to the identification of "patterns of economic growth". The objective was to determine the "normal" pattern which selected groups of economies experience as their per capita incomes increased over time.[127] This work helped to identify the types of policies and institutional changes which countries have used to enhance their growth performance.

Taken together, these various threads in the economics literature provide a rich intellectual tradition for the idea that policy reforms should (or ought to) be "optimally" sequenced. Yet, few proponents of policy sequencing have drawn on this literature. The typical starting point for discussions of sequencing is the presumption that there is a broadly applicable set of measures, which if taken in the "optimal" sequence, will minimise the time taken and/or costs associated with economic reform.[128]

This point is illustrated by the set of studies related to the "Southern Cone Syndrome" which first highlighted the problem of sequencing. This syndrome became evident following Chile and Argentina's attempts at adjustment during the 1970's and 1980's.[129] The view taken was that many problems associated with structural reform -- capital flight, financial stress, "de-industrialisation", currency appreciation -- resulted from pit-falls in the design of the respective adjustment programmes. It was believed that these problems could have been contained, or their impact substantially reduced, <u>if</u> the appropriate sequencing of reforms had been agreed in advance.

Much subsequent mis-interpretation and confusion about the sequencing of policies could have been avoided if this had been treated as an hypothesis, which required testing, rather than a fact!

Annex C

Finance Capital and Real Savings

A common presumption in developing countries such as Zambia has been that financial capital (i.e. money and credit) will create real capital. This is a major, widespread, error in economic logic common to Latin America and Africa and, more recently, the economies in transition. It has led to a general overexpansion of finance resulting in high inflation, devaluation, capital flight, and financial disintermediation. Indeed, if finance would promote capital accumulation Zambia, which has seen massive increases in credit over the last two and a half decades, would now be a fabulously wealthy country.[130]

The conditions under which finance can "create" real capital -- stable prices, adequate foreign exchange reserves, an excess supply of productive resources, and no adverse effects on expectations -- are exceedingly stringent. They have rarely been satisfied anywhere in Africa over the last three decades.

Finance can only increase real capital if it mobilizes (or frees up) real savings, that is, real resources which have been explicitly set aside from current income flows for purposes other than consumption. The following quote makes the point[131]:

> Although the existence of a more developed capital market and financial intermediaries will aid in the collection and distribution of investible funds, they in no way lessen the need for real saving. The rate of investment which it is physically possible to carry out is limited by saving, and a "shortage of capital" -- in the sense of a shortage of real resources available for investment purposes -- cannot be solved merely by increasing the supply of finance.

The basic task of any financial system is to transfer resources from those who have the capacity to lend to those who have the capacity to borrow. By accepting financial liabilities (i.e., providing credit), individual lenders release their surplus resources (i.e., their savings) to other individuals and firms, who promise to discharge the liabilities from the financial surpluses which they anticipate from their investments[132].

By aggregating over all borrowers and lenders in the economy (or, more generally, all savers and investors), the familiar national accounting identities emerge[133]:

(1) $Y = C + S$

(2) $Y = C + I + X - M$

where
Y gross domestic product
C aggregate consumption (private and public)
S gross domestic savings
I gross domestic investment (including inventories)
X exports of goods and non-factor services
M imports of goods and non-factor services.

Equating (1) and (2) and rearranging gives:

(3) $S - I = X - M$

An excess of real domestic investment over real domestic saving is balanced by an excess of imports over exports, and vice-versa.

Identity (3) can be satisfied in several different ways. Consider, for example, some of the possible reactions to an increase in government expenditure without any change in tax rates. The rise in expenditure can:

- crowd out private investment through higher interest rates, or credit rationing;
- if there are idle resources (including ample foreign exchange reserves), the increased demand may raise real output yielding higher tax revenues and increased private saving;
- if there are no idle resources and monetary policy does not limit the growth of demand, prices will rise and government spending will be covered by forced saving (the so-called "inflation tax");
- alternatively, the increased domestic demand may be matched by higher imports. That may occur through exchange depreciation or by capital inflow. The latter could result from foreign aid, government borrowing from foreign banks, or private flows in response to higher interest rates.

In African countries there are seldom sufficient idle resources to permit a substantial "Keynesian" output response to higher government spending. Increased government spending is often directly linked to increased foreign assistance. Private resources are limited, especially as investor confidence has declined due to economic instability. Exchange depreciation has its own costs in terms of inflation and the redistribution of wealth. The forced saving solution is costly and counterproductive, and interest rate effects are typically too small relative to other risks to attract capital inflow.

For real output to increase on a sustained basis, additional real resources have to be mobilised. This process is supported by a stable financial setting in which the individuals and firms who generate surpluses will transfer them to those who have the capacity to create the additional output. By contrast, the explicit use of financial instruments to extract these surpluses (via inflation or low interest rates) is counterproductive. It eventually produces lower saving and investment and slower growth or, in Zambia's case, economic contraction.

Annex D

Chronology of Zambia's Economic Reforms

1991

November

First comprehensive sets of Zambia's external debt data produced.

December

Priority programme to rehabilitate infrastructure (roads, schools, hospitals) commenced.

1992

January

Non-traditional exporters allowed 100 percent foreign exchange retention;
Official exchange rate devalued by 30 percent and rate of crawl accelerated (to 8 percent per month)
Subsidies on maize meal (breakfast meal) removed.
Programme to reduce military expenditure in real terms over period 1992 to 1994.
Commitment to limit net borrowing by Government from the banking system to zero (not achieved).
Plan for privatisation announced.
Subsidies, loans, and loan guarantees eliminated for all parastatals except Zambia Airways and ZCCM.
Increase budget allocations for educations and health; priority given to repair of basic infrastructure.
Import preferences (except for PTA) revoked.
Debt Management Task Force created to coordinate all issues related to external debt.

March

First evidence of major failure of maize crop; efforts to mobilise donor support started.
Controls on export of petroleum eliminated.

June

Subsidies on maize meal (roller meal) removed.
Controls on all prices eased; most eliminated.
Fertiliser market opened up to full competition.
Pan-territorial pricing of maize eliminated; pricing to reflect differential transport costs

July

Agreement with Paris Club on rescheduling of bilateral debt. A total of $1.1 billion was rescheduled on enhanced Toronto terms producing a (present value) reduction of debt of 50 percent.

Legislation enacted to increase autonomy of Local Councils.

Act to establish the Zambia Privatisation Agency passed

Investment Act amended to make incentives automatic and transparent.

August

Introduction of Pre-Shipment Inspection for all imports above $5000.

September

First phase of government lay-offs (12,000) contract daily employees.

October

Bureaux de change system for foreign exchange introduced

Open General License System changed from a positive list to a negative list.

Report of Tax Policy Task Force recommending sweeping changes in the tax system.

November

Rationalisation of interlocking debts between Nitrogen Chemicals Ltd. (a parastatal) and Government; sets principles for subsequent rationalisations.

December

Joint MoF/BoZ Data Monitoring Committee established

Exchange rates unified (with ZCCM selling at the market exchange rate)

1993

January

Cash budget introduced

Weekly Treasury Bill tender commenced

Announcement that Exchange Control Act will be repealed.

General reduction in tariffs and excises; shift to Harmonised Code for trade classification.
Reduction of Corporate Tax Rate; modification of personal income tax rates and bands.
Budget Heads established for Defense and Security Forces.
Elimination of import and export licenses announced; import license levy abolished.
Company tax reduced from 40 percent to 35 percent.
Special fund set up to accelerate road rehabilitation.

<u>March</u>

All bilateral (Paris Club) agreements finalised. Negotiations on interest rate reductions and additional debt write-off produce savings of $100 million.

<u>June</u>

Import and export licenses eliminated.
Establishment of Zambia Revenue Board.
Preparations for sale of first tranche of parastatals.
IDA and four other donors agree to provide US $ 49 million to support the commercial debt buy-back.

<u>July</u>

Formal establishment of the Lusaka Stock Exchange
Markets for maize and fertiliser opened to full competition.

<u>November</u>

Commencement of Public Sector Reform Programme

1994

<u>January</u>

Exchange controls removed.
Manufacturing-in-bond permitted.
Duty drawback extended to include third party exporters.
Property transfer tax reduced from 7.5 percent to 2.5 percent.
Monitoring of ministry's commitments commenced.
Provision for countervailing duties if unfair trade practiced can be proved.

<u>April</u>

Zambia Revenue Authority commenced operations.

Privatisation Fund account established.
Government built up Strategic Reserves of maize (2.6 million bags).

June

Retirement package for civil servants determined.

August

Mineral Tax Act revoked and replaced by Mineral Royalty Tax Act. (This change brought Zambia into line with international norms.)
Land Act amended to facilitate trading in land and reduce land and property transfer tax (other changes with respect to land held over awaiting broader consultations).

September

Commercial debt buy-back operation (ongoing since 1992) completed. Approximately $652 million in debt extinguished.

December

Zambia Airways put into receivership.

1995

January

Conversion of most commercial banks' statutory reserve deposits to medium term government debt as a means of reducing the interest rate spread.
Adjustment of personal income tax limits to overcome "bracket creep".

February

Meridien Bank supported by BoZ and Government after major run on its deposits.

March

ZIMCO put into voluntary liquidation

May

Sale by public flotation of shares of Chilanga Cement

to the general public.
Meridien Bank put into receivership.

July

Value-Added Tax introduced (1st July) Sales Tax repealed.
Sale of Zambia Sugar Company Ltd.

Ongoing Efforts

Some actions can have specific dates attached to them. Others, however, are the result of ongoing efforts. These include:

- deepening the inter-bank financial market;
- improvement of debt service management;
- improve efficiency of non-tax revenue monitoring and collection;
- raise the standard of tax administration;
- shift public resources to RDC's and capital;
- effectively mobilise and use donor resources;
- disengage from budget support to agriculture;
- close selected overseas missions;
- move monetary management by Bank of Zambia to indirect controls;
- improve supervision of the financial system by the Bank of Zambia;
- reorganisation of the Public Service;
- privatisation of parastatals;
- modify land legislation to reduce restrictions on valuation and transfer;
- upgrade rural infrastructure -- storage, veterinary services, national agricultural information;
- adopt new Mining Code to make Zambia's mining system consistent with international standards;
- determine plan for privatising ZCCM;
- extend rural electrification programme;
- improve efficiency of transport system;
- upgrade telecommunications;
- devolve administration of Health and Education to District level;
- increase cost recovery in Health and Education;
- extend and upgrade water and sanitation;
- strengthen poverty reduction and social safety net programmes;
- improve the scope and quality of official statistics, especially balance of payments and price data.

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Endnotes

1. Bruno (1985) was explicit. He noted that "... theory tells us virtually nothing about optimal transition paths from a distorted system to one that is more fully liberalised. Unfortunately, this is the most important problem for any successful reform." Subsequently, McKinnon (1991:4) asserted: "How fiscal, monetary and foreign exchange policies are <u>sequenced</u> is of critical importance" (emphasis in original).

2. di Gropella 1992; Levy 1993; World Bank 1994a; Edwards 1994.

3. The NERP was formulated in 1989 by the Kaunda government (GRZ 1989). The basic policies differed little from those contained in the earlier programme for "restructuring in the midst of crisis" (GRZ 1984).

4. At the beginning of the Rights Accumulation Programme (RAP) in 1992, Zambia's arrears to the IMF exceeded US $1.2 billion (approximately one-third of GDP). The RAP will convert the arrears to a concessional ESAF loan.

5. At one time, Zambia had an excellent credit rating. From the late 1970's onwards, external payments lagged and arrears mounted. Serious efforts to reduce the arrears did not begin until the change of government.

6. The earliest references cited in the survey by Edwards (1994) were McKinnon (1982), Edwards (1984), and Fischer (1986). Other discussions of sequencing may be found in Corbo and de Melo (1985), Bruno (1985; 1988), Edwards (1986), de la Cuadra and Hachette (1988), Edwards and van Wijnbergen (1989), Selowsky (1990), Smith and Spooner (1990), Roemer and Radelet (1991:71-74), di Gropella (1992), Edwards (1992), Levy (1993), Krueger (1993), Killick (1993), van Drunen and van der Kraaij (1994), World Bank (1994a), and CDR (1995).

7. World Bank (1994a:1,2,13,14). That there is some "correct" sequence is reinforced by numerous references to the ordering of policies that were "wrong", or "mistakes". See also Bruno (1988:224-230) and CDR (1995:67).

8. The World Bank (1994a:3) noted: "(T)he question of sequencing arises usually in connection with three groups of reforms that need to be implemented simultaneously or in a certain sequence if they are to produce the intended benefits in good time."

9. McKinnon (1991:4) noted:

> Governments cannot, and perhaps should not, undertake all liberalizing measures simultaneously. Instead,

there is an "optimal" order of economic liberalization which may vary for different liberalising countries depending on their initial conditions, as described in the various country studies contained in Chapters 3 to 12, but whose common characteristics are the unifying theme of this book.

10. The "big bang" in London's financial markets was implemented only after several years of detailed preparation.

11. Political considerations usually dictate that this process involves "squeezing the squeezable" (as Boulding once put it).

12. Proponents of sequencing have tended to ignore the fact that many economists and political scientists spend most of their careers deriving strategies for, and approaches to, policy implementation. Indeed, schools of public administration devote major parts of their curricula to these topics. Yet, despite all this effort, no optimal policy sequence which can be broadly applied has been derived.

13. An example is the foreign exchange auction in Zambia (1985 to 1987). The government floated the currency but failed to reduce the budget deficit and control the money supply so as to ensure that domestic absorption would decline. The auction was abandoned and foreign exchange controls were reimposed (Harber 1989; SIDA 1989; Aron and Elbadawi 1992; Lewis and McPherson 1994).

14. It is implicitly assumed that agreement exists about the definition and objectives of "economic reform". But, on this point the literature offers little help. "Economic reform" is widely discussed but rarely defined. A recent OECD study described the different approaches to economic reform used in the industrial countries (OECD 1994). Some countries have reformed their financial systems; others have not. Some have restructured their tax systems; others have only tinkered with tax reform. Some countries have fundamentally changed their labour laws; others have not even tried. And, some have revamped their industrial policies; others have avoided the issue. Yet, all countries, by their own definition, are undergoing fundamental economic reform. Furthermore, as I noted in the Introduction, many developing countries (including Zambia) have had to devote much of their initial efforts to promote reform to ensuring that external financing continues. External finance is a means of achieving adjustment and reform; it is not an objective as such. But, it is often the dominant concern of heavily indebted countries at the start of their reform programmes. Finally, disagreement exists among specialists whether reform, however defined, is actually being achieved in Africa (ENDA 1990; Thomas et al. 1991; Gallagher 1991; World Bank 1994; Schatz 1994; Cornia

and Helleiner 1994).

15. Based on the "Southern Cone" experience, it is generally believed that trade liberalisation involves the opening of the current account of the balance of payments <u>before</u> the capital account is opened. Similarly, it is commonly believed that fiscal stability has to be established <u>before</u> financial reform is attempted. Moreover, economic stabilisation is seen as having to precede structural adjustment. Finally, on the institutional side, a common view is that central banks have to be strengthened (often by legislation making them "independent") before financial liberalisation can be attempted or exchange controls can be removed. Exceptions to all of these propositions are noted throughout this essay.

16. A reviewer on an earlier draft commented that:

> Here, I think you set up an artificial straw man by implying that the sequencing people ask for a multi-dimensional dynamic program specified in advance. This is a rather extreme position that I doubt anyone seriously proposes.

There is no straw man! The above is not stated or implied. It is the discussion about <u>optimality</u> by the "sequencing people" that implies a multi-dimensional dynamic framework. Without this, there can be no notion of "optimality" or even "sub-optimality". (See endnote 1) Otherwise how else could the "sequence people" derive the relevant sequence of "next best moves" in a rigorous and unambiguous way?

17. To illustrate, most African countries do not know the full extent of their external or internal debts. In Zambia, it took two years of detailed analysis to determine and fully document the external debts. Disagreements still arise over amounts due and payment schedules. Similarly, the full extent of interlocking government-parastatal debt is still being worked out. Finally, despite three year's effort by several teams of accountants and various consultants, questions remain about the Bank of Zambia's assets and liabilities.

18. In Africa, an obvious difference has been exchange rate adjustment. For over four decades, the francophone countries fixed their nominal exchange rate. By contrast, other countries adopted a range of exchange rate mechanisms such as auctions, crawling pegs, step-wise devaluations, and floats (Duesenberry et al. 1994). Similar differences are evident in the approaches to and objectives of budget policy (Reisen 1989; Easterly and Schmidt-Hebbel 1993; Easterly, Rodriguez, and Schmidt-Hebbel 1994; World Bank 1994).

19. For example, governance was not a major concern prior to the collapse of the Berlin wall and widespread democratisation became a possibility. For some donors, it has become the principal issue. Two Consultative Group meetings for Zambia (December 1993 and December 1994) almost unravelled on governance issues.

20. This is derived from the "Lucas critique" of economic policy models (Lucas 1976; Goodhart 1989:349-350). Major shifts in policy change the historical relationships among targets and instruments. Policy instruments are supposed to be exogenous or "controllable". If the structure of the economy changes as a result of adjustment, this condition collapses. The same idea of policy-induced structural changes underlies Goodhart's Law that variables become distorted (and therefore unreliable for prediction purposes) once they are used as targets (Goodhart 1989:100;377).

21. On this point, the political economy perspective is even more forceful. Krueger (1993:9-10) noted:

> ...it is often unsatisfactory to discuss either economic policies or governments as one-shot, enduring phenomena. The adoption by a government -- be it a weak democratic coalition, a strong dictatorship, or any other type -- of particular economic policies usually sets in motion political and economic responses that are likely to change both the nature of government and the economic policies. Thus "policy cycles" of various types may emerge where neither the governmental type nor the set of economic policies are exogenous. Earlier policies and market reactions to them may determine what the political coalitions are, and what economic policies are adopted. Those policies in turn would have effects on the evolution of markets and political coalitions.

22. This follows Kuznets' critique of theories of "stages of growth". Kuznets argued that these theories provided no mechanism by which one stage progressed to the next. This critique can be applied to sequencing by asking what is inherent in the process of economic reform which requires one policy change to precede, be concurrent with, or follow another? Since economic reform is not a rigidly structured process, there is no specific reason why optimal -- or desirable/proper/appropriate/right -- sequences of policy change exist, or should be followed.

23. Young 1982; Leys 1982; Obasanjo 1987; Nyang'oro 1989; Phillips 1992

24. The "Southern Cone Syndrome" (Bruno 1988; Edwards 1994) has so overwhelmingly dominated discussions of sequencing that many other perspectives (and contrary results) have been systematically excluded. During their adjustment programmes, Chile and Argentina experienced currency appreciations as a result of capital flows when their trade and exchange regimes were liberalised. This undercut efforts to expand exports. Based on this experience it is now presumed that trade reforms <u>have</u> to precede the opening of the capital account (World Bank 1994a). Indonesia's experience provides contradicts this. It is also at odds with research by de la Cuadra and Hachette (1988:211-212). Based on the history of trade liberalisation in Chile, they concluded that, when capital movements are seen as an equilibrating mechanism, "... the optimum sequencing of market openings should favour opening the capital market first."

25. <u>Economist</u> April 8th-14th 1995. On this matter, perceptions have changed. It used to be asserted (see Roemer and Radelet 1991), that stabilisation had to precede structural adjustment. A milder view was that structural adjustment could not occur without stabilisation. Russia's experience casts doubt on both of these propositions.

26. Any adjustment programme can be modified by financing the macroeconomic imbalances. The economic reforms in the industrial countries, referred to earlier, combined major policy and institutional changes with liberal financing (OECD 1994). By contrast, the shortage of financing, has forced the "transitional economies" of Eastern Europe and the Former Soviet Union to give greater emphasis to adjustment (Sachs and Wing Thye Woo 1994; Ebrill et al. 1994; Murrell 1995).

27. Since 1979, there has been much hand-wringing, several Acts of Congress, millions of words pro and con, and increasingly dire warnings about the effects of the budget deficit in the United States. Little has been done. One reason is that the United States has been able to finance its deficit <u>in dollars</u>. As such, there has been no pressure to deal effectively with the fundamental structural problems which generate the deficit (low domestic savings and declining average productivity relative to world standards). It has been more convenient politically to let other variables, such as the exchange rate and the national debt, adjust than to cut expenditure or raise taxes to cover the deficit. This process has led to a significant shift in US attitudes about deficits and debt. Some economists have even attempted to deny that the unprecedented change in the net indebtedness of the United States is a problem (Eisner and Pieper 1984). Budget deficits in the US were once viewed with the utmost seriousness. A prevalent view now is that having "got away" with deficits for so long, they do not constitute a long-term threat to growth. The same arguments were once used in many

developing countries (including Zambia). Those that have not collapsed (Zaire, Sierra Leone), are now attempting to revive their economies.

28. Sandbrook 1987; 1993; Nelson 1990; Rimmer 1991; Thomas et al. 1991; Meier 1991; Haggard and Kaufman 1992; CSIS 1992; Hyden and Bratton 1992; Lafay and Lecaillon 1993; Lindauer and Roemer 1994

29. Dervis and Petri 1987; Lindauer and Roemer 1994.

30. A reader of an earlier draft noted that: "What is going on here is that governments may not be programming the country's welfare function, but their own (or some set)." This is precisely the essence of the political economy argument which appears in Hyden (1983), Sandbrook (1987; 1990), Ayittey (1992) and Hyden and Bratton (1992).

31. Wolf (1979; 1988) examines both market and bureaucratic failures. Tweeten (1989), McPherson and Zinnes (1991), and Ayittey (1992) explore related issues.

32. Even such reform-oriented entities such as "privatisation agencies" have had little success, particularly during the early period of adjustment. There are often questions about the commitment, integrity, and even-handedness of the staff of these agencies. Finding competent, honest staff to manage them has been difficult. Results so far have been modest. Zambia's situation appears typical. Many of the bureaucratic problems which hinder the operations of the Zambia Privatisation Agency are similar to those of the State-owned enterprises that ZPA is meant to be privatising.

33. In Zambia, the floating of the exchange rate and the liberalisation of interest rates at the beginning of 1993 led to a period in which nominal interest rates (on 28-day Bills) reached compounded annual rates in excess of 600 percent. The exchange rate rose as asset-holders continued moving their resources into foreign exchange. By the third quarter of 1993, interest rates began to fall (reflecting the sharp decline in inflation). Real interest rates remained high until the final months of 1994.

34. World Bank 1977; McPherson 1980; GRZ 1984; Zuckerman 1986; Kayizza-Mugerwa 1988, 1990; Gulhati 1989; GRZ 1989; Callaghy 1990; Seshamani 1990; <u>Economist</u> 1991; Fardi 1991; GRZ 1991; Bates and Collier 1992; West 1992; World Bank 1993; and Lewis and McPherson 1994.

35. Much has been said of Zambia's poor performance, but there has been little critical analysis of the donors' roles in

Zambia's economic collapse. Why was it that the IMF and World Bank and other donors continued lending to a country that, by 1978, could not fully service its external debt. (Indeed, by 1978, Zambia's debt/GDP ratio surpassed the highest levels reached by Latin American countries at the height of the "debt crisis".) Moreover, donor support continued even as Zambia incurred arrears, thereby allowing the Kaunda government to postpone reform.

36. Growth came from higher copper production, the expansion of associated manufacturing activity, transport, construction, and growth in agriculture (Deane 1949; Baldwin 1966; McPherson 1980).

37. The group is small but it includes Tanzania and Senegal.

38. Kindleberger (1988), Friedman (1992). Over the last two decades, many countries -- Argentina, Bolivia, Peru, Zaire, Brazil, Turkey, Yugoslavia, Sierra Leone, Ghana, and Uganda -- have had similar experiences. Ukraine, Russia, and Serbia are more recent examples.

39. The lack of good economic analysis is <u>not</u> an explanation. There were many useful attempts to highlight the key problems facing the economy and a constructive path forward (Goodman 1971; Siedman 1974; IMF 1977; World Bank 1977).

40. UN/ECA/FAO "Seers Mission" 1964

41. Income inequalities in Zambia were stark even though racial discrimination had not been pushed to the institutionalised extremes in South Africa and Zimbabwe (Gray 1960; Loney 1975).

42. Mwanza 1973; McPherson 1980:Ch.2

43. This speech was the fourth in a series, dating from 1968, 1970, and 1972, which Zambia's leaders saw as "taking back" the nation's assets. This action was meant to give Zambia financial and economic independence so that Zambia would move "... towards complete independence" (Kaunda 1969; Faber and Potter 1971; Harvey 1972; Martin 1972). However, as time has shown, owning assets is one thing; making them productive, and using them <u>in the national interest</u> on a sustainable basis are entirely different matters.

44. In 1974, the budget <u>surplus</u> was 3.4 percent of GDP, and the current account balance of payments <u>surplus</u> was 0.5 percent of GDP. Corresponding data for 1975 were <u>deficits</u> of 21.5 percent of GDP and 29.4 percent of GDP. (<u>IFS Yearbook 1994</u> 1994:778-781).

45. Gulhati 1989; Callaghy 1990; Bates and Collier 1992; West 1992

46. Former President Kaunda regularly attributed Zambia's poor economic performance to such things as fluctuations in copper prices, the oil shock, the closure of the Zimbabwe border, transport problems, civil wars in neighbouring countries, exploitation by transnational corporations, and rising real interest rates in world markets. Kayizzi-Mugerwa (1988) examined the impact of the major external shocks on the Zambian economy. Even after taking external shocks into account, a large residual remained. The implications is that internal responses (policies, institutional changes) were also responsible for the poor performance.

47. The term is from Sandbrook (1987). Szeftel (1982), Good (1989) and Crown Agents (1991) provide details.

48. The decline in social conditions in Zambia has been widely documented (ILO 1977; GRZ 1984; Iliffe 1987: Ch. 13; Seshamani 1990; Kelley 1991; ILO 1992; World Bank 1994b). Perhaps the most telling datum is that, over the period 1970 to 1992, Zambia's infant mortality did not decline. Based on World Bank sources (<u>World Development Report</u> 1994:Table 27) this occurred in only two other countries in the world. These were Uganda (which were subject to the excesses of Idi Amin and Milton Obote) and Mozambique (which had two decades of civil war).

49. There are several sources -- gaps in the balance of payments, the holdings by Zambian residents of foreign bank accounts and other assets abroad, estimates of the unrecorded gem trade, and parastatal transfers abroad.

50. Zambia also made a brief attempt in 1988 at "growth from own resources" (SIDA 1988; Kayizza-Mugerwa 1990). This followed the cancellation of the foreign exchange auction in 1987 and Zambia's break with the IMF.

51. If Zambia had simply grown at the rate of Sub-Saharan Africa as a whole over the last two decades (which was the worst regional performance in the world), its real GDP (and real per capita income) would be more than double the present level.

52. The donor response was rapid and generous. Approximately one million tonnes of food aid were provided. This was slightly less than Zambia's normal annual production of maize (USDA 1990:546).

53. These issues had been widely debated during the election campaign. Indeed, the MMD Party had an advertisement which stated:

> "President Chiluba will answer ... for all his actions, to YOU! The hour has come for a new President who makes

himself answerable, for all his actions, to the people. A man who will also hold himself responsible for the actions of his ministers. That man is President Frederick Chiluba of MMD."

54. The budget was "balanced" in the sense that domestic revenues equaled domestic expenditure. Foreign flows for debt service, development assistance, and commodity grants were separately accounted for.

55. This outcome was embarrassing. Senior government officials were making preparations to request the donors for further large amounts of aid at the Paris Consultative Group meeting in December 1992.

56. Kasonde 1994

57. The limit was imposed by a specific allowance in the budget and the threat, subsequently carried out, that taxes would be raised to cover wage settlements above the budgeted amount.

58. Exchange controls were not formally removed until January 1994. The government's announcement in January 1993 that it intended lifting them was, in effect, a *de facto* removal.

59. In practice, Zambia has run the "cash budget" with a small surplus. Expenditures are funded (i.e., money is released from Bank of Zambia accounts) only when revenue receipts (either in the form of taxes, fees, or direct donor support) will cover the fundings on a daily basis in advance. These amounts are released into designated Bank of Zambia accounts for use by line ministries and government agencies. It normally takes some weeks for these funds to be drawn down. Since early 1993, the balances in these accounts have averaged roughly half the monthly fundings. The cash budget has been correspondingly tighter than its name suggests.

60. Major confusion surrounded this episode. In mid-February 1993, BoZ management informed the IMF and MoF that it was not lending to ZIMOIL. Due to the lack of BoZ data, this claim could not be checked. In the interim, much effort was wasted searching for other sources of reserve money growth when, in fact, it was BoZ lending to ZIMOIL.

61. The exchange rate appreciated significantly and prices fell in November 1993. This episode has attracted much comment. The IMF, for example, believed that the government squeezed the money supply too severely. Its staff argued, after the fact, that the government should have aimed for a more gentle reduction in inflation and minimal (or preferably no) appreciation of the kwacha. There were three reasons why this was not feasible.

First, MoF officials recognised that the exchange rate and real interest rates would over-shoot. (A memo was prepared for the minister on this issue in September 1993.) Second, the IMF did not offer before the fact to make the necessary changes in the performance criteria which would have provided the margins for an attempted "soft-landing". The September and December 1993 targets for reserve money, net international reserves, the debt stock, net claims on government, and reductions in arrears to the IMF remained as had been earlier agreed. And third, as a practical matter, no one anywhere has demonstrated that the Zambian economy (or any other economy that had been so badly mis-managed for so long) could have been stabilised gradually. The government faced a major credibility problem. No one had any confidence that the government would achieve its objective. By standing the economy "on its nose", the government began to build a reputation for prudent economic management. Reducing monthly inflation rates from 15.1 percent to minus 1.6 percent over a period of five months, while allowing nominal rates of interest on 91-day T Bills to reach 348 percent (in compound annual terms), was a complete break with anything Zambia had ever experienced. It demonstrated unambiguously that the government was serious about reform. In my view, subsequent analyses will show that although the movement in the exchange rate was a temporary disruption, it was fully consistent with reducing the costs of disinflation. Indeed, a growing literature (Kahn and Weiner 1990; Posen 1995; Fuhrer 1995) has linked the costs of disinflation to credibility. Since economic policy lacked credibility prior to the introduction of the cash budget, some purposeful, constructive, and forceful demonstration of the government's commitment to reform was needed. Anything less would not have created the conditions needed to bring inflation down and ultimately keep it down.

62. In November 1993, following the lead of the United States, the donor community took a stand on allegations of drug-running and corruption among cabinet members. The message was repeated at the December 1993 Paris Consultative Group meeting. Several hundred million dollars of donor pledges to Zambia were put on hold. When the public learned of this, there was a scramble for foreign exchange. The kwacha depreciated sharply. In response, the government reduced the growth rate of reserve money and Treasury Bill interest rates, which had been falling during the second half of 1993, rose sharply. (The average annual T Bill rate was 399 percent in the third week of January 1994.) A similar problem emerged in December 1994 when the government baulked on its commitment to liquidate Zambia Airways. Once the government acted, the donors re-confirmed their support. The foreign exchange and T Bill markets, which had begun to move, settled down.

63. Meridien BIAO Ltd. experienced a run in January/February 1995. There were many causes. The bank was grossly under-capitalised. With BoZ supervisory indulgence, it had been that way for an extended period. It had also been poorly managed and many of its assets had been transferred abroad. The run on Meridien produced a "flight to quality". Deposits were transferred to the "old" Zambian banks (Standard, Barclays) and the demand for foreign exchange increased. The exchange rate, which had been around K680=$1 for most of 1994 jumped to K820=$1 in February 1994. The Minister of Finance issued a statement to Parliament in late February to assure the public that the government would not permit the troubles at Meridien to undermine the economic recovery. This helped insulate the rest of the financial system. Meridien itself did not recover. It was placed in receivership in May 1995.

64. In early 1993, some economists were predicting that Zambia was headed for hyper-inflation (Adams and Bevan 1993).

65. Prima facie evidence that the government has not paid explicit attention to sequencing is the delay in reforming the mining company (ZCCM). Indeed, had the government based its actions on the relative costs and benefits of accelerating economic growth, the restructuring of ZCCM would have been a major priority. The net present value of the delays in improving ZCCM's performance amounts to hundreds of millions of dollars. In view of the plans by Chile to almost double its copper output over the next several years (Wall Street Journal, 25th July, 1995), these costs are now even higher. So far, it has been widely presumed in Zambia that sustained growth can be achieved without the fundamental and rapid transformation of ZCCM. This has been a major mistake.

66. Zambia's history of reform is more closely related to the "cycles" or "phases" of trade liberalisation identified by Bhagwati and Krueger (Krueger 1993:135-138). One of the phases was "reversion" to the pre-reform state. Prior to 1991, Zambia provided an almost continual study of "reversion".

67. The budget deficit in 1986 exceeded 25 percent of GDP (Harber 1989; SIDA 1988; Aron and Elbadawi 1992; Lewis and McPherson 1994).

68. The projection results reported in McPherson (1980: Ch.3) demonstrated that the economic policies in place during the late 1970's -- fixed, overvalued exchange rate, rapid increases in real wages, declining investment in mining and agriculture, high rates of external borrowing, and high levels of government consumption -- were unsustainable. Similar results were obtained by Kayizza-Mugerwa (1988).

69. Since the early 1970's, the donor community has had more than one major new initiative a year. The list includes small farmer development, rural growth centres, the poorest 40 percent, basic human needs, industrial development, agricultural development, sites-and-services programmes, environment, structural adjustment, sectoral adjustment, private sector development, industrial reconstruction, debt reduction, poverty alleviation, basic infrastructure, and (for 1995) work and workers. The World Bank's World Development Report (published annually) traces this shifting agenda. Little detailed attention has been given to the confusion these shifts create in development bureaucracies, the demands they place on the scarce analytical and managerial capacity in developing countries, and how poorly it reflects on the development profession's inability to focus on the few key issues that are crucial to overcoming poverty and promoting growth.

70. One point which has received little attention is the extra-ordinary funds which sustained the Kaunda government. Various grants from Zambia's "friends", such as Saddam Hussein and the non-callable deposits of the Bank of Kuwait, are now well known. However, the role of the gem trade, drugs, and "transfers" from the parastatals to support the "Party and its Government" has never been fully revealed. One hypothesis which has not yet been rejected is that this unofficial financing allowed the government to resist reform, despite the collapse of the economy.

71. The introduction of the Treasury Bill tender and removal of exchange controls were other structural changes which reinforced the policy of market-based liberalisation. These changes were radical departures from past practices in which interest rates and the exchange rate were administratively determined.

72. Smith and Spooner 1990; Edwards 1994

73. There has been a steady stream of criticism of the SAP (structural adjustment programme). Over the last three years, the SAP has been blamed for almost every conceivable economic (and other) problem in Zambia. The President and other senior government officials have repeatedly stated that there is no alternative to adjustment. They have stated categorically that there can be no going back. Yet, having said this, the Government has been slow in restructuring ZCCM, reforming the public sector, disengaging from agricultural marketing and input supply, and reducing the civil service. Reform in these areas would play a major role in promoting sustainable growth.

74. In several countries, tax reform has been a key institutional reform which has accelerated the adjustment process (UNCTAD 1995).

75. This is now the third year in a row that such a correction has been required.

76. The "war of attrition" among interest groups discussed by Alesina and Drazen (1989) provides a useful model of the sources of adjustment delays.

77. By extension, there are no sub-sequences of reforms which apply widely either. A reviewer of an earlier draft noted that "...some sequence did occur [in Zambia]. What was it? ... Even if a happenstance, the order may have mattered." (Emphasis in original.) The point of showing that there is no theoretical foundation for a pre-determined optimal model of policy sequencing is that the order in which policy reforms take place is, in fact, "happenstance". Within a particular country, the order will have obviously "mattered"; but, it was the country's specific circumstances which generated the order and not some common theoretical framework.

78. The emphasis in Zambia on improved social service delivery is an example.

79. Dornbusch (1990), Pindyck (1991) and Hubbard (1994). Potential investors have the option of waiting to see how the reform programme unfolds. (During the wait, resources are often kept abroad which acts as a drag on reform.) While the incentives for waiting are now well understood, much less attention has been given to means by which governments can cut through the cycle of self-fulfilling lack of reform as all investors wait for reform to "get under way." Under these circumstances, Government action can have an important effect on the "micro-structure" of reform. For example, economic liberalisation usually results in a general improvement in the incentives faced by the small-scale, "informal" sector operators by reducing the inefficiencies created by government interference. In Zambia, these small-scale operators have been a major source of dynamism in the economy. As more opportunities begin to open up, the waiting option become less attractive (and more costly).

80. As Phelps (1990: Ch.1) pointed out, this is an old problem in economics which has engaged some of its best minds. It was basic issue to Keynes' contribution. Referring to the problem of coordinating the expectations of decentralised consumers and producers, Phelps noted (ibid.:5):

> This was radical stuff. In pressing on economists the uncertainty of future conditions, the difficulty of gauging the analyses of others, and the consequent impossibility of a collective mind and collective rationality, Keynes was the bearer in economics of

the intellectual revolution of his time.

81. This theme was common to the series of World Bank reports on Sub-Saharan Africa (World Bank 1981, 1984, 1986, 1989). It was emphasised at the special United Nations conference on Africa (United Nations 1986). It was also implied by the Organisation of African Unity's "alternate" structural adjustment programme (ECA/OAU 1989). Government of Zambia submissions to the donor community make the same point (GRZ 1984, 1989, 1992).

82. This was one explanation for abandoning the exchange rate auction in 1987 (SIDA 1989; Harber 1989; Gulhati 1989).

83. Over recent years, the reverse has been the case. There have been major improvements in the commitment to reform by various governments only after donors have suspended their support. For example, in The Gambia donors suspended most forms of support in the last half of 1985 because they perceived that the government was not serious about reform. In response, the government from June 1985 onwards completely reversed its policies. Aid was finally restored in August 1986. The government's commitment to reform was sustained. Until the coup of July 1994, The Gambia was an African success story (McPherson and Radelet 1992). The experience in Kenya in 1991 and 1992 is another example. In Zambia, donors suspended aid in 1991 as the economy unravelled in the lead-up to elections.

84. Attempts by African countries to convince donors to limit the conditions attached to <u>current aid flows</u> have not succeeded. There has been more success in limiting the conditions attached to debt relief and debt reduction. On several occasions, the Development Assistance Committee countries have unilaterally eased the terms on outstanding debt.

85. This is the only practical way for many African countries to work their way out of that status of being "wards of the international community" (Krugman 1989:184).

86. The aid flows can be generous. For Zambia, gross aid over the period 1992 to 1995 is estimated to be US $5.5 billion. Over the same period, the government will collect the equivalent of US $2.5 billion in local taxes and fees. (These data are from the 1995 budget speech.)

87. World Bank 1994a; Edwards 1994; European Commission 1994.

88. A reviewer commented that "... governments with little credibility need to enact tougher reforms (cash budget, currency convertibility, float ...) <u>before</u> announcing a programme, but that pre-announced reforms work well when, ..., government has established its credibility." I agree. This comment reinforces

my point that strategic behaviour can undercut the most carefully worked out sequence of reforms.

89. An example was ZIMCO (the Zambia Industrial and Mining Corporation), the government's holding company. Economic reform directly reduced ZIMCO's influence. The new government, however, was committed to dissolving ZIMCO. After much delay and obstruction, donor pressure became so intense, that the government has to honour its commitment. ZIMCO was formally dissolved in March 1995.

90. The unions have generally opposed the structural adjustment programme. Traditionally, union workers have been pampered in Zambia at the expense of non-union workers. The result is that Zambia's unit labour costs have been exceedingly high by international standards (World Bank 1977; 1993).

91. Hyden 1983, 1990; Brown and Wolf 1985; Ravenhill 1990; World Bank 1990; Mwanakatwe 1990; North 1990, 1991; Goldsmith 1992; Sandbrook 1993; Williamson 1994; European Commission 1994; van der Walle and Chiwele 1994.

92. The Public Sector Reform Programme was initiated by President Chiluba in November 1993. Considerable momentum seemed to exist for the first few months as ministry's and departments underwent to internal and external reviews. The effort has faded to the point that the lead story in the Times of Zambia (22 July 1995) was "Reforms flop: Civil Service Still Bloated".

93. All donors made this point at the December 1994 Consultative Group meeting in Paris.

94. Moreover, it is not clear that creating an "autonomous" central bank (which many development economists have emphasised) is crucial for reform. It is more important for the government to ensure that its own actions are not a source of instability. This requires fiscal and monetary self-restraint. As Collier (1990) noted, African governments have to re-create "agencies of restraint". This is why the cash budget is so effective in Zambia. It has prevented the Government budget from destabilising the economy. That, in turn, has provided the necessary background for economic agents to recognise and respond to the signals generated by other policy changes (such as price decontrol and prudent monetary management).

95. The difficulties in agriculture are not technical. There are well-entrenched vested interests, especially within the organisations which provide marketing and fertiliser "credits", that have been able to resist government withdrawal from maize marketing. As result, the agricultural "credit" programme has failed dramatically. Over the last four years, close to K100

billion has been provided by Government in the forms of agricultural loans. The recovery rate so far has been minimal. The loans, in fact, have become grants.

96. A reviewer of an earlier draft noted:

> I think that your attack on theory here has misplaced emphasis. If theory just means organised a priori thinking, then that's exactly what the sequencing literature needs. What is the list of proposed policy actions? Within this list, which are complementary; which are substitutable; and which are the necessary or sufficient conditions for other actions on the list? Then the answer to the sequencing debate is clear. Do the necessary ones first. To the extent that resources are limited, do the sufficient ones early. Do the complementary ones simultaneously. And economise on the ones that are mutually substitutable.

There is, however, nothing "optimal" about this scenario. It is, in fact, the essence of the pragmatic approach to the implementation of policy reform.

97. None of these measures is entirely satisfactory, or easy to implement. Civil service reform is highly contentious. For the government, it is politically dangerous since it threatens the livelihood and prerogatives of a powerful group. For the donors, it represents a question of "governance", namely, whether the government can reform itself. Unfortunately, in Zambia, an important point about the function of government wage payments has been overlooked which is that a large proportion of them comprise disguised welfare payments. Relative to productivity levels outside of the government, perhaps as much as half the civil service is redundant. And, since the legally mandated retrenchment costs amount to an average of 10 years' salary for each civil servant, the most economical approach has been for the government to retain workers rather than retrench them. In effect, the slow pace of civil service reform is a rational response to the costs involved. Yet, despite the criticism of its slow pace of civil service reform, the government has made some important changes. For instance, during the mid-1980s, the civil service wage bill was reached 8 percent of GDP. With roughly the same numbers, the present wage bill is under around 4 percent of GDP.

98. Again, the cash budget is an excellent mechanism for forcing improvements in revenue collection. Since the government is committed not to spend until it has the revenue, the lack of tax compliance forcibly reduces government expenditure. The impact

was severe during 1993. So that its expenditure can rise, the government has had to find more revenue. Since tax rates are already high and, under the impact of reform, being lowered, tax compliance <u>has</u> to improve. This has been a key element of Zambia's revenue policy.

99. One of the less obvious but serious costs of economic collapse is the decline in efficiency due to the reduction in specialisation and the consequent increase in redundancy. For example, as the reliability of telephones decline, more messages are sent by personal carrier. This increases the rate of deterioration of the roads, which are usually already bad, further raising the costs of vehicle operation. More spare parts are needed. But, due to foreign exchange limitations local suppliers typically have difficulty getting them. This forces individuals and firms to hold larger operating inventories, to make direct contact with suppliers abroad, and/or to cannibalise old equipment. Over time, this cumulative process of regression and contraction extends to all segments of the economy (McPherson and Zinnes 1991). It systematically reduces the scope of the market, limits the gains from specialisation, lowers efficiency, and raises unit costs.

100. This process in Zambia has been reinforced by two institutional changes. First, several implementation task forces have been created. The Data Monitoring Committee brings together MoF and BoZ officials three times a week to review the day-to-day performance of the budget and monetary aggregates. The Balance of Payments and External Aid Coordinating Committee meets weekly to review external resource flows and debt payments. These, and other committees, provide timely warnings of stresses in the economy. Their staff are responsible for alerting senior officials to emerging problems. Second, a Technical Committee of Economic Ministers meets regularly to review the overall performance of the recovery programme. This keeps the recovery programme under Cabinet level scrutiny.

101. As the main text makes clear, it is not clear that these two factors are the source of the problems. Many reforming governments recognise that the government itself does not have the capacity or credibility to effectively change its policies in such a "phased" way. Moreover, because a key determinant of economic collapse has been the disengagement from economic activity by the private sector, any attempt by government to re-engage the private sector other than by its own withdrawal is unlikely to succeed. Thus, what the CDR authors see as a major "error" by reforming governments can often (more charitably) be interpreted as a hard-nosed assessment of what has to be done to re-engage the private sector and force the existing institutions to change.

102. This is the interpretation of Say's Law of Markets as presented in Keynes (1936:26). Schumpeter (1952:615-620) provides a more detailed explanation of what Say wrote or meant to write.

103. Leijonhuvud 1968; Laidler 1982; Goodhart 1989; Phelps 1990; Mayer, Duesenberry, and Aliber 1993:Chs.20,21.

104. Numerous "stage" theories exist. The most prominent were those of Smith, Marx, List, and Rostow (Schumpeter 1952:570-574; Rostow 1961; Arndt 1988:36ff,58-60).

105. Kuznets produced a series of 10 articles on "quantitative aspects of the economic growth of nations" in Economic Development and Cultural Change over the period 1956 to 1967. The results are summarised in Kuznets (1966).

106. Lewis 1955; Chenery 1958, 1971; Dobb 1960; Meier 1970:X; Wellisz 1971; Blitzer, Clark and Taylor 1975; Killick 1976; Arndt 1988:Ch.3.

107. GRZ 1966; Green 1974; OAU 1979, 1980. There have been many proposals for "accelerating" development. One of these, which is relevant to sequencing, was "supply-leading finance". The argument was that in order to grow, industries and firms require adequate finance. To overcome the constraints imposed by the lack of financial development, governments should provide the institutional base for improving access to finance (Patrick 1966). Although this was a fundamental mis-reading of the history of financial development (Goldsmith 1969), the principle was widely applied. It did not promote development, but it was responsible for exaggerated rates of inflation and currency depreciation, and the failure of many (so-called) "development banks". Over time, development economists have increasingly understood that the issues are more complicated than setting up institutions to "provide finance" (Duesenberry and McPherson 1992).

108. Rosenstein-Rodan 1943

109. Nurkse 1953; Nelson 1956; Leibenstein 1957. A related contribution was Myrdal's (1957) notion of "cumulative causation" which highlighted the positive effects of economic expansion resulting from the use of well-structured economic policies. Zambia's experience is an example of this idea operating in reverse. The cumulative effects of inappropriate policies intensified the economic decline (Tweeten 1989; McPherson and Zinnes 1991).

110. A spin-off of this debate was whether growth needed to be "balanced" or "unbalanced" (Fleming 1955; Arndt 1988:54-60). The

implied sequence of policies for each alternative differs substantially.

111. Hirschman 1958

112. Linkages are key elements of inter-industry or input-output analysis (Leontief 1944, 1966; Rasmussen 1956).

113. The theoretical basis of the idea was solid. Rapid growth occurred in sectors and sub-sectors where the effective demand for the output was income elastic. This was consistent with both Engels and Bennet's laws. Engels' Law implies that the demand for food is income inelastic. Bennet's Law implies that the income elasticity for calories (starchy foods) is negative. As income grows, the demand for the output of food-producing sectors will decline relative to the demand for the output of the non-food sectors. Within the food producing sector itself, the demand for starchy food products would decline relative to the demand for better quality food. Thus, at the aggregate level, leading sectors would typically specialise in the output of non-food products. The leading food sub-sectors would be those which specialise in products whose demand is income elastic (red meat, poultry, fish, etc.).

114. Myrdal (1957) argued that growth produced positive ("spread") and negative ("backwash") effects. Both should elicit some policy response -- the first to enhance the effects; the second to ameliorate the damage. This is the essence of the political economy approach to policy reform discussed in Krueger (1993).

115. There has been a long debate over the relation between growth and income inequality. According to the Kuznets inverted U hypothesis, growth in its initial stages worsens the distribution of income (Chenery et al. 1974). Debate on this issue has resurfaced in the adjustment literature. Donor-supported reform programmes are helping governments to revive economic growth while, at the same time, allocating a larger share of public resources to social sector programmes and poverty alleviation. In effect, the donors are prepared to support economic revival, so long as it does not worsen the conditions of the poor. Recent research shows that pro-growth reform programmes do not worsen inequality even in the short-run (Bruno 1994; Bruno, Ravallion, and Squire 1995).

116. Economists as early as Ricardo had grappled with idea that economic stimuli were arranged, and could be understood in sequential terms. Schumpeter (1952:563-4) traces the idea that the basic economic system was driven by flows and re-flows of "advances". This led to a distinction between "advance economies" and "synchronisaton economies" (ibid.:565).

117. Wold (1964) There has also been a long debate about the role of "causality" in economics. Various tests have been devised for determining which variable (or its lag) determines others within a set of structural relations. Properly applied, formal sequencing models would highlight the basic causality underlying the system being reformed.

118. Tinbergen 1956; Boulding 1958

119. Examples include interest rates, government expenditure, tax rates, bank reserve ratios, exchange rates, domestic content requirements, and quantitative restrictions on imports.

120. Examples include output, employment, imports, prices, savings, government revenue, foreign reserves, and exports.

121. One of the first such models was Ramsey's (1928) theory of optimal saving. This model was expressed in terms of the calculus of variations. Subsequent work was based on dynamic programming and optimal control techniques (Koopmans 1965; Brody 1970; Manne 1974; Chow 1975).

122. Fishlow (1965). The stages idea continues to resurface. Cecelski (1987:pp53ff.) traces a stages approach to "environmental and socio-economic degradation" arising from the energy crisis facing rural women. In a different vein, Selowsky (1990) proposed a stages theory of adjustment for Latin America.

123. Following the East Asia example, the general view is that economic reform should be export-oriented (Dervis and Petri 1987; Edwards 1993; Lindauer and Roemer 1994). This is a "leading sector" approach.

124. The presumption was that countries which had not grown had not made the required effort, or been subjected to a "big" enough "push", and vice-versa. This begs the issue. More recently, environmental economists have revived the idea of "vicious cycles" of deterioration, which degrade forests, diminish whale stocks, threaten fragile ecosystems, and create deserts. To deal with these, require large scale efforts (Vincent 1994; Kaji 1995).

125. Optimising models have been criticised by (among others) Hayek, Simon, Day and others who have argued that decision makers' have limited capacity for collecting and processing information, their rationality is "bounded", and real-world behaviour is adaptive rather than optimising. In effect, economic behaviour and the institutions which support it are seen as evolving through learning (by making mistakes or "doing"). Work on these topics has increased over recent years, boosted in part by the growing use of the techniques of non-linear dynamics

(Day and Groves 1975; Day and Chen 1993; Day 1993).

126. Myrdal (1970:284) noted that "... planning does not counteract poverty." See also Killick (1976), Arndt (1988:Ch.4), Meier (1989:531ff.), and Lal (1994). A major institutional shift was evident at the World Bank following the publication of the volume edited by Blitzer, Clark and Taylor (1975). Interest moved from planning techniques in two directions. One was the development of broad accounting frameworks using Social Accounting Matrixes (Pyatt and Round 1977). The other was the formulation of smaller, more flexible, computable general equilibrium models and simulation techniques designed to highlight the impact of specific policy changes. An early example of these models was Blitzer's dynamic simulation model for Zambia (World Bank 1977, vol.4).

127. This work was primarily undertaken by Chenery and his associates (Chenery 1960; 1979; Chenery and Taylor 1968; Chenery and Syrquin 1975; Syrquin and Chenery 1989; Syrquin 1989).

128. Edwards 1985; Bruno 1988; World Bank 1994a; CDR 1995:67.

129. Bruno 1985, 1988; McKinnon 1991; Edwards 1994

130. From 1970 to 1994, the kwacha value of domestic credit in Zambia increased by a factor of 1147 (i.e., approximately 115,000 percent). The result was not growth but stagnation and decline with an significant capital decumulation.

131. Meier 1989:178

132. Kitchen 1986; Meier 1989:178-182.

133. Helmers in Appendix B of Dornbusch and Helmers (1988) casts the following relationships in terms of gross national income, gross national savings, and the current account of the balance of payments. The difference arises because gross national income (which is equivalent to consumption plus gross national savings) equals gross domestic product minus net factor payments abroad plus net unrequited transfers received. The essential point of these relationships, however, is that any gap between savings and investment is offset (ex post) by corresponding adjustments flows to and from the rest of the world.