

MACROECONOMIC CONSEQUENCES OF FISCAL DEFICITS IN DEVELOPING COUNTRIES:

**A comparative study of Zimbabwe and
selected African countries (1980-2008)**

TAPIWA LEONARD JAISON MASHAKADA



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Promoter: Professor BW Smit

Co-promoter: Professor S van der Berg

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DECLARATION

I, the undersigned, hereby declare that the work contained is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

DEDICATION

This thesis is dedicated to my late mother, **Margaret Mhere**,

May Her Soul Rest In Eternal Peace.

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TABLE OF CONTENTS

TABLE OF CONTENTS	i
LIST OF TABLES	iii
ABSTRACT	iv
CHAPTER 1	1
INTRODUCTION	1
1.1 Introduction	1
1.2 The Problem	2
1.3 Hypothesis	10
1.4 Objectives	10
1.5 Methodology	11
1.6 Justification for the study	12
1.7 Delimitation of Scope	13
1.8 Summary and Conclusion	13
CHAPTER 2	15
MACROECONOMIC CONSEQUENCES OF FISCAL DEFICITS: Review of Theoretical Literature	15
2.1 Introduction	15
2.2 Fiscal Deficits: Definitions and Conceptual Issues	16
2.3 Schools of thought on fiscal deficits	31
2.4 Fiscal deficits and macroeconomic implications	43
2.5 Summary	58
CHAPTER 3	60
MACROECONOMIC CONSEQUENCES OF FISCAL DEFICITS: Empirical Evidence	60
3.1 Introduction	60
3.2 Budget deficits and crowding out	60
3.3 Budget Deficits and Growth	62
3.4 Budget Deficits and Inflation	64
3.5 The Twin Deficits	70
3.6 Budget Deficits and Exchange Rates	75
3.7 Budget Deficits and Interest Rates	80
3.8 Summary	82
CHAPTER 4	84
FISCAL DEFICITS AND ECONOMIC PERFORMANCE: The Experiences of Selected African Countries	84
4.1 Introduction	84
4.2 Sub-Saharan Africa	85
4.2.1 <i>General overview of macro-economic performance in Sub- Saharan Africa before structural adjustment programmes ..</i>	<i>85</i>
4.2.2 <i>General-Economic Performance of Sub-Saharan Africa under Structural Adjustment Programmes (1980-1999)</i>	<i>91</i>
4.2.3 <i>Sub-Saharan Africa's Economic Renaissance (1999 – 2008)</i>	<i>99</i>
4.3 Ghana	107
4.3.1 <i>Introduction</i>	<i>107</i>
4.3.2 <i>Political history</i>	<i>107</i>
4.3.3 <i>Government finances</i>	<i>108</i>
4.3.4 <i>Budget Deficits and Economic Mismanagement</i>	<i>116</i>
4.3.5 <i>Conclusion</i>	<i>127</i>

4.4	Morocco	129
4.4.1	<i>Introduction</i>	129
4.4.2	<i>Fiscal Expenditure</i>	130
4.4.3	<i>Budget Deficits and Economic Performance</i>	134
4.4.4	<i>Conclusion</i>	139
4.5	Zambia	139
4.5.1	<i>Introduction</i>	139
4.5.2	<i>Fiscal Expenditure</i>	140
4.5.3	<i>Budget Deficits and Economic Performance</i>	143
4.5.4	<i>Conclusion</i>	156
4.6	Botswana	157
4.6.1	<i>Introduction</i>	157
4.6.2	<i>Public Finances</i>	157
4.6.3	<i>Conclusion</i>	166
4.7	Summary and Conclusions.....	167
CHAPTER 5	.....	169
	The Experiences of Zimbabwe (1980 – 2008)	169
5.1	Introduction	169
5.2	Political Background.....	170
5.3	Overview	172
5.4	The Genesis of Budget Deficits in Zimbabwe (1980-1988) ...	179
5.4.1	<i>Growth with Equity</i>	179
5.4.2	<i>Transitional National Development Plan (TNDP): 1982-1984</i>	184
5.4.3	<i>Short Term Stabilization (1985-1988)</i>	186
5.4.4	<i>Macroeconomic Implications</i>	189
5.5	Fiscal deficits and macroeconomic consequences during the period of market based reforms (1989-1996)	196
5.5.1	<i>Introduction</i>	196
5.5.2	<i>Economic Structural Adjustment Program (ESAP), 1990-1995</i>	199
5.5.3	<i>Implications for Macroeconomic Stability</i>	203
5.6	Fiscal deficit and implications on macroeconomic performance during the period of failed controls (1997-2003)	205
5.7	Fiscal deficit and implications on macro-economic performance during the period of political chaos (2004-2008)	212
5.7.1	<i>Acceleration of the budget deficit: quasi-fiscal operations during the era of political chaos (2004 – 2006)</i>	216
5.7.2	<i>Impact of bad governance and political blunders on Zimbabwe's economy</i>	225
5.8	Summary	234
CHAPTER 6	.....	238
	CONCLUSIONS.....	238
6.1	Introduction	238
6.2	Findings.....	243
6.3	Implications	247
6.4	Recommendations.....	247
6.5	Limitations of this Study.....	251
6.6	Conclusion	252
References	.....	254

LIST OF TABLES

Table 1: Zimbabwe: Trend of fiscal deficit and public debt stock as % of GDP (1980 – 1988)	4
Table 2: Zimbabwe: Trend of fiscal deficit and public debt stock as % of GDP (1991 – 1999)	6
Table 3: Rating of fiscal performance for selected African countries	95
Table 4: Tax revenue in selected African countries (% of GDP)	96
Table 5: Sub-Saharan Africa – selected economic indicators (2002 – 2007)	100
Table 6: Sub-Saharan Africa: Real GDP growth rates of strong performers	101
Table 7: Sub-Saharan average per capita GDP growth (1996 – 2005) ..	103
Table 8: Ghana: Debt Profile (1983 – 1995).....	114
Table 9: Ghana: Deficit since 2000	124
Table 10: Ghana: Selected Economic and Financial Indicators % (1996 – 2008)	126
Table 11: Morocco: Central government expenditure as percentage of GDP (1971-2005).....	132
Table 12: Selected economic and financial indicators (1999 – 2007)....	137
Table 13: Zambia Inflationary trends (1970 – 1999)	146
Table 14: Zambia: Exchange Rate Movements (1970 – 2004).....	147
Table 15: Zambia: Economic and financial indicators (1995 – 1999) ..	149
Table 16: Zambia: Selected economic indicators (2001 – 2007).....	156
Table 17: Botswana: Selected economic and financial indicators: 1999 – 2008	166
Table 18: Zimbabwe: Central government budget account (Z\$ thousand, 1980 –1988)	190
Table 19: Zimbabwe: Escalation of Domestic Debt (Z\$ million) (1980-1988)	191
Table 20: Zimbabwe: Deficit (nominal increase) and % increase of macro-economic indicators (1980-1990).....	192
Table 21: Zimbabwe: Economic indicators (1980-1987)	197
Table 22: Zimbabwe: Deficit financing (Z\$m)	202
Table 23: Zimbabwe: Increase in public debt from 1991 to December 31 1998	204
Table 24: Zimbabwe: Deficit (1986-2000) as % of GDP	207
Table 25: Illustration of Hyperinflation	215
Table 26: Hyperinflation in Zimbabwe (% change in CPI, 2000 – 2008)	216
Table 27: Sectoral allocation of productive sector facility (Z\$billion) by the Reserve Bank (quasi-fiscal operations).....	219

ABSTRACT

Fiscal deficits, which are the end result of fiscal indiscipline and lack of fiscal space, have been the focus of fiscal and macroeconomic adjustment in developed and developing countries. Developments in the euro zone between 2007 and 2011, have reminded policy makers about the macro-economic dangers posed by government debt. The nasty experiences of Portugal, Italy, Greece and Spain forced policy makers in Europe to introduce painful austerity measures. Up to this day, the eurozone debt crisis threatens the survival of the European Union. Although most African countries were not directly affected by the contagion of the euro zone debt crisis, they too had their own structural problems of unsustainable fiscal deficits and bad governance which caused macroeconomic imbalances. This study examines the macro-economic effects of fiscal deficits and the contribution of bad governance to macroeconomic instability in Zimbabwe.

In chapter one the problem and methodology of the study are introduced. The key questions are basically whether deficits are harmful or neutral? Linked to this is of course, the political economy of these deficits, especially the method of financing them and how this affects the macro-economic equilibrium. In order to investigate these issues, this study uses a qualitative and comparative methodology which juxtaposes Zimbabwe's experiences with those of other developing countries, namely Ghana, Morocco, Zambia and Botswana. These countries are chosen as they collectively depict both cases of good fiscal management (Botswana and Morocco) on the one hand, and bad fiscal management (Ghana and Zambia), on the other. This methodology adequately captures political economy issues which are not capable of being estimated without running the risk of lack of validity and spurious inferences given the softness of

data under hyperinflationary conditions that occurred in Zimbabwe prior to 2009.

In chapter two the study examines various theoretical propositions on the relationship between the fiscal deficit and selected macroeconomic variables. The traditional theory postulates that the fiscal deficit has a negative impact on macroeconomic performance whereas the Ricardian Equivalence Theorem posits that the impact of the deficit is neutral. Keynesians argue that deficits arising from public expenditure on investment as opposed to consumption actually crowd-in rather than crowd out private sector investment. In theory, there is a close connection between a monetized deficit and inflation. A positive theoretical relationship is also found between the twin deficits (that is, the trade and fiscal deficits). However, the relationship between the budget deficit, interest rates and exchange rate is ambiguous.

In chapter three we find that the majority of empirical studies support the view that budget deficits are generally inflationary when they are financed by printing money. A causal link is also found between the budget deficit and trade deficit. However, empirical evidence on the relationship between the deficit, exchange rate and interest rates is largely ambiguous.

The comparative politico-economic and fiscal experiences of Ghana, Zambia, Morocco and Botswana in chapter four are used to provide the trajectory for the Zimbabwean case study in chapter 5. The review of the experiences of Ghana and Zambia showed that fiscal indiscipline resulted in high fiscal deficits which led to the deterioration of macroeconomic performance whereas in Morocco and Botswana, fiscal discipline resulted in low fiscal deficits and improved macro-economic performance. But central to the politico-

economic performance of these countries, was the issue of bad governance and how this worsened the impact of fiscal deficits.

In chapter five the experiences of Zimbabwe confirm the view that fiscal deficits are harmful to the economy. Many years of fiscal indiscipline and bad governance, led to macro-economic instability that resulted in record hyperinflation levels in 2008.

Finally, the study concludes that, cumulative fiscal deficits in Zimbabwe since 1980, precipitated macroeconomic instability and fiscal unsustainability. Prolonged fiscal and quasi-fiscal deficits, which were largely financed by printing money, triggered hyperinflation and macroeconomic disequilibria. The lack of fiscal probity and the profligacy of the state, corruption, macroeconomic mismanagement and dirigistic policies, all rolled into one, caused the unprecedented economic meltdown and eventual economic collapse in Zimbabwe. The study finds that fiscal indiscipline in Zimbabwe, other than causing macroeconomic instability, also contributed to an unprecedented humanitarian crisis, never witnessed in a country not waging a war. Going forward, the study recommends a battery of policy measures in the area of institutional, fiscal and macro-economic adjustment in order to control and manage the deficit in Zimbabwe.

CHAPTER 1

INTRODUCTION

1.1 Introduction

The purpose of this study is to examine the macroeconomic impact of fiscal deficits and the catalytic effect of bad governance in Zimbabwe since independence in 1980 up to the end of 2008 when an inclusive government was formed. To inform this discussion, a comparative study of the experiences of selected African countries is done and lessons drawn. The hypothesis of the study is that fiscal deficits, which are induced by recurrent expenditure, are generally harmful to the economy.

The background to this study is that high fiscal deficits have been at the centre of macro-economic adjustment in Africa and other developing countries since the 1980s. During the 1990s, lack of fiscal adjustment was blamed for an assortment of economic ills, namely: poor economic growth, high inflation, low investment and unsustainable debt in most developing countries (Easterly, 1994). Moreover, the debt crisis that engulfed the Euro Zone since 2010, coming hard on the heels of the 2007 global financial crisis, rekindled the debate on the efficacy and centrality of fiscal policy in macroeconomic adjustment. However, this study adds a new dimension to the study of fiscal deficits by examining the role played by bad governance in abating macro-economic instability. The underlying objective is to find out whether or not fiscal deficits posed any macro-economic problems for Zimbabwe and the role played by bad governance.

The study begins by reviewing the political-economy and fiscal developments in Zimbabwe since independence in 1980. The Study employs a comparative and qualitative analysis methodology to examine the impact of fiscal deficits in Zimbabwe with special

reference to selected African countries, *in casu*, Zambia, Ghana, Morocco and Botswana. The rest of the study proceeds as follows: chapter one gives the background of the study and its chosen methodology; chapter two reviews theoretical literature; chapter three reviews various empirical studies; chapter four focuses on the experiences of selected African countries; chapter five discusses the experiences of Zimbabwe and chapter six concludes the study.

1.2 The Problem

The root of the macroeconomic problems in Zimbabwe can be traced from the cumulative budget deficits incurred since independence in 1980. Admittedly, however, bad governance further worsened the economic situation, especially after the year 2000. Since 1980, issues of budget deficits have preoccupied policy makers in Zimbabwe. Fiscal deficits have been blamed by the IMF and World Bank for most of the macroeconomic problems affecting Zimbabwe since 1980. In the 1990s, Zimbabwe embarked on the IMF backed economic structural adjustment programs whose major thrust was the liberalization of the economy, the removal of controls and subsidies and the introduction of competition, among others. During structural adjustment, Investment increased but consumer prices continued to increase. Economic growth was sluggish and many companies retrenched employees. The deficit remained above the 5% of GDP threshold. After 2000, the country entered a phase of quasi-fiscal operations and monetization of deficits. This plunged Zimbabwe into a record hyperinflation which precipitated the unprecedented economic collapse from 2000 to 2008 (A detailed discussion is found in Chapter 5). But more significantly, fiscal deficits have been roundly blamed for seeding Zimbabwe's national debt stock estimated at around US\$9billion as at December 2008 (GoZ, 2009).

The early years of independence

Zimbabwe's fiscal problems can be traced back from its expansionist fiscal policies that began soon after independence in 1980, when fiscal expenditures were incurred on social development programs in education and health. Defense expenditure and government consumption (civil service wages, subsidies to parastatals and local authorities, purchases of goods and services) also chewed up a large chunk of the budget. Expansionary fiscal policy precipitated budget overruns which were initially funded from domestic and later external borrowing.

Yet at independence in 1980, Zimbabwe had started off with an economy that was relatively robust and characterized by a balanced current account, low inflation and stable growth rates (Morande and Schmidt-Hebbel, 1991). However, growing public expenditures in the late 1980s put Zimbabwe's economic position in a fragile position - a stagnating economy showing low rates of growth and high budget deficits.

Despite a surplus in the current account, Zimbabwe ran fiscal deficits exceeding 10% of GDP since 1981. In addition, due to borrowing, the stock of public debt has been on the increase since independence. This posed serious fiscal and macroeconomic adjustment challenges for the Zimbabwean government.

The following table shows trends of the deficit, foreign debt and domestic debt in the 1980s.

Table 1: Zimbabwe: Trend of fiscal deficit and public debt stock as % of GDP (1980 – 1988)

	Deficit	Foreign Debt	Domestic Debt
1980	9.1	12.0	43.4
1981	13.5	17.6	37.2
1982	13.1	23.3	33.7
1983	14.4	27.0	31.3
1984	12.7	33.3	35.7
1985	14.3	42.2	35.5
1986	14.4	40.6	36.6
1987	10.9	41.1	41.7
1988	10.4	38.0	42.9

Source: Reserve Bank of Zimbabwe Monthly Review, June 2000

As the above table shows, the deficit increased steadily between 1980 and 1983 before coming down in 1984. The deficit rose again in 1985 and 1986 as a result of public spending and borrowing. However, in 1987, a partial fiscal adjustment took place and this led to the improvement in the fiscal deficit in 1987 and 1988. Foreign debt increased from 12% of GDP in 1980 to 38% of GDP in 1988 while domestic debt slightly declined from 43.4% in 1980 to 42.9% in 1988. The high levels of fiscal deficits and public debt showed the lack of capacity by the new government to control spending and borrowing. There is a general consensus that fiscal deficits that are above 5% of GDP can become chronic and become difficult to tame. The European Union has set a budget deficit threshold of 5% of GDP –the Maastricht treaty. Member countries were obliged to contain their budget deficits within a given threshold. However, this was not followed resulting in the infamous Euro Zone crisis. In SADC, the goal of macro-economic convergence by 2015, is premised on budget deficit of 5%.

The impact of the fiscal deficit during the first decade of independence in Zimbabwe was well captured by Morande and Schmidt-Hebbel (1991), when they observed that high public sector spending crowded out both private consumption and investment during the eighties. Restrictions imposed on consumer and capital

imports are also cited as typical examples of the crowding out of private spending in the eighties (Davis and Rattso, 1990). This was caused by the scarcity of foreign exchange which meant that government consumed more foreign exchange leaving nothing for the private sector.

Market based reforms

Public spending and borrowing continued unabated in the late 1980s. Despite the adoption of the economic structural adjustment program in 1990, government failed to exercise fiscal discipline. It is noted that government either failed or was politically unable to exercise fiscal discipline. Of particular note during the 1990s, was the failure by government to reform the loss making public enterprises which demanded huge resources from the treasury, the unbudgeted defense expenditures incurred in the Democratic Republic of Congo (DRC) war of 1997/1998 , a huge civil service bill and interest payments. The fiscal stance created by the above issues, reinforced internal fiscal imbalances which had a destabilizing effect on the economy.

In the following table, we show the trends in the deficit, foreign debt and domestic debt during the economic structural adjustment period, 1991 and 1999.

Table 2: Zimbabwe: Trend of fiscal deficit and public debt stock as % of GDP (1991 – 1999)

	Deficit	Foreign Debt	Domestic Debt
1991	8.0	36	23.5
1992	9.0	56	30.0
1993	5.0	62	30.0
1994	10.0	63	25.0
1995	12.0	62	19.6
1996	8.0	55	17.8
1997	8.0	59	20.0
1998	6.0	78	22.0
1999	8.0	82	24.8

Source: Reserve Bank of Zimbabwe Monthly Review, March 2001

The above table shows that the government of Zimbabwe continued to fail to reduce the budget deficit to 5% of GDP by 1995 as targeted by the IMF and World Bank. Foreign debt ballooned from 36% in 1991 to 82% of GDP in 1999 with debt service payments remaining high. During the 1980s and 1990s, government also relied heavily on foreign financing of public debt.

Government also borrowed from the domestic market by resorting to short-term instruments such as Treasury Bills to finance budget deficits. Treasury bills react quickly to interest rate changes. The Reserve Bank often raised interest rates in order to curb inflation but the underlying force driving inflation was the excess demand in the economy caused by excessive public expenditure-in other words by the fiscal deficit itself. Continued fiscal deficits meant further borrowing and higher interest rates on a larger stock of debt, hence the debt problem became self-reinforcing (Davies, 1994).

Failed Controls and Chaos

During the third decade of independence (2000 -2008), the Zimbabwean economy was plunged into hyperinflation which was primarily triggered by the decline in production in the agricultural sector, followed by a fall in manufacturing and mining production, decline in foreign direct investment (FDI) as a result of the land reform, sanctions, poor export performance and the central bank's quasi-fiscal operations which were characterized by deficit monetization and the total collapse of the local currency as a unit of exchange after several futile attempts to revalue the domestic currency through the removal of zeros.

Due to poor revenue performance in the absence of external support, the public sector became insolvent and the state was no longer able to discharge its obligations. Social and economic infrastructure collapsed due to lack of investment and maintenance. Service delivery was hamstrung by lack of resources. Health, education and social services virtually collapsed. In the health sector, lack of sanitation led to the outbreak of cholera which cost more than a thousand lives in Harare and other urban centers in 2008. Because of public sector insolvency, the central bank directed the financial affairs of the state and government by bankrolling its quasi-fiscal operations across all sectors of the Zimbabwean economy. This resulted in high money supply growth and hyperinflation. Quasi-fiscal losses compounded the deficit which stood at 98 % of GDP in December 2008 although the non-financial public sector deficit was way below that figure.

Role of Governance

Political developments since 1980 are also largely blamed for the macroeconomic woes of Zimbabwe. Since 1980, the state dabbled in politically expedient policies and programs based on a

knee-jerk reaction to problems. For example, the awarding of unbudgeted pensions to war veterans in 1997 sparked a serious currency crisis and budgetary problems. The fiscus was strained by the army's involvement in the war in Mozambique in the 1980s as well as the civil war in Matebeleland. Widespread corruption in the 1980s took its toll on the economy. In the 1990s, government failed or was politically unable to operate within the budgeted revenue due to expenditures that were politically expedient, like for example the maintenance of a state bureaucratic machinery- large cabinet and bloated civil service. The Democratic Republic of Congo war of 1998 triggered an unprecedented hemorrhage of state resources and wiped out Zimbabwe's external reserves. After the year 2000, the state became pre-occupied with maintaining power at all costs. Zimbabwe became a rogue state and resources were used up in defending a state whose popularity was waning. As is often said, dictatorship is not cheap. At the same time accountability broke down and corruption increased. The so-called land reform program was the last straw to break the backbone of the economy. Productive and commercial Agriculture was decimated. Agricultural production declined by 75% and Zimbabwe morphed from being the bread basket of Africa to a basket case. Concurrently, bad governance led to political instability that took its toll on the economy, which was isolated. The European Union imposed economic sanctions in 2002 and the USA crafted the Zimbabwe Democracy and Economic Recovery Act (ZIDERA) which prevented Zimbabwe from accessing loans from multilateral institutions like the IMF and World Bank where the USA has a majority shareholding.

Therefore, between 1980 and 2008, governance issues invariably negatively impacted on the economic stability of the country. First it was political expediency followed by bad

governance. The result was that government ran down the economy. The hall mark of all this were the quasi-fiscal activities of the Reserve Bank between 2003 and 2008. These activities were basically meant to reproduce the state which was under siege, economically and politically. It is important, therefore to note the political developments in Zimbabwe and how they contributed to the economic ruin of the country. This background is important as it informs us about the importance and relevance of political economy issues in Zimbabwe during the period under study. More importantly it helps us understand a political economy question – why do politicians seem to be reluctant to pursue fiscal adjustment? The most common answer is that fiscal adjustments are politically costly: namely they lead to a loss of popularity and eventually to a loss of office. Risk averse politicians will avoid fiscal adjustments (Alesina, 1998).

Alesina and Perotti (1998) suggest that large and persistent deficits may point to the existence of a deficit bias explained by several political economy factors: voters and policymakers may be subject to fiscal illusion (i.e. not be fully aware of government's intertemporal budget constraint), and therefore favour deficits over surpluses; current voters (and policy makers) may want to shift the burden of fiscal adjustment onto future generations; debt accumulation may be used as a strategic instrument to limit the fiscal room for manouvre of future governments; fiscal consolidation may be delayed by political conflicts regarding the sharing of adjustment costs between various groups, resulting in persistent deficits and finally, existing budget institutions may function in a way that leads to persistently high spending.

Given this brief background, the central question to be answered in this study is: To what extent did cumulative fiscal deficits cause macroeconomic instability in Zimbabwe during the

first, second and third post independence decades? This study examines in detail, the political economy of fiscal deficits and the macro-economic implications thereof.

1.3 Hypothesis

The study hypothesizes that growing public expenditures, especially of a recurrent nature, cause fiscal deficits which are generally harmful to macroeconomic performance and eventually trigger macro-economic instability. Thus, it is hypothesized that poorly financed budget deficits cause macroeconomic instability as they affect key variables such as inflation, exchange rate, interest rate, trade deficit and growth. Besides the negative impact of the budget deficit, we also underline the hypothesis that the political economy of a country roundly affects its macro-economic performance. In this regard, the budget deficit and bad governance are posited to co-impact macroeconomic stability.

1.4 Objectives

The objective of this study is to primarily investigate the impact of cumulative budget deficits on macroeconomic performance and develops policy recommendations in order to influence the formulation of better fiscal policies in Zimbabwe. The adverse impact of the deficit is however, juxtaposed against bad governance and how the combination of the two, negatively affected the economy.

It is further hoped that the findings of this study and its recommendations will result in the enactment of appropriate legal instruments that may regulate fiscal policy in order to bring about a sound public finance management framework. This study therefore hopes to influence policy reforms in public finance and fiscal policy in Zimbabwe.

1.5 Methodology

Several studies have employed econometric tests to determine the relationship between the deficit and macroeconomic variables. The estimation techniques employed to examine the relationship include but are not limited to: the Error Correction Model (ECM) (Monadjeni and Huh, 1998), OLS (Darrat, 1985), Univariate Cointegration tests such as the autoregressive distributed lag models and Phillips-Hanse methods (Abbas and Sanhita, 2005), Cointegration Analysis (Solomon, De Wet and Walter 2004), Granger Technique (Darrat, 1998) Linear Model (Easterly et al, 1994), Vector Autoregression Model (Dwyer, 1982), Non-Linear Model, Catao and Torrones (2005), Granger-Sims Causality Techniques (Piersanti, 2000), Overlapping Generations Model (Blanchard, 1996), Engle Granger Two Step Procedure (Cheng, 1988) and SURE Technique (Vamvoukas, 2002). These Estimation models were applied on consistent data which abstracted from structural and political influences

This study is however, not a quantitative study. It is a political economy study based on a qualitative and comparative analysis methodology. The aim is to explore political, structural and economic reasons for persistent fiscal deficits in developing countries. In this regard, case studies of selected African countries' experiences with overspending will be reviewed with a specific focus on public expenditures and the extent to which they affected macroeconomic performance in general, and in particular, the impact of fiscal deficits on inflation, interest rates, exchange rate and trade deficit in those countries. For this qualitative and comparative analysis methodology, the countries picked are **Morocco** and **Botswana** (representing the best case scenario), **Ghana** and **Zambia** (representing the worst case scenario). The qualitative and comparative methodological approach marks a

departure from the conventional quantitative models which fail to capture political economy and structural factors which nevertheless have an important bearing on the budget deficit. Moreover, in a hyperinflationary economy like Zimbabwe, econometric modeling using soft data may be spurious and misleading. Hyperinflation occurs when month-on-month inflation exceeds 50% (Hanke, 2010). In this regard, the qualitative and comparative methodological approach provides a unique and alternative platform to investigate what has always been a subject of econometric application – the macroeconomic impact of the fiscal deficit.

Therefore chapter four of this study embodies and embraces the qualitative and comparative Methodology of the Study. This approach naturally removes the need for a dedicated chapter on Research Methodology, Data Analysis and Interpretation which would have been necessary in the case of an econometric study. In short, this is a political economy study based on exploratory, qualitative and comparative analysis methodology.

1.6 Justification for the study

Zimbabwe is in search of long-term policies not only for macro-economic stabilization but also for sustainable economic growth and development. The private sector has always mourned that the fiscal deficit and its inflationary financing has led to a slow-down in economic activity. There is need for a comprehensive study which exposes the dynamics of the public sector expenditure, fiscal deficit and its boomerang effects on the economy. The justification of the study is that it will add value to policy making especially in regard to fiscal adjustment and macroeconomic management. The findings of the study will also assist policy makers to understand the centrality of the public sector deficit in policy formulation. It is further hoped that the findings of the study will assist policy makers

to place the right emphasis on the role of fiscal adjustment in economic policy.

1.7 Delimitation of Scope

This study suffered limitations with regard to the availability of continuous and consistent data. Due to the economic challenges experienced in Zimbabwe, the various statistical agencies were not able to periodically update information. Data bases of other selected African countries were in some cases very difficult to access and also not quite user-friendly. Because of the differences in the data structure and format for Zimbabwe and other selected African countries, it was not possible, in the chapters dealing with these countries, to strictly maintain the template and style of presentation which was provided in the chapters dealing with the review of theoretical literature and empirical evidence. The use of soft nominal data in hyperinflationary economies like Zimbabwe could also present data comparability problems. However, these limitations are in my view not material enough to alter the findings and conclusions of this study because of the use of the qualitative and comparative methodological framework.

The rest of the study proceeds as follows: chapter two reviews the theoretical literature; chapter three reviews various empirical studies; chapter four looks at the comparative experiences of selected African countries. Chapter five looks at the Zimbabwean economic history, *which for the purpose of this study may be periodized as follows : 1980-1988 (dirigisme), 1989-1996 (market based reforms), 1997-2003 (failed controls) and 2004-2008 (chaos)*. Finally, Chapter six concludes the study.

1.8 Summary and Conclusion

The purpose of this chapter was to set the background and problem of the study. The chapter summarized fiscal developments

in Zimbabwe and traced the origins of fiscal deficits to expansionary fiscal policies pursued by the government of Zimbabwe since independence in 1980. The chapter discussed the methodology of this study and reasons for choosing the qualitative and comparative analysis methodology as opposed to doing conventional econometric estimation. With this background, the Study progresses to the next stage – the review of theoretical literature on fiscal deficits and their macro-economic implications.

CHAPTER 2

MACROECONOMIC CONSEQUENCES OF FISCAL DEFICITS: Review of Theoretical Literature

2.1 Introduction

This section reviews the theoretical literature on fiscal deficits with a view to helping us understand the macro-economic consequences of fiscal deficits. However, in doing so, we also critique the various theoretical postulations.

Fiscal deficits have been at the forefront of macroeconomic adjustment since the 1980s, both in developed and developing countries. Deficits are often blamed for the assortment of ills that beset developing countries in the 1980s: over-indebtedness leading to the debt crisis beginning 1982, high inflation, poor investment and growth performance (Easterly and Schmidt-Hebbel, 1991). On the other hand, fiscal deficits form a central part of macroeconomic policies aimed at stabilizing business cycle fluctuations. Over the past two decades, this role of fiscal policy has been under-emphasized but during the current global financial and economic crises, fiscal policy (and fiscal deficits in particular) has come to play a central role. Recently, the debt crisis faced by the PIGS (Portugal, Ireland, Greece and Spain) shows the importance of fiscal policy in maintaining macroeconomic stability. The US is weighed by unsustainable public debt and so is Britain.

The assessment of the macroeconomic effects of fiscal deficits has been the subject of an extensive literature, both in developed and developing countries. In particular, the connection between fiscal deficits, money growth and inflation has long been a dominant theme in the traditional view of the inflationary process. Focus has also been placed on the alternative deficit financing options and their impact on the behavior of interest rates and the sustainability

of fiscal deficits as well as the impact of public sector imbalances on the current account and the real exchange rate.

The macroeconomic effects of fiscal deficits depend on how they are financed as well as on the composition of spending (Easterly and Schmidt-Hebbel, 1991). Each major type of financing corresponds to a macroeconomic imbalance, if used excessively (Easterly, 1995). Money creation to finance the deficit leads to inflation; domestic borrowing leads to a credit squeeze and crowding out of private investment and consumption; external borrowing leads to a current account deficit and real exchange rate appreciation.

In this chapter the theoretical aspects of the various relationships between fiscal deficits and the other major macroeconomic variables are considered. The first section is devoted to the definition of the budget deficit and a brief outline of the various relevant alternative concepts used in the literature on fiscal deficits. We also define the public sector and discuss some measurement issues within the context of defining the scope of the public sector. This is followed by a discussion of the three major schools of thought on fiscal deficits, viz. the Keynesian, Neo-classical and Ricardian schools. Finally the relationships between fiscal deficits and the various relevant macroeconomic aggregates such as inflation, interest rates, the balance of payments, exchange rates and economic growth are discussed.

2.2 Fiscal Deficits: Definitions and Conceptual Issues

Introduction

The concept of a fiscal (budget) deficit is, in principle, simple enough: It basically represents the difference between the government's normal income from taxes and other sources, and its expenditure. Under this section we however go beyond the simple

definition of the budget deficit and provide a more sophisticated economic definition. We will also look at the alternative deficit concepts that are used in the calibration of various deficit measures.

Simplified Definition

A budget deficit occurs when fiscal revenues fall short of current and capital expenditures (including interest payments on public debt). Government budget constraints implies that any excess of government expenditure and net interest payments on debts over current revenue (taxes) has to be financed by public borrowing, sale of assets or money creation. Starting from the national income identity, the government budget deficit (G-T) is equal to net private Saving (S-I) plus current account deficit (IMP-EXP). Therefore $(G-T) = (S-I) + (IMP-EXP)$. This suggests that an increased fiscal deficit will have to be balanced by increased net private saving (either by "crowding out" I, or by raising S, i.e the so-called Ricardian Equivalence) or by increasing the current account deficit (i.e increasing reliance on foreign savings)

From the financing side:

$G-T = \text{foreign borrowing} + \text{domestic borrowing} + \text{printing money} + \text{depleting assets.}$

(external grants may be counted "above the line" and would therefore be included in G-T.)

Printing money is one way to finance a deficit. So long as the demand for base money (M3) is growing, as in a growing economy, governments can print money without raising inflation. If elasticity of money demand is unity, base money could be increased at the same rate as GDP growth.

Increasing base money at a higher rate can spur inflation. Inflation reduces the value of government debt and yields seignorage revenue (hence somewhat provides an incentive for governments to expand money supply).

Another way of financing the deficit is to draw down on foreign exchange reserves or other assets. However, reducing reserves may cause the domestic currency to depreciate. Finally, deficits can be financed through domestic or external borrowing.

The government budget constraint provides the linkage between taxes, expenditure, and alternative sources of financing of public imbalances. It is an essential tool for understanding the relationship between monetary and fiscal policies, and more generally the macroeconomic effects of fiscal deficits.

More Sophisticated Definition

A more sophisticated definition of a consolidated budget deficit is demonstrated by Agenor and Montiel (1996). Following Agenor and Montiel (1996), we consider a small open economy operating under a predetermined exchange rate regime. The central bank provides loans only to the general government, which includes central and local government. In general, the government can finance its budget deficit by either issuing domestic bonds, borrowing abroad or borrowing from the central bank. The consolidated budget identity of the general government can thus be written as:

$$L_t + B_t + E_t F_t^g = P_t (g_t - \tau_t) + i_t B_t + i_t^* E_t F_t^g + i_c L_t \quad (1)$$

Where L_t is the nominal stock of credit allocated by the central bank, B_t the stock of domestic currency denominated interest bearing public debt, F_t^g the stock of foreign currency

denominated interest bearing public debt, g_t real public spending on goods and services (including current and capital expenditure), τ_t the real tax revenue (net of transfer payments), i_t the domestic interest rate, i_t^* the foreign interest rate, $0 \leq i_c \leq i_t$ the interest rate paid by the government on central bank loans, E_t the nominal exchange rate, and P_t the domestic price level. It is important to note that equation (1) abstracts from the existence of non-tax revenue and foreign grants, although these components may be sizable in developing countries. Normally in developing countries the proportion of non-tax revenue in total fiscus resources is much larger than in developed countries (Burgess and Stein, 1993). The exclusion of non-tax revenues and foreign grants is purely for reasons of simplicity.

The right hand side of equation (1) shows the components of the general government deficit (expenditure, taxes, and interest on domestic and foreign debt), and the left hand side identifies the sources of financing of fiscal imbalance. The government budget constraint thus indicates that the fiscal deficit i_c is financed by an increase in interest bearing domestic and external debt, or credit from the central bank.

The central bank balance sheet in this economy is given by

$$M_t = L_t + E_t R_t - \Omega_t, \quad (2)$$

Where M_t is the nominal stock of base money (currency held by the public and reserves held by commercial banks), R_t the stock of foreign exchange reserves and Ω_t the central bank's accumulated profits or, equivalently, its net worth. Profits of the central bank consist of the interest received on its loans to the government, its interest earnings on foreign reserves, and capital gains resulting

from the revaluation of reserves $E_t R_t$. In the absence of operating costs, the counterpart of these profits is an increase in the central bank's net worth, the nominal value of which is also affected by capital gains arising from exchange rate depreciation:

$$\Omega_t = I_t^* E_t R_t + i_c + L_t + E_t R_t, \quad (3)$$

Where for simplicity, the interest rate earned on reserves is assumed to be the same as that paid on the government's foreign debt.

Obtaining the overall public sector deficit requires consolidating the general government budget constraint with that of the central bank. To do so, central bank profits need to be subtracted from the general government deficit, and the increase in its net worth must be deducted from the general government's increase in liabilities. Thus from equation (1) and (3),

$$L_t + B_t + E_t F_t^g - \Omega_t = P_t (g_t - \tau_t) + i_t B_t + I_t^* E_t (B_t^g - R_t) - E_t R_t, \quad (4)$$

From equation (2), $L_t = M_t - E_t R_t - E_t R_t + \Omega_t$. Substituting this result in equation (4) yields

$$M_t + B_t + E_t (F_t^g - R_t) = P_t (g_t - \tau_t) + i_t B_t + i_t^* E_t (F_t^g - R_t).$$

Defining net public foreign debt as $F_t^* = F_t^g - R_t$ yields

$$M_t + B_t + E_t F_t^* = P_t (g_t - \tau_t) + i_t B_t + i_t^* E_t F_t^*. \quad (5)$$

On the basis of equation (5), several commonly used budget concepts can thus be derived.

Conventional Deficit

The conventional deficit is, as the name suggests, the most common term used to designate the government's budget deficit. From the onset, it is instructive to note that the conventional deficit is a composite measure that includes capital expenditure, like for example expenditure on infrastructure. The conventional deficit may generally be described as the resource use of the public sector which remains to be financed after the government has offset its receipts against its outlays (Abedian and Biggs (1998)). More formally Tanzi, Blejer and Tejeiro(1993: 178) define the conventional budget deficit as measured on a cash basis as "the difference between total government cash outlays, including interest outlays but excluding amortization payments on the outstanding stock of public debt, and total cash receipts, including tax and non-tax revenues, and grants, but excluding borrowing proceeds."

The conventional deficit may also be defined with reference to the government's budget constraint (see Agenor (2004)).

$$G-(T_T+T_N)+iB_{-1}+i^*EB^*_{t-1} = \Delta L+\Delta B+E\Delta B^* \dots\dots\dots(1)$$

Where

G = public spending on goods and services (both current and capital expenditure)

T_T = tax revenue

T_N = non-tax revenue

B(B*)= domestic (foreign currency denominated) public debt (end of period)

i(i*) = domestic (foreign currency denominated) public debt interest rate

E = nominal exchange rate

ΔL = change in nominal stock of credit allocated by the central bank.

From equation (1), the conventional deficit can then be defined algebraically as:

$$D = G - (T_T + T_N) + iB_{-1} + i^*EB_{-1}^* \dots \dots \dots (2)$$

The conventional deficit can be very sensitive to inflation. The key reason is the effect of inflation on nominal interest payments on the public debt (Tanzi, Blejer and Teijero, 1993). The Olivera-Tanzi effect means that inflation can reduce real revenue in the presence of collection lags (Agenor (2004)). The reason being that there typically is a time lag between the time tax payments are assessed and the time they are collected by the fiscal authorities. The Patinkin effect (Agenor (2004)) refers to a situation where inflation can reduce nominal government spending in real value if it is fixed.

Blejer and Cheasty (1991) stress the point that the choice of accounting method has a bearing on the size or magnitude of the conventional deficit. A cash-basis deficit would differ in magnitude from an accrual basis-deficit. For example, in a cash-basis deficit, only expenses and revenues based on cash transactions are used to calculate the deficit whereas in accrual basis-deficit, transactions are recorded on a payment order basis or accruals which do not necessarily imply present cash flows, e.g payment arrears or interest payment arrears (Abedian and Biggs, 1998). Therefore, accrual-basis deficits are normally larger than cash-basis deficits.

Because of the reliance on the cash-basis deficit by the conventional deficit measure, it is argued that the conventional deficit fails to adequately explain or present the fiscal stance which

is defined as the “aggregate demand pressure exerted by the public sector on the currently available resources” (Abedian and Biggs, 1998, p. 186).

But given the computational difficulties associated with the derivation of more accurate budget deficit constructs, the conventional deficit will probably continue to be the most widely used deficit measure.

Primary Deficit

The primary deficit is derived by subtracting interest payments on the stock of debt from the conventional deficit. By removing the effects of previous deficits on the budget, the primary deficit paints a more accurate picture of the fiscal stance than the conventional deficit measure (Abedian and Biggs, 1998).

In algebraic terms the primary deficit can thus be defined as:

$$D = G - (T_T + T_N) \dots\dots\dots(3)$$

The primary deficit is important for evaluating the sustainability of government deficits and the consistency among macroeconomic targets (Agenor and Montiel, 1996)

Operational Deficit

The sensitivity of the conventional deficit to inflation has resulted in the development of an alternative concept, the so-called operational deficit, which is calculated by adjusting the conventional deficit for the inflation component of nominal interest rates. More specifically, Abedian and Biggs (1998: 191) define the operational deficit as the “conventional deficit minus that part of debt service which compensates debt holders for actual inflation, or equivalently as the primary deficit plus the real component of interest payments”. It should be noted however, that the operational deficit

is rendered less useful when inflation is highly variable. This follows from the difficulties in measuring and interpreting real interest rates under these circumstances (see Agenor (2004)).

The operational deficit can be thought of as providing an approximate measure of the size of the deficit the government would face at a zero inflation rate (Agenor and Montiel, 1996)

Current Deficit

In order to relate the budget deficit to total savings in the economy, the fact that the conventional deficit is measured on a basis that includes capital spending by government needs to be recognized. The concept of a current deficit provides for this by measuring only non-capital revenues and expenditures. Abedian and Biggs (1998: 194) define the current deficit as the conventional deficit exclusive of investment outlays and capital revenues by the government. It should be noted, however, that a number of difficulties may arise in calculating current deficits. See Abedian and Biggs (1998: 195-196) for a detailed discussion of these difficulties.

Structural Deficit

The structural budget balance is a useful tool for assessing the medium term stance of fiscal policy. A structural deficit is a deficit which is not pro-cyclical. In other words it does not depend on the business cycle. For example, a structural deficit could remain across a business cycle because the general level of government spending is too high for prevailing tax levels. The structural deficit shows the extent to which changes in the actual budget deficit reflect structural factors, in particular discretionary fiscal policy options rather than cyclical movements associated with movements in the business cycle or short term fluctuations in aggregate demand. Movements of the deficit attributable to the business cycle

can be viewed as essentially self-correcting whereas changes in deficits owing to structural factors can be offset only through discretionary policy measures. Removing the self correcting cyclical component from the observed budget deficit, therefore provides a more accurate indication of medium term fiscal positions. See Abedian and Biggs (1989: 197-198) for a discussion of the methodology for constructing such a structural deficit.

Quasi-Fiscal Deficits

Quasi-fiscal deficits arise from off budget activities conducted by the central bank. According to Mackenzie and Stella (1996), quasi-fiscal activities can be defined as operations whose effects can in principle be duplicated by budgetary measures in the form of an explicit tax subsidy or direct expenditure. Quasi-fiscal activities can take the form of implicit (unfunded) contingent liabilities or explicit contingent liabilities. Quasi-fiscal operations are often carried out by the country's central bank but sometimes also by the state owned commercial banks and other public financial institutions, such as development banks. They are at times motivated by the desire to hide what are essentially budgetary activities for political or other reasons. In defining the budget deficit, it is important to consider off budget activities of the central bank in order to arrive at the correct level or magnitude of the deficit.

By shifting what are essentially taxes and subsidies from government accounts to accounts of the central bank, quasi fiscal activities can severely distort the size of the deficit. Studies of Chile and Argentina by Easterly (1995) demonstrates this point. In Chile quasi fiscal deficits exceeded the conventional deficit by 10% of GDP. In Argentina, the conventional deficit was falling during 1984 but the fiscal stance of the public sector, including the central bank, deteriorated greatly.

The use of the conventional deficit under circumstances of quasi-fiscal operations can be highly deceptive since it underestimates the degree of fiscal adjustment that would be required. (Abedian and Biggs, 1998). Because of their potentially severe distortionary effects on the allocation of resources, eliminating or at least reducing these quasi-fiscal activities has become a key objective of macroeconomic management and fiscal policy. It then becomes important to bring all quasi-fiscal operations into the budget, by first identifying and quantifying them and subsequently by transforming them into explicit taxes and expenditures. Therefore appropriate accounting of all explicit and implicit contingent liabilities is essential for assessing the stance of fiscal policy. Contingent implicit liabilities can be broadly defined as obligations that the government is legally compelled to honour if the entity that incurred them in the first place cannot (or chooses not to) do so (Polackova, 1998). Examples are state guarantees of borrowing by parastatals or local government entities. However, this may be a very difficult task as noted by Bleijer and Cheasty (1991) because of moral hazard issues and the fears that increasing fiscal transparency may encounter strong political resistance.

The discussion of the above alternative deficit concept is very important and relevant to this study. According to Agenor and Montiel (1996), in practice, the difference between alternative measures of fiscal balance can be substantial. For example in certain instances, it is possible that the primary fiscal balance can indicate a surplus while by contrast, the operational balance may indicate a deficit or vice versa. In Ghana, in 1981, the conventional deficit amounted to 6.4% of GDP, the primary deficit to 4.3%, and the operational balance to a surplus of 5.5% (Blejer and Cheasty, 1991). Furthermore, the discussion of various alternative measures helps us understand the conceptual deficiencies of the simplistic

definition of the budget deficit (excess of government expenditure over revenue). Understanding the different deficit concepts sharpens policy focus and leads to better targeted measures.

Fiscal Sustainability

The concept of fiscal sustainability has received substantial attention in the literature in recent years, including at the International Monetary Fund and the European Commission (see Krejdl, 2006). In general terms, a sustainable fiscal policy (budget deficit) is a policy that can be maintained without any major interventions in tax and/or spending patterns. According to Blanchard (1990) fiscal sustainability is about whether, based on current fiscal policy, a government is headed towards excessive debt accumulation. Buiters (1985) uses a similar definition viz. that a fiscal policy is sustainable if it maintains the ratio of government net worth to GDP at its current level.

A more formal definition is provided by Krejdl (2006: 2), "fiscal policy is called sustainable if the present value of future primary surpluses equal the current level of debt (the so-called intertemporal budget constraint)". This relates the sustainability concept to that of solvency, i.e. that a government can continue to service its debt obligations in perpetuity without explicit default.

Sustainable public sector deficit measures are derived by looking at the below-the-line financing constraints of the deficits (Easterly, 1995). The government budget constraint model developed by Perotti (2007) and Agenor and Montiel (1996) shows the relationship between taxes, expenditure and other sources of the financing of deficits. Fiscal deficits have the following components: interest rates on domestic and foreign debt; expenditure on goods and services and taxes.

The central question is how government expenditure is financed? Practically, there are four sources, namely government revenue, domestic and external borrowing and money creation. The problems faced by developing countries in raising revenue include an inadequate tax base, a limited ability to collect taxes, reliance on money financing and, in some cases, high levels of public debt (Agenor, 2004). Administrative and sometimes political constraints on the ability of tax authorities to collect revenue have often led to the imposition of high tax rates on a narrow tax base. The consequences have been endemic tax evasions and unbridled expansion of the informal sector. At times the high degree of reliance on monetary financing of fiscal deficits in some countries has also resulted in macroeconomic instability, capital flight and currency crisis. Although taxation is the main source of central government revenue, the share of non-tax revenue is higher in developing than industrialized countries (Burgess and Stein, 1993). Because of all these bottlenecks encountered on raising revenues, developing countries tend to rely more on seigniorage than do developed countries. Seigniorage consists of the amount of real resources extracted by the government by means of base money creation.

Linked to fiscal sustainability are the notions of fiscal strength and fiscal space. Fiscal strength refers to the perceived probability of default on public debt (Abedian and Gibbs, 1998) whereas fiscal space refers to the room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing sustainability.

Scope of the Public Sector

The definition of the scope of the public sector has an influence on the magnitude of the deficit and will resultantly have

important implications for accurately analyzing the macroeconomic consequences of budget deficits. A narrow definition of the public sector can lead to erroneous conclusions of fiscal stance. Central government manages the main or national budgets. But there is also provincial and local governments which are the other levels of general government. Therefore general government comprises central, provincial and local government. The consolidated non-financial public sector refers to general government consolidated with non-financial public enterprises (Abedian, 1998). Public enterprises are included because any change in their net worth will influence public finances. Moreover, as government enterprises, parastatals receive government transfers. In developing countries, public enterprises have been criticized for widening the deficit.

The IMF's Manual on Government Financial Statistics distinguishes between general government and non-financial public enterprises on the basis of the nature of goods and services they supply and the different character of their revenues: taxes are compulsory levies while income from the market sales is voluntary. The function of government is defined as the implementation of public policy through the provision of primarily non-market services and the transfer of income, supported mainly by compulsory levies on other sectors (IMF, 1986)

The concept of a fiscal deficit is associated with balances of the consolidated non-financial sector. This is different from the budget deficit which is associated with the balances of central government.

However, in most developing countries, and some developed countries, central banks also dabble in quasi-fiscal activities as discussed above. These quasi-fiscal activities, together with balances of financial public enterprises, fundamentally influence the

size of the deficit. When a central bank operates profitably, it generally transfers a substantial portion of its profits to the government. However, when it operates at a loss, the central bank generally runs down its reserves (or prints money) rather than receiving a transfer from the government to cover all or part of the loss. Such an asymmetric accounting treatment may seriously bias the accuracy of a country's measured fiscal deficit when central bank losses are large. Symmetry needs to be restored and the full amount of the central bank loss must be included in the government accounts in order for the size of the fiscal deficit to be accurately assessed. Quasi-fiscal activities should therefore be consolidated into a comprehensive measure of the public sector deficit.

Although it is ideal to use deficit measures which are based on the widest possible public sector coverage in order to get as precise a picture as possible of government's fiscal stance, in practice, consolidated total government finances are not presented when national budgets are tabled in parliaments. The reason is that information on all levels of general or total government expenditure and the financing thereof through revenue, balances brought forward and transfer payments, is not readily and timeously available, especially from local government accounts.

Because of the complex nature of constructing a public sector deficit which covers as wide a spectrum as possible, Abedian (1998: 231) reached the conclusion that "the deficit is a myth". Indeed which of the alternative deficit constructs is appropriate depends on the definition of the scope of the public sector.

Measurement

The choice of accounting method also affects the magnitude of the reported deficit. Cash based deficit measures only include expenditures for which cash has been disbursed and only cash

revenues received during the fiscal year. To the contrary, accrual-only deficits record transactions on a payment order basis and reflect income and spending transactions measured at the time they take place, even if they do not immediately generate cash flows. Accrual-based deficits tend to be larger than cash-based deficits as they incorporate arrears accumulated on interest, wages or goods expenditure.

Another important measurement problem arises in countries where controls on interest rates or key public and private prices are pervasive. To the extent that expenditure is measured at official prices, the deficit may be largely underestimated. The appropriate solution in this case is to determine, for valuation purposes, an adequate "shadow" price for the goods or services whose prices are subject to government regulations – a daunting task often fraught with empirical and conceptual difficulties (Agenor and Montiel, 1996)

The above discussion is far from being exhaustive, but it clearly demonstrates that a holistic deficit record has to be augmented by other measures which view periods outside the current one. And more importantly, how the deficit is measured has an important bearing on the accuracy of the macroeconomic implications of the deficit.

In view of the controversies surrounding the alternative deficit concepts (see above) the following section proceeds to look at the theoretical literature on fiscal deficits.

2.3 Schools of thought on fiscal deficits

Although there now appears to be widespread support for the use of fiscal policy, and in particular running large fiscal deficits, in response to the current world financial and economic crisis,

economists disagree about the impact of such deficits on economic activity. This is especially the case in more normal cyclical economic circumstances. Generally speaking, three broad schools of thought regarding the economic effects of fiscal deficits can be identified. These are the Neoclassical, Keynesian and Ricardian schools. The Neoclassical school is generally associated with the view that increased budget deficits cause interest rate increases, thus crowding out private investment (Bernheim, 1989). The Keynesian school is generally associated with a more positive view, viz. an increase in the budget deficit increases aggregate demand which, under conditions of less than full employment, may stimulate investment and growth. In the so-called Ricardian view, budget deficits do not have important effects since rational consumers know that deficit increases merely imply increased future taxes and thus imply increase in their savings. The three alternative paradigms are discussed in more detail below.

The Neoclassical paradigm

A natural place to start a review of the theoretical literature is with the neoclassical approach, which places considerable emphasis on the supply side effects of fiscal deficits.

The Neoclassical view regarding the economic effects of budget deficits has three central assumptions (Bernheim (1989)). Firstly, individual consumption is determined as the solution to an intertemporal optimization problem under perfect capital markets. Secondly, individuals have limited life spans so they plan their consumption over their life cycles. Thirdly, market clearing is assumed in all periods, i.e. the economy is always at, or moving rapidly towards, full employment of resources. *Therefore, deficits thus affect growth only through their effect on the rate of capital accumulation.* Under these conditions a permanent increase in

government consumption following from a permanent increase in the budget deficit raises interest rates, reducing private investment (Diamond (1965)). Thus permanent increases in government budget deficits crowds out private investment and thus reduce long term growth. Neoclassicals argue alternatively that if government chooses to finance the deficit by issuing out government paper in the form of treasury bills or bonds, instead of increasing taxes, aggregate demand increases and national savings fall, thereby crowding out private sector investment. Thus, neoclassicals emphasize the adverse impact of budget deficit financing on interest rates and savings as a central feature in their crowding out debate.

The effect of an increase in the budget deficit on interest rates depends on whether the economy is "closed" or "open". In a closed economy (*where government does not resort to money financing of the deficit*), interest rates would increase because the demand for loanable funds (to finance the deficit) increases relative to the supply. *Investment falls and saving in, increases until savings and investment are once equal again. The increased interest rates are said to have crowded out private investment (Abedian, 1998).* In an open economy (particularly one with a floating exchange rate and mobile international capital flows), the increase in the interest rates would result in increased foreign capital inflows which cause the real exchange rate to appreciate and decrease the competitiveness of local goods on international markets (implying the deterioration of the country's trade balance, which in effect means, the higher government budget deficit is financed by an increased trade deficit). The deficit thus crowd out exports rather than investment.

For comparative purposes (especially with respect to the Keynesian paradigm) the neoclassical perspective differentiates between the effects of the permanent deficit, which is the average

deficit over time, and the temporary deficit, which is the deviation away from the permanent deficit. In other words, the neoclassical paradigm generally focuses on the **long run** effects of **permanent** changes in the budget deficits under conditions of **full employment** of resources. The neoclassical paradigm asserts that the expected permanent portion of the deficit is built into the aggregate demand curve and is taken into account when equilibrium prices and quantities are determined (Bernheim, 1989). Permanent deficits, therefore, do not have expansionary demand effects. They affect capital accumulation, but not resource utilization. The Keynesian, by contrast focuses on the **short run** with **underemployment** of resources.

In the literature, a further distinction is made between financial crowding out and resource crowding out. The former relates to competition to access borrowed funds between government and the private sector at a given rate of interest. The latter occurs when the government competes with the private sector on purchasing certain resources like human resources, raw materials and other inputs.

The Neoclassical thinking has been challenged for, amongst other things, the validity of the neoclassical crowding-out proposition.

Barro (1990, 1991) is one of the leading critics of the neoclassical crowding out hypothesis. He argued that government consumption has no direct effect on private productivity, but lowers savings and growth through the distorting effects from taxation only. *We therefore conclude that there cannot be any doubt that once savings are lowered and growth reduced, the crowding out effect becomes unavoidable.*

Another challenge to the neoclassical theory comes from Heng (1997) who opines that public capital “crowd in” private capital through two channels, namely, through its impact on the marginal productivity of labour and savings, depending on whether there is a relationship of complementarity or substitutability between public and private capital. Heng argues that government expenditure on social programs can promote socio-economic development by reducing poverty and hence, creating a climate conducive for investment in human and physical capital through what he called the peace dividend.

Moreover, Kelly (1997) argues that in developing countries where there is dualism between agriculture and industry, public investment is likely to be a catalyst of successful private sector activity and economic growth.

The complementary hypothesis is crucial because it clarifies the fact that the public sector can either crowd in or crowd out the private sector depending on the form that public investment takes. It all depends on whether the budget deficit is incurred for recurrent or productive purposes. As Aschauer (1989) rightly points out, higher public investment may raise the marginal productivity of private capital and, thereby, “crowd-in” private investment.

This brings us to the conclusion that in order to correctly understand the effects of budget deficits on the private sector, we need to distinguish between capital and recurrent expenditure and above all how the budget deficit is structured. In our view, the major breakdown in the neoclassical proposition as espoused by Bernheim is its bold assumption on the long run effects of permanent changes in the budget deficits. We argue that a long run time horizon cannot exclusively explain the behavior effects of deficit changes. Moreover, the assumption of full employment of

resources is spurious in the context of both developed and developing countries. We also challenge Bernheim's trajectory of perfect markets that clear. In theory (even in practice) the concept of perfect markets is an ideal and not a possibility. We also argue that individuals are not as rational as Bernheim asserts, especially to suggest they have all the information to enable them to plan ahead in a given life cycle. Even in theory we all know about the dangers of information asymmetry. In our view the emphasis on "permanent" deficit changes is misplaced. Whether the change is permanent or not, we argue what matters is the degree and not the kind of impact. Finally we also argue that Bernheim was uncritical and unassuming about the elasticity of interest rates in relation to deficit changes. In this regard the neoclassical crowding-out hypothesis is based on a rather weak and assumed sensitivity of interest rates to deficits.

The Keynesian School

The Keynesian paradigm points to the existence of unemployment as evidence that deficits can increase growth through their effect on resource utilization.

The simplest Keynesian model assumes price rigidity and excess capacity, so that output is determined by aggregate demand. In this model, a fiscal expansion has a multiplier effect on aggregate demand and output. When the Keynesian multiplier exceeds one, it increases with the responsiveness of consumption to current income. It is larger for a spending increase than for a tax cut. If a spending increase is matched by a tax increase, the resulting 'balanced budget multiplier' is exactly one.

The Keynesian model firstly assumes that the economy is not at the full employment level of production, i.e. there exist unemployed resources. Secondly, it assumes that there exists a

substantial number of liquidity constrained economic participants. Thirdly, it assumes that consumption is related to current income.

The combination of these three assumptions renders a positive impact of an increase in the budget deficit on consumption and investment and thus output. Deficit spending increases demand, which brings previously unutilized resources into the production process and increases output. Liquidity constrained consumers have a high propensity to consume from the increases in disposable income which follow tax cuts or government expenditure increases. The underutilization of resources then implies that increases in aggregate demand increases production and the profitability of investments (Eisner (1989)). Keynesians argue that public investment is complementary to private investment and that the high level of demand resulting from large deficits increases investors' expectations of profitability. Through these two mechanisms, deficit-financed public investment can crowd in private investment, and thereby increase the rate of capital accumulation.

In the more modern Neo Keynesian models, increased government spending shifts out the demand for goods because of nominal rigidities or countercyclical markups or increasing returns to scale (Perotti (2007)). Under these conditions the demand for labour and thus real wages increase resulting in increases in private consumption expenditure (Gadi, Lopez-Salido and Valles (2007)).

Keynesian theory postulates that discretionary fiscal policy can be used to stabilize the economy. Keynes wrote that once an economy had moved into a situation of high unemployment, the price mechanism would not work to adjust the economy back to a high level of employment. Instead, the government needed to intervene to raise the demand for output by increasing public expenditure such that once demand had increased, firms would

produce more output and employ more labour, which in turn would increase demand still further (Levacic and Rebmann, 1986).

According to Keynes, fiscal policy is a pivotal instrument of demand management. Keynes doubted the efficacy of monetary policy. Keynes's argument was that, money did not influence macro variables. Keynesian policies were followed in post-war Europe. In 1948, Britain practiced Keynesian demand management policies to replace the planned economy. However, in the 1960s, unemployment rose and growth became sluggish leading also to the questioning of the efficacy of Keynesian policies by many scholars.

In the literature, critics of Keynesian economic thought argue that money supply has a more pervasive influence on economic behavior than Keynesians had allowed for. Hence emphasis was now equally put on inflation as a policy problem in contrast to Keynesian traditional focus on unemployment. This marked the resurgence of neo-classical thinking in the field of monetary economics which came to be known as monetarism (the Chicago School of Milton Friedman) or new macroeconomics.

The other criticism directed against Keynesian theory was that Keynesian short run models analyzed the economy as coming to rest in equilibrium while there were still imbalances in the economy yet these imbalances were not dealt with. A further critique of Keynesian policies was that they failed to capture private sector expectations, in particular, expectations on what government policy will be.

As a result of these criticisms, macro-economic models even of a Keynesian nature now incorporate fuller monetary sectors and make greater allowances for the role of expectations and long run adjustment than did the Keynesian models of the 1950s, leading to what is called the Keynesian-Neo-classical Synthesis in the

exposition of macro-economic theory and policy. Our view is that Keynes overestimated the supply response generated by the increase in aggregate demand. It does not necessarily mean that the economy can fully respond to all government stimulus measures. Keynesians do not anticipate policy gaps or the mere fact that time leads and poor implementation can blunt the effectiveness of policy stimuli. In any case, it is unrealistic to assume a positive supply response in the so-called short run. Moreover Keynes does not question the reason for the existence of underemployed resources. Instead, he takes it for granted and thereby commits a fallacy of composition. As a result we believe that Keynes's preoccupation with the efficacy of fiscal policy at the expense of monetary policy and the complementarity between the two, renders his analysis heavily biased in favour of state interventionist policies to stimulate aggregate demand at all costs. Nevertheless, we think that the dimension of crowding –in which Keynesians introduced is quite groundbreaking in that it allows for the differentiation or categorization of expenditure between capital and recurrent. The challenge posed by the Keynesian model is that it fails to draw the line regarding the extent or limits of public spending and hence leaves room for excessive spending which invariably can become harmful to the economy. This is quite evident in the Keynesian belief that public expenditure is still good even if it means digging holes and refilling them.

Regarding the 'resource utilization' effect of deficits, problems may be encountered when this theory is translated into actual policy. Firstly, for given technologies it may be necessary to have spare capital capacity as well as unemployment if sustained increases in demand are to lead to sustained increases in output. Secondly, spare capacity may occur in specific sectors only. Increasing aggregate demand in these sectors will have spillover

effects into other sectors which may have not had spare capacity. Bottlenecks can arise, which will either push prices up or increase imports. To the extent that imports increase, the trade balance will worsen, and the aggregate demand effects will be weakened (Abedian, 1998). It is unclear then whether running deficits increases capacity utilization.

The most serious and well-known shortcoming of the Keynesian approach is its lack of microeconomic foundations and overly focus on the demand side of the economy.

Ricardian Equivalence

The Ricardian equivalence proposition states that deficits and taxes are equivalent in their effect on consumption (Barro, 1974). The focus in the Ricardian equivalence literature is on the effects of cuts in lump-sum taxes for a given path of government spending.

An increase in the budget deficit as a result of a cut in taxes, has no impact on consumer spending. Alternatively formulated, a decrease in the government's saving as a result of a cut in taxes, leads to an offsetting increase in desired private saving, and thus no change in desired national saving.

This is explained by the view that if consumers are Ricardian in the sense that are forward-looking, and are fully aware of the government's intertemporal budget constraint, they will anticipate that a tax cut today, financed by issuing government debt, will result in higher taxes being imposed on their infinitely lived families in the future. Permanent income is therefore unaffected, and in the absence of liquidity constraints and with perfect capital markets, consumption will not change (Barro, 1974). Thus there is a Ricardian equivalence between taxes and debt. Perfect Ricardian equivalence implies that a reduction in government saving resulting

from a tax cut is fully offset by higher private saving, and aggregate demand is not affected. The fiscal multiplier effect is zero in this case (Hemming, Kell and Mahfouz, 2002).

The Ricardian Equivalence theorem further asserts that whether the deficit is financed by borrowing (debt finance) or increasing revenue (tax finance) it makes no difference to aggregate demand. The assumption is that individuals are rational and have all the information about their present and future tax liabilities hence they don't need to alter their present consumption. Thus, under conditions of short run full employment equilibrium, debt finance has no effect on the price level or the cost of borrowing.

It is important to note that the Ricardian equivalence is based on strong assumptions: Thus short time horizons, less than perfect foresight, partial liquidity constraints, imperfect capital markets, and a non-altruistic desire to pass some of the current fiscal burden to future generations can reestablish a stronger link between fiscal policy and consumption. (Mankiw and Summers, 1984) and of course that consumers are fully rational and farsighted. Consequently, the practical significance of Ricardian equivalence is problematic, at least in its perfect form (Hemming, Kell and Mahfouz, 2002).

Barro (1989) argued that the reduction of taxes in the current period would somehow still have to be offset by some future tax hikes induced by the government debt. The effect of this is to leave interest rates constant. The corollary is that private investment will also remain the same. Therefore the wealth effect of the deficit would be neutralized.

Barro is supported by Huang (1986), another proponent of the Ricardian Equivalence, who argues, whether a given level of

government spending is tax financed or bond financed, that is irrelevant. The neutrality argument will still hold.

Huang's argument is premised upon the presence of "intergenerational transfers" so that the public equates the current value of the bonds with the present value of future tax liabilities generated by the bonds. Consequently, no net wealth is involved when government bonds are issued, and the public is indifferent to the use of either tax or debt financing instruments.

The conditions required for Ricardian Equivalence to hold are the existence of infinite planning horizons, certainty about future tax burdens, perfect capital markets (or the absence of borrowing constraints), rational expectations and non-distortionary taxes. According to Agenor and Montiel (1996), the restrictive nature of these assumptions poses practical problems. In particular, the debt neutrality has been shown to break down if agents have finite horizons, capital markets are imperfect, or uncertainty and distributional effects play a pervasive role in individuals' consumption and savings decisions.

And as Hemming et al (2002) pontificate, it is nevertheless, worth asking whether there are circumstances where a Ricardian response is more likely. For example, if a government is bound by a fiscal rule which requires that a fiscal expansion has to be reversed, then even individuals who do not have very long time horizons may adjust their saving behavior to at least partially for higher future taxes. Similarly, where it is widely perceived that the current path of government debt is unsustainable, and that future tax increases will soon be required to lower the debt, there could be a seemingly Ricardian offset to a fiscal expansion even in a Keynesian framework.

We also challenge the so-called neutrality of the deficit. Our view is that the effect of the deficit can either be positive or negative but not neutral. As we pointed out elsewhere in this section, the assumption of rational agents who have all the information at their disposal is fallacious.

Given the Keynesian, Neoclassical and Ricardian Equivalence paradigms on the general theoretical effects of the deficit on the overall economy, we proceed to look at the specific theoretical relationships between the deficit and particular macroeconomic aggregates. We therefore abstract from the general to more specific theoretical relationships in order to fully understand the centrality of the deficit to macroeconomic stability.

2.4 Fiscal deficits and macroeconomic implications

Introduction

No issue in fiscal policy has generated more debate over the past decades than the effects of fiscal deficits. Many economists share the view that deficits are harmful, and perhaps even disastrous (Ball and Mankiw, 1995).

When economists and policy makers decry deficits, they cite diverse reasons. Thus, despite almost unanimous concern over deficits, there is considerable controversy about the effects of deficits on the economy.

Ball and Mankiw (1995), argue that fiscal deficits have many effects but they all follow from a single initial effect: deficits reduce national saving. National saving is the sum of private saving (the after tax income that households save rather than consume) and public saving (the tax revenue that the government saves rather than spends). When the government runs a budget deficit, public

saving is negative, which reduces national saving below private saving.

The effect of a budget deficit on national saving is most likely less than one –for-one, for a decrease in public saving produces a partially offsetting increase in private saving. For example consider a \$1 tax cut. This tax cut reduces public saving by \$1, but it also raises households' after tax income by \$1. It is likely that households spend part of this windfall but save part as well. This implies that national saving falls, but by less than the fall in public saving.

We then need to apply our minds on the question: How does lower national saving affect the economy? To answer this question, we consider some simple accounting identities. Following Ball and Mankiw(1995)-

Let Y denote gross domestic product; T , taxes; C , consumption; and G , government purchases, then private saving is $Y-T-C$, and public saving is $T-G$. Adding these yields national saving, S .

$$S = Y - C - G$$

National saving is current income not used immediately to finance consumption by households or purchases by the government.

The second crucial accounting identity is the one that divides DGP into four types of spending:

$$Y = C + I + G + NX$$

Output Y , is the sum of consumption C , Investment I , government purchases G , and net exports NX . Substituting this expression for Y into the previous equation for national saving yields

$$S = I + NX$$

This simple equation sheds considerable light on the effects of budget deficits. It says that national saving equals the sum of investment and net exports. When budget deficits reduce national saving, they must reduce investment, reduce net exports, or both. The total fall in investment and net exports must exactly match the fall in national saving.

To the extent that budget deficits increase the trade deficit (that is reducing net exports) another effect follows immediately: budget deficits create a flow of assets abroad. This fact follows from the equality of the current account and the capital account. When a country imports more than it exports, it does not receive these extra goods and services for free; instead it gives up assets in return. Initially, these assets may be the local currency, but foreigners quickly use this money to buy corporate or government bonds, equity or real estate. In any case, when a budget deficit turns a country into a net importer of goods and services, the country also becomes a net exporter of assets.

A decline in national saving reduces the supply of loans available to private borrowers which pushes up interest rates. Faced with a higher interest rate, households and firms choose to reduce investment.

Higher interest rates also affect the flow of capital across national boundaries. When domestic assets pay higher returns, they are more attractive to investors both at home and abroad. The increased demand for domestic assets affects the market for foreign currency: if a foreigner wants to buy a domestic bond, he must first acquire the domestic currency. Thus, a rise in interest rates increases the demand for the domestic currency in the market for foreign exchange, causing the currency to appreciate.

The appreciation of the currency in turn affects trade in goods and services. With a stronger currency, domestic goods are more expensive for foreigners, and foreign goods are cheaper for domestic residents. Exports fall, imports rise, and the trade balance moves towards deficit.

To sum up: government budget deficits reduce national saving, reduce investment, reduce net exports, and create a corresponding flow of assets overseas. These effects occur because deficits also raise interest rates and the value of the currency in the market for foreign exchange.

We now proceed to look at the specific theoretical relationships between deficits and some of the macroeconomic variables in a little more detail below.

Deficits and Inflation

The debt crisis of 1982 and recent events in Europe (the PIGS) and the United States of America have renewed the debate regarding the macroeconomic impact of deficits. But what does theory say about the relationship between the deficit and inflation?

In the literature, there are a number of theories which support the view that fiscal deficits are negatively related to money creation (seigniorage), (Rodriguez, 1998). In other words, these theories do not associate the deficit with inflation. In this regard, the argument advanced is that the relationship between deficits and inflation is blurred because governments finance deficits by borrowing as well as by printing money, therefore the impact of the latter cannot be easily fingered. These arguments are fortified by the view that the relationship is further muddied by other factors such as unstable money demand, inflationary exchange rate

depreciations, widespread indexation practices and sticky expectations (Easterly, Rodriguez and Schimdt-Hebbel, 1996).

Milton Friedman (1968), however propounded a different view altogether. Friedman argues that inflation is always and everywhere a monetary phenomenon. Friedman interpreted inflation as a result of too much money chasing too few goods. Hence the reason why the monetization of fiscal deficits is singled out as the root cause of inflation by Monetarists.

In order to solve the problem of inflation, Friedman (1968) argued that monetary authorities had the leverage to rein in inflation in the long run by dealing with money supply growth in view of the fact that the monetization of deficits caused inflation.

The monetarist view, found a lot of traction from other scholars. Easterly and Schmidt-Hebbel (1991) supported the monetarist view and argued the extent to which deficits are financed by money creation, indisputably determines the relationship between fiscal deficits and inflation. The question whether large deficits are always associated with higher inflation was also affirmatively answered by Sargent and Wallace (1985) - in their "monetarist arithmetic". Sargent and Wallace argue that the monetization of debt is often unavoidable and is something which happens anyhow. Similarly, Dwyer (1982) opines that deficits increase the real value of outstanding bonds as well as perceived wealth and its consumption and raises the price level. Such monetization results in an increase in money supply growth and the rate of inflation, at least in the long-run period. Miller (1983), holds the uncompromising view that fiscal deficits are always inflationary irrespective of whether the deficits are monetized or not.

According to Miller, a deficit policy leads to inflation through different channels The Central Bank might be politically forced into

monetary accommodation of the deficits as argued by Sargent and Wallace (1985). But, he further goes on to say that even if the Central Bank does not monetize the deficit, deficits are still inflationary through crowding out.

Barro (1978; 1979) poses a post hoc propter hoc claim. He argues that deficits are a result of inflation, rather than inflation being a result of deficits. The government deficit is symptomatic of the variation in the nominal value of outstanding government bonds. The nominal value of outstanding bonds is indexed to inflationary increases.

As Agenor and Montiel (1996) pointed out, one common explanation for the inflationary consequences of fiscal deficits in developing nations is the lack of sufficiently developed domestic capital markets that can absorb newly issued government debt (Shahin, 1992). Moreover, in some countries, the central bank is under the direct control of the government and often passively finances fiscal deficits through money creation (Agenor and Montiel, 1996)

In developing countries, because of limited financing options, printing of money, together with the associated seigniorage revenue, is the most popular method to finance deficits. This is the reason why in the context of developing countries the percentage of money supply to GDP is fairly larger than in developed countries. To this extent, in our view, there is merit in the theories that link inflation to monetized fiscal deficits. No wonder why in successful fiscal adjustments, money supply growth is almost always targeted. The incidence of hyperinflation in developing economies bears testimony to the centrality of the dangers of money financing of deficits.

Notwithstanding the compelling arguments by monetarists, it is however, not entirely correct to attribute inflation solely to deficit

financing. We now know that inflation is more than just a monetary phenomenon. There are various policy and structural issues that may trigger inflationary pressures other than deficit financing. For example, utility prices are known to stoke inflationary pressures in developing countries. Moreover, supply side economics does affect prices. Other inflation drivers include the exchange rate, international prices of imports, operational costs and food prices. Most Consumer Price Indices are actually based on weighted averages of a basket of non-monetary items. Therefore, monetarists do an over-kill in their emphasis of inflation as a monetary phenomenon. Such a bias cannot be justified as it clearly precludes other important causes.

Deficits, Interest Rates and Crowding out

Another vexing question is the link between deficits and interest rates. Do deficits raise domestic real interest rates when governments rely heavily on domestic debt financing?. Easterly and Schmidt-Hebbel (1995) argue that it all depends on the money and interest elasticity of investment, although of course this relationship is heavily blurred by financial repression (Easterly, 1989) and the high substitutability between public debt and other assets held by the private sector (Giovannini and de Melo, 1993).

Yet another contentious issue is the relationship between budget deficits, private consumption and investment. The central question to be asked is: How does private consumption and investment react to deficits? Barro (1974) argues that consumers will only offset changes in government consumption – without reacting to changes in government tax or debt financing. In a related discussion, Barro's (1974) Ricardian Equivalence proposition talks of a one-to-one crowding out of private consumption by public consumption. This proposition has gone under refutation from

various scholars (Haque and Montiel, 1989, Corbo and Schmidt-Hebbel, 1991). Giovannini (1983), Corbo and Schmidt Hebbel, (1991) support the theory that private consumption is insensitive to real interest rates.

In regard to government investment, the recurring question is whether government spending crowds-in or crowds-out private investment? In other words, does a higher level of public capital spending crowd in or crowd out private investment? Theory predicts this will depend on the degree of substitutability or complementarity of private and public capital (Easterly, Rogriguez and Schmidt-Hebbel, 1989, Blejer and Khan, 1984, Khan and Reinhart, 1990).

Easterly (1995) argues that public deficits could have indirect effects on private consumption and investment if real interest rates rise in response to higher domestic debt financing. Easterly (1995) argues that although theory predicts that real interest rates will have an unambiguous effect on private consumption, nevertheless, private investment should decline unambiguously with higher interest rates.

The demand side effects of fiscal policy are articulated by Hemming, Kell and Selma (2002). In their analysis they start by looking at the Keynesian model which assumes that prices are rigid, and that there is excess capacity so that output is determined by aggregate demand. Under such a scenario, a fiscal expansion would have a multiplier effect on aggregate demand and output. When the Keynesian multiplier exceeds one, it increases with the responsiveness of consumption to current income, and it is larger for a spending increase than for a tax cut. If the spending increase is matched by a tax increase, the resulting balanced budget multiplier is exactly equal to one (Hemming, Kell and Selma, 2002).

The negative relationship between investment and interest rates postulated in the IS-LM curve implies that a borrowing induced fiscal expansion would increase interest rates and reduce investment. Crowding out can also manifest itself via the exchange rate as argued in a typical open market IS-LM (Mundell-Fleming) model. In addition higher interest rates, attract capital inflows which in turn can appreciate the exchange rate and cause a deterioration in the external current account. This can actually offset the domestic demand arising out of the initial fiscal expansion (Blanchard and Summers, 1984).

It is important to take note of conditions under which crowding out can happen. First, crowding out will be more if investment is fairly sensitive to interest rates but if investment is sensitive to income, larger fiscal multipliers can be created even with the existence of crowding out (Evans 1987). The other factor that determines the extent of crowding out is money demand. Crowding out via interest rates assumes money demand is a function of interest rates and income. If the money demand is less sensitive to interest rates but more sensitive to income, there will be more crowding out (Goldfeld and Sichel, 1990).

The exchange rate and the degree of openness will also affect the extent of crowding out. In an open economy, fiscal multipliers depend on whether the exchange rate is flexible or fixed. We have also already mentioned the appreciation of the exchange rate due to capital inflows attracted by high interest rates. This implies that crowding-out is more pronounced under situations of high capital mobility. In such cases, fiscal policy is rendered ineffective. In an open economy, however, a fiscal stimulus will produce a small increase in interest rates than in a closed economy and given full capital mobility, fiscal policy is effective since money supply will rise and dampen interest rate hikes.

Price flexibility also determines the extent of crowding out. When prices are rigid in a closed economy, interest induced crowding out will be reinforced by higher prices arising from the fiscal expansion. This partly chokes off the increase in aggregate demand.

Interest rates can also influence crowding out via wealth or real balance effects (Pigou effects). Alesina and Perotti (1995) also say that institutional factors can determine the extent of crowding out. For example, large and persistent deficits may mean that there is a **deficit bias** – there is political pressure from voters to maintain high levels of aggregate demand. This is also called fiscal illusion, which means that voters are ignorant of the government's inter temporal budget constraint or resistance from politicians to reduce the deficit. Moreover, in developing countries, deficit bias arises from the low tax base, inefficient tax administration and other factors.

In theory, where interest rates are relatively flexible, large public deficits financed by borrowing from domestic credit markets will exert upward pressure on real interest rates and thus reduce private investment and output.

Furthermore, in financially repressed economies where the structure of interest rates is determined by government fiat, excessive domestic borrowing may also lead to crowding out of private sector expenditure, by entailing a direct reduction of the amount of credit allocated by the banking system. Whether fiscal deficits have a negative effect on private investment, output and growth depends to a large extent on the sources of the deficit and the composition of government expenditure (Agenor and Montiel, 1996).

However, theoretical postulations of bond financed deficits depend on the elasticities of interest to bond financing and the prevalence of the Ricardian equivalent. Financial repression also complicates this relationship. Moreover, where capital markets are not sufficiently deep, it is impossible to reach a conclusive pronouncement. In addition, the degree of substitutability between public debt and other assets held by the private sector further complicates the theoretical predictions on deficits and interest rates. Therefore, theory does not convincingly explain the link between deficits, interest rates, private consumption and investment. All it does is open the debate to more questions than answers.

Budget Deficits, Trade Deficits (the Twin Deficits) and Real Exchange Rates

Several theoretical models attempt to link fiscal deficits, trade deficits and the real exchange rate.

First we examine the question how do fiscal imbalances feed into external deficits? Theory predicts a strong link between fiscal and current account deficits in financially open economies when either consumers are not Ricardian or the national versus imported composition of public and private sector spending differs.

In the literature, fiscal balances have a spillover effect on external account balances (Rogriguez and Schmidt-Hebbel, 1995). This lends support to the fiscal approach to the balance of payments which says that fiscal imbalances are the main sources of external imbalances. Theory postulates that the fiscal deficit is a prime determinant of the trade deficit (Bernheim, 1998) and Miller and Russel (1989),

Theory says that consumers will anticipate that the government will raise taxes in the future to close the fiscal gap and pay back the accumulated debt.

To pay for the future tax increases, consumers have to save and accumulate wealth which they can do in two ways – by spending less and by boosting their income by increasing working hours. The later makes the capital stock more productive which fosters more private investment. The increase in investment partially offsets the increase in private saving, so that, overall, the current account balance deteriorates in response to the deterioration of the fiscal balance.

A look at a simple Keynesian open economy model will illustrate this relationship. According to Saleh (2006), in an open economy, gross domestic product, Y , is the sum of private consumption expenditures, C , gross private domestic investment expenditures, I , government expenditures, G , and exports, X , over imports, M : $Y = C + I + G + X - M$ (1)

Alternatively, Y equals private consumption expenditures, C , savings, S , and taxes, T : $Y = C + S + T$ (2)

Substituting (2) in (1) and rearranging terms yields:

$$(X-M) = (S-I) + (T-G) \quad (3)$$

Equation (3) suggests net exports equal private and public savings. Assuming there is a balanced fiscal budget ($T-G = 0$) and balanced trade ($X-M = 0$, that is, net exports are 0), then (3) suggests that private domestic saving equals private domestic investment. This is necessarily the case in a closed economy where domestic investment is constrained by domestic saving.

In practice however, in an open economy, such a relationship may not always exist. An economy with a foreign sector has access to international financial markets.

The hypothesis that increases in the government's budget deficit leads to an increase in the trade deficit follows directly from the Mundell-Fleming model (Fleming, 1962; Mundell, 1963).

In the Mundell-Fleming framework, an increase in the government's budget deficit can generate an accompanying increase in the trade deficit through increased consumer spending. By increasing the disposable incomes and the financial wealth of consumers, the budget deficit encourages an increase in imports. To the extent that increased demand for foreign goods leads to a depreciation in the exchange rate, the effect on net exports is mitigated.

However, the larger budget deficit also pushes up the interest rate (in large open economies) because this appreciates the exchange rate, which encourages a net capital inflow and a larger decline in net exports. The size of the effect is an empirical matter (Shojai, 1999). Volcker (1987) argues that budget deficits lead to trade deficits and both hinder economic growth in the long run. Fieleke (1987) provided the theoretical basis for the relationship between the budget deficit and the trade deficit. He argued that the dominant theory is that an increase in government borrowing in a country will, other things being equal, put upward pressure on interest rates thereby attracting foreign investment. As foreign investors acquire the country's currency in order to invest there, they bid up the price of that currency in the foreign exchange market.

The higher price of the country's currency will discourage foreigners from purchasing its goods but will conversely encourage residents of the country to use their now more valuable currency to purchase foreign goods, so that the country's current account will move toward a deficit.

In addition, any increase in the country's total spending resulting from the enlarged government deficit will go partly for imports and for domestic goods that would otherwise be exported, also worsening the current account balance.

Moreover, the Keynesian absorption theory suggests that an increase in the budget deficit would induce domestic absorption and hence import expansion, causing a current account deficit.

Feldstein and Horioka (1980) argue that savings and investment are highly linked, hence budget deficits and current account deficits are thought to move together. An alternative view is that the "twin deficits" are not related in the simple manner depicted by conventional economists. The link from the budget deficit to the current account deficit can be weak or non-existent. Therefore, there may not exist any predictable or systematic relationship between the two deficits given that there could be many other factors that might serve to make the "twin" relationship doubtful (Saleh, 2006).

For example, the stability of savings and investment over time can complicate the twin deficit relationship (Khalid et al., 1999). And as the Ricardian Equivalence Hypothesis (REH) states, a shift between taxes and budget deficits does not matter for the real interest rate, the quantity of investment, or the current account balance. In other words, the REH negates any link between the two deficits.

An alternative way to view the link between fiscal deficits and the current account is through expectations about future policy. Suppose the government runs a bond-financed fiscal deficit for a limited period of time. The dynamics of the economy during the transition period depend on whether the public anticipates the government to switch in the future to a tax finance regime or to a

money finance regime (Kawai and Maccini, 1991). If tax finance is expected to be used to close the deficits in the future, then current fiscal deficits will be associated with a current account deficit. On the contrary, if money finance – or seignorage-is primarily anticipated to be used, then fiscal deficits may be associated with current account surpluses. 'Twin deficits' therefore arise only when private agents anticipate that the government will raise taxes in the future to eliminate current fiscal deficits (Agenor and Montiel, 1996)

The trinity of fiscal deficit, trade deficit and real exchange rate can be seen as a chain reaction. Theory predicts that fiscal deficits lead to external borrowing. In turn, external borrowing leads to a current account deficit and real exchange rate appreciation and sometimes to a balance of payments crisis (if foreign reserves are run down) or an external debt crisis (if debt is too high)(Easterly and Schmidt-Hebbel, 1996).

Carlos Rodriguez (1991) develops an analytical framework that captures several mechanisms through which fiscal policies affect private spending and the accumulation of foreign assets. The external deficit determines the real exchange rate that is consistent with the clearing of the market for non-traded goods. An important implication of such models is that the effects of deficits, or more generally, fiscal policy – on the current account and the real exchange rate depends not only on the level but also on the composition of public expenditure (Montiel, 1986, Khan and Lizondo, 1987)

Hakkio (1996) argues that the domestic currency depreciates as a result of high demand for foreign currency that is triggered by the lowering of interest which arises from government lowering its deficit financing by reducing the demand for loanable funds. Thus deficit reduction makes domestic assets more attractive and causes

the currency to appreciate. Stoker (1999) argues that in the short term, an increase in deficit spending increases the value of the currency. Other theories say that a deficit can lead to a weaker exchange rate. According to Easterly and Schmidt-Hebbel (1991) real exchange rates also seem to be affected considerably by whether government spending is oriented more towards tradables or non tradables. But according to Dornbusch, (1985) and Easterly (1995), the relationship between the deficit and exchange rate is, however, generally ambiguous.

To sum up, economic theory suggests that there is a close link between the trade deficit and budget deficit (the so-called twin deficits) in open economies. Increased budget deficits lead to an increase in the interest rate. On the other hand an increase in the interest rate tends to appreciate the exchange rate. In turn, exports become relatively expensive and imports cheaper, thus generating a trade deficit.

2.5 Summary

This chapter discussed the theoretical postulations on the deficit and its impact on macroeconomic variables. The deficit occupies a central position in fiscal and macro-economic adjustment. However, the efficacy of fiscal policy depends on a correct understanding of the alternative deficit measures and how they impact on fiscal policy. Despite the various conceptual definitions of the deficit, it has emerged that the conventional deficit, despite all its weaknesses, will probably continue to be the most widely used deficit measure. This is so because of the computational difficulties associated with the derivation of more accurate deficit measures and the unavailability of timely data (Abedian and Biggs, 1998:186).

Three competing schools of thought explain the impact of the deficit on the economy. The three main schools of thought are the Neo-Classical, Keynesian and Ricardian Equivalence (Bernheim, 1998). The Neoclassical school argues that deficits are harmful to the economy via the mechanism of raising interest rates which causes crowding out. This view is countered by Keynesians who argue that as long as the economy has excess capacity and is operating below full employment, deficits will stimulate economic activity via aggregate demand. The Ricardian Equivalence, however, opines that deficits are at best neutral (Barro, 1991). This is due to the fact that rational agents interpret a deficit rise as merely implying an equivalent future tax hence they will increase their present savings to offset the impact of the deficit increase and therefore neutralizing it.

Finally the chapter discussed the theoretical relationships between the deficit and key macroeconomic variables, which are namely inflation, trade deficit, exchange rate and interest rate.

In general, the impact of the deficit depends on how it is financed (Easterly and Schmidt-Hebbel, 1991). Each major type of financing, if used excessively, brings about a macroeconomic-imbalance. The impact of the deficit on interest rates, private consumption and investment is generally ambiguous. However, theory establishes a strong link between deficits and trade deficits (the twin deficits) via the exchange rate transmission mechanism.

CHAPTER 3

MACROECONOMIC CONSEQUENCES OF FISCAL DEFICITS: Empirical Evidence

3.1 Introduction

Having analyzed the theoretical literature on the deficit and its macroeconomic implications in chapter two, this chapter reviews the associated empirical literature. In the course of reviewing the various empirical studies below, we also give our own independent opinion and critique of the empirical findings.

The relationship between fiscal deficits and the major macroeconomic variables has been considered in a large number of empirical studies over time. In this chapter this empirical evidence is considered.

3.2 Budget deficits and crowding out

In the discussion of the various schools of thought on the impact of government budget deficits on macroeconomic performance, crowding out of private investment as a result of an increase in the budget deficit was identified as a central imperator by the Neoclassical school. The argument was that a permanent increase in the budget deficit would, at least in a closed economy, raise interest rates and thus curtail investment and with that, economic growth.

According to Spectar (2005) there is a significant and positive association between deficits and interest rates, thereby giving a ring of truth regarding the crowding out effect.

However, empirical studies carried out by Kormendi and Meguire (1985) found no significant cross-sectional relationship between the growth rate of the economy and government spending.

Using annual data for the US over the period (1953-1986), Aschauer (1989) empirically examined the effect of public expenditure on private investment and the rate of return to private capital. He concluded that the net effect of a rise in public investment had a positive effect on private investment. This applied to the crowding in effect as opposed to crowding out.

In other empirical studies it was revealed that debt incurred on financing such expenditures like defense, health, and social welfare negatively affected the growth of real per capita GDP especially in developing countries, while debt-financed increases in education had a positive effect on growth in developed countries.

Kelly (1999) found that public investment in infrastructure, and particularly housing expenditure, and social security programmes are positively connected to economic growth thereby suggesting that countries can actually increase budgetary spending on social security.

Using Saudi Arabian annual data over the period (1960-1996), Ghali (1997) found no relationship existed between public spending and private investment and economic growth.

Monadjemi and Huh (1998) employed the error correction model (ECM) to examine the relationship between private investment and public spending in Australia, UK, and the US over the period 1970:1-1991:4 and found limited support for "crowding out" effects of government investment on private investment.

Empirical results established that in the long run, public spending had a positive impact on growth and private spending. However, in the short-run, it was observed that public investment had a negative impact on private investment and no effect on growth.

However, Saleh (2003) notes that outcomes from cross-section analysis cannot capture the country specific nature of the government spending and growth relationship. Time series analysis reveals the causal relationship between variables, while cross-section analysis can identify correlation but not causation between variables. Saleh concludes that, in general, both the method of financing and the components of government expenditure could have different impacts.

The above empirical findings on the relationship between the deficit and crowding out make one challengeable assumption – the assumption of a closed economy. In practice, most economies are open, whether small or big. Crowding out operates via the mechanism of interest rates. To therefore make a bold assumption that interest rates are always responsive to deficits is open to contestation. I would tend to agree with Kelly's findings that public investment in infrastructure crowds-in rather than crowd-out investment subject to a long-term gestation period.

Moreover it is crucial to distinguish between current and capital expenditure when measuring the impact of fiscal deficits on private investment and output growth. Some empirical studies find a significantly negative effect of public consumption expenditure on growth while the effects of public investment expenditure are found to be somewhat positive. We therefore want to pursue the debate regarding the empirical relationship between growth and the deficit.

3.3 Budget Deficits and Growth

A great deal of attention has been devoted in empirical literature to the possible impact of various fiscal magnitudes on growth (Adam and Bevan, 2004). Linked to this, there is debate whether the relationship between growth and deficit is linear. The Linear model has been widely used as it tends to fit the data

reasonably well for developing countries (Easterly et al, 1994). However, this approach overlooks important non-linearities which are nevertheless policy relevant especially when the deficit is at low levels. Empirical studies by Adam and Bevan (2004) for a panel of 45 middle and low income countries over the period 1970-1999 revealed that the relationship is not linear, that is, the positive effect of fiscal contraction to growth are most noted as the deficit falls from a high level, but these taper out well before the economy reaches a balanced budget position (Adam and Bevan, 2004:594). A statistically significant non-linearity in the impact of the budget deficit on growth at around 1.5% of GDP was found. This non-linearity underlined the significance of the composition of deficit financing and the effect of seigniorage financing on growth. Deficit financing can reinforce growth since its distortionary effects are less, compared to the distortionary impact of taxation and the accompanying increase in the tax rate.

Moreover, empirical studies argue that the government budget need not be balanced. It is argued that there are two types of government spending and five ways of financing it – taxes, grants and three forms of deficit finance (printing money and by issuing domestic or external debt). This analysis implies that while the impact on growth of taxes and grants are straightforward, the impact of the deficit is more complex depending on the financing mix and the debt stock. As Adam and Bevan (2004:594) argue, deficits may be growth enhancing if financed by limited seigniorage; they are likely to be growth inhibiting if financed by domestic debt and to have opposite flow and stock effects if financed by external loans at market rates. In this connection, two types of non-linearities may emerge, one involving the size of the deficit and the other involving the interactions between the deficit and the public debt stock. Hence the study by Adam and Bevan shows that at a

deficit threshold of 1.5% of GDP, growth is enhanced but any further contraction in the deficit becomes detrimental to growth. The magnitude of this payoff will depend on the manner in which the deficit is financed and how the change in the deficit is accommodated elsewhere in the budget. It is further argued that high debt stocks exacerbate the adverse impact of high deficits on growth.

All we can conclude from the above discussion is that budgets do not necessarily need to balance and that the relationship between the budget deficit and growth is non-linear and subject to the budget constraint. Finally a deficit threshold of 1.5% of GDP is growth enhancing but a further deficit contraction becomes growth-inhibiting.

3.4 Budget Deficits and Inflation

As we saw in the review of theoretical literature [e.g. Metzler (1951); Patinkin (1965); Friedman (1968); Sargent and Wallace (1981) Dwyer (1982); Miller (1983); among others] it was argued that government deficit spending is a primary cause of inflation. We also noted that the inflationary effect of government deficits depends upon the means by which the deficit is financed and the impact of that on aggregate demand.

Dwyer (1982) sought to test the relationship between the federal deficit and inflation. He employed a vector auto regression model to test the linkage between government deficits and a number of macroeconomic variables in the U.S. over the period 1952-1978. Dwyer found that deficits played no role in the inflationary spiral. Dwyer's conclusions ran directly counter to the views of Buchanan and Wagner (1977) who argued that deficits lead central banks to engage in debt monetization which is highly inflationary.

Following on Dwyer's study, a number of critical scholarly articles were written challenging Dwyer's findings. The most outstanding criticism came from Garrison (1984). Garrison raised theoretical, conceptual and methodological questions regarding Dwyer's study. Garrison criticized Dwyer for using comparative dynamics as opposed to market dynamics. Furthermore he criticized Dwyer's redefinition of the deficit as the change in the real value of the debt and called this an analytical error. He says, "to focus on the real value of outstanding bonds for each of a sequence of years, as Dwyer does, limits the analysis to the comparative-statics mode and overlooks the debt monetization process and the subsequent market process by which the economy becomes adjusted to each increment of monetized debt. These processes constitute the market dynamics that cause the real value of outstanding bonds to fall largely offsetting the newest increment of debt. That is, the monetization of debt is an important part of the market dynamics that cause the amount of debt in real terms to be no higher than before" (Garrison (1984: 593-596)).

In summary, Garrison argued that Dwyer committed the historical fallacy of post hoc ergo propter hoc by failing to capture the consequences of debt monetization on monetary growth. However, there is a strong argument regarding the inflationary impact of deficit financing. It is almost a truism that, among other factors, the printing of money to finance deficit almost always stokes inflation.

Catao and Torrones (2005) found, in a study of 107 countries over the period (1960 – 2001), a strong and positive relationship between deficits and inflation among high-inflation and developing country groups but not among low-inflation advanced countries. They used panel econometric techniques on non-linear equation specifications to distinguish explicitly between short- and long-run

effects of fiscal deficits. We find the argument that deficit financing has little impact in low inflation countries as self-serving. In the first place, low inflation rates cannot be achieved without fiscal dexterity.

Hamburger and Zwick (1981) examined the influence of deficits on monetary growth in the U.S. The evidence was that the effect of deficits on the growth of money was present between (1961 and 1974) and again in (1977 and 1978). Hence the conclusion that a combination of an expansionary fiscal policy and the Federal Reserve's attempts at moderating interest rate movements, begun in the mid-1960s, had caused higher inflation.

This view was counteracted by McMillan and Bread (1982) who did not see any connection between fiscal policy and monetary expansion.

Darrat (1985)'s empirical studies on the deficits and inflation in the U.S. during the post-1960 period found a connection between the two variables. He employed the OLS technique. He further observed the linkage between monetary growth and inflation although he explained that this link was weaker than the one between deficits and inflation.

McCallum (1984) argued that only primary deficits could be said to be neutral. Once interest payments are considered, it is difficult to maintain the argument that per capita budget deficits could be maintained if financed by bonds rather than by money without causing inflation. The logic of this argument is perplexing. Interest is calculated on the primary deficit. To me it makes little sense therefore to try and make a distinction between the two. I argue that, the two are jointly and severally responsible for inflation increases. The difference is the same.

Other empirical studies by Shojai (1999) and Ahking and Miller (1985) all cast doubt on the link between inflation and deficits. However, empirical studies by Dornbusch and Fischer (1981), Metin (1995; 1998) and Darrat (2000), found that budget deficits, as well as the growth rate of money supply, have significant impacts on inflation.

Abbas and Sanhita (2005) examined the impact of the budget deficit on inflation in the Islamic Republic of Iran. The study was based on an analysis of time series annual data (1963-1999). Using univariate cointegration tests such as the autoregressive distributed lag models (ARDL) and Phillips-Hanse methods to explore the relationship of budget deficits and inflation in the long-term, and the error correction model to study the behavior of the model in the short-term, the study showed budget deficits as well as liquidity had an impact on inflation rates in the Islamic Republic of Iran.

Burdekin and Wohar (1990) sought to establish the relative impacts of monetized and non-monetized deficits on output and inflation in the US using annual data for the period 1923-1982. As a measure of the degree of monetization, Federal Reserve purchases of government debt were used. Using Granger causality tests for the period 1923-1960, they concluded that in this instance neither deficit growth nor monetization affected real GNP growth or inflation. However for the period 1961-1982, the study found that monetization had fuelled inflation but had no effect on real GNP. Non-monetized deficit were found to have a negative impact on the rate of inflation in the short-run over the same period.

Solomon, De Wet and Walter (2004) tested the effect of the budget deficit and inflation in Tanzania. The Tanzanian economy had experienced the dual problems of high deficit and high inflation simultaneously for a prolonged period despite the absence of

hyperinflation. The tests involved cointegration analysis over the period 1967-2001. The study concluded that the monetization of the deficit, led to significant increases in inflationary trends in Tanzania.

Metin (1995) used multivariate cointegration analysis of the Turkish economy and arrived at the conclusion that excess demand in the government sector was the main cause of Turkish inflation rate and that inflation could be reduced by eliminating the fiscal deficit. These findings are consistent with the empirical evidence from Dornbusch (1977), Fischer and Easterly (1990).

Catao and Torrones (2005) found, in a study of 107 countries over the period (1960 – 2001), a strong positive relationship between deficits and inflation among high-inflation and developing country groups but not among low-inflation advanced countries. They used panel econometric techniques on non-linear equation specifications to distinguish explicitly between short- and long-run effects of fiscal deficits.

Meltzer (1989) buttressed the Chicago School by supporting the view that budget deficits were inflationary. He referred to countries like Argentina, Bolivia, and Brazil as good examples of inflation that was financed by printing money to meet government spending needs during the 1980s. But on the other hand, he argued that the experience in most developed countries does not support the view that deficits induce money supply growth and inflation. He gave an example of Italy, which experienced a budget deficit of about 10 percent of GDP throughout the 1980s.

However, inflation was reduced from about 20 percent to about 5 percent a year during this very same period. Other examples of persistent deficits and declining inflation were noticed

in Japan and the United States. In Japan the inflation rate was almost zero while the budget deficit climbed during the 1980s.

During the same period the inflation rate in the U.S. declined from 10 percent to about 4 percent, despite the increasing budget deficit of the 1980s (Meltzer, 1989). Abizadeh et al. (1986) in their studies focus on the link between deficits and inflation. They argue that one way of resolving the controversy over deficits and inflation was to test the possibility of a causal link between the growth of government expenditures and inflation. The authors' study led them to conclude that there was a link between the size of the budget deficit and the size of government.

According to Easterly (1996) any notion that fiscal deficits and inflation have a simple relationship fails to capture the fact that countries make different choices about seigniorage to finance their deficits partly because they differ in the extent to which other means of finance are available. Second, money creation and inflation are non-linearly related – the relationship between the inflation rate and revenue from seigniorage is of a laffer curve nature. Seigniorage is calculated as the ratio to real GDP of the yearly sum of deflated monthly changes in the money base (Easterly, Rodriguez and Schmidt-Hebbel, 1995)

In summary, extensive empirical studies on the connection between budget deficits and inflation, point towards a strong positive relationship in high-inflation and developing countries but not among low-inflation advanced countries. We would generally agree with the findings of the empirical studies positively linking budget deficits to inflation. Of course, this is not to say that "inflation is always and everywhere a monetary phenomenon".

3.5 The Twin Deficits

Several empirical studies have been conducted to establish the link between the budget deficit and the trade deficit. The two are commonly referred to as the twin deficits in the literature. In the US, studies were conducted by various scholars. The US economy had experienced negative current account balance for a prolonged period since the mid –seventies. By the end of 2004 the trade deficit was in the neighborhood of 6% of GDP. Exports increased by 11.2% while imports grew by 16.8%. So clearly, trade deficit was a burning issue hence the desire to seek to find out the extent to which the federal deficit had contributed to the escalation of the trade deficit.

Theory postures that there is a link between the twin deficits via interest rates and the effect on the value of the currency. This link has been the subject of many empirical studies. Darrat (1998) used the Granger technique to test the relationship and concluded that indeed, the budget deficit caused trade deficits. Hutchison and Piggot (1984) looked at the relationship that exists between three variables, namely, budget deficits, exchange rates and the current account balance. The conclusion was that the increase in the budget deficit tended to push up real domestic interest rates, which in turn appreciates the currency and thereby increases the trade balance.

Kim and Roubini (2004) did an empirical study of the effects of budget deficits on the current account by capturing effects of output fluctuations. Overall they found that at horizons of one to two years, output fluctuations explained most of the divergence between the budget balance and the current account. But after controlling for the effects of business cycles on the budget deficit and current account balance, they actually found that the trade deficit increased in the short run regardless of whether the deficit is

as a result of increases in government spending or a reduction in taxes.

The empirical results by Kim and Roubini (2004) were supported by Erceg, Guerrieri and Gust (2005) and Cavallo (2005). They found that budget deficits regardless of their source, had a far more modest effect than Baxter (1995) had allowed for. In particular they found that a deficit financed increase in government expenditure corresponding to 1% of GDP induces the trade balance to decline by about 0.15% of GDP, and a persistent cut in labour tax rates that produces a decline in tax receipts equivalent to 1% of GDP induces a trade balance deterioration of about 0.12% of GDP. This was because when the budget deficit increases, the resulting higher interest rates induce an appreciation of the exchange rate, which makes domestic goods relatively more expensive than imported goods. In theory these relative price changes would depress sales of domestic goods and stimulate imports thereby leading to deterioration in the trade balance.

Cavallo (2005) aptly described the problematic relationship of the twin deficits when he said that sibling relationships were always complicated. He noted that despite theoretical postulates that a deterioration in the budget balance results in a deterioration of current account balance, the two siblings did not always move together. For policy makers this raises questions as to whether a reduction in the deficit would necessarily lead to an improvement in the current account balance.

Other researchers such as Dewald (1983), Dwyer (1982), Holescher(1983) and Evans (1985) however, challenge the relationship between the twin deficits arguing that interest rates were not responsive to deficit changes.

Feldstein (1992) argued that the trade deficit was a product of the spendthrift tendencies of American consumers and not a result of the budget deficit. He argued that Americans were spending more than they produced. To do this, they were forced to borrow from foreigners at very high levels of interest rates.

Bahmani-Oskoei, et al study (1993) examined the statistical relationship between the twin deficits over the period 1970-1990 and found that the two variables were cointegrated. No conclusive evidence of a relationship between large budget deficits and high interest rates was found by Beck (1993) study. On the other hand, Thorbecke (1993) affirms the positive link between the twin deficits. He argued that a reduction in the budget deficit would reduce excess spending and lower the trade deficit.

Eravi et al (1992) found that deficits did not directly Granger cause exchange rate changes although there was an indirect effect through the money supply and the price level. According to Humpage (1992) there was no evidence of a long term relationship between fiscal policy, long term interest rates, the real dollar exchange rates and real net exports in a study he conducted applying cointegration tests.

Similar findings were reached by Mohammadi and Skaggs (1996), Johnson and Marquez (1998), Houthakker and Magee (1996), Cline (1989), Wren-Lewis and Driver (1998).

Kearney and Monadjemi (1990), in a study of eight countries (Australia, Britain, Canada, France, Germany, Ireland, Italy, and the United States) found the existence of a temporary twin deficit relationship between the stance of fiscal policy and performance on the current account of the balance of payments, which however was temporary. They further argued that fiscal expansions would lead to prolonged periods of improved current account performance as the

economy adjusts towards its long run equilibrium. They concluded that the twin deficit relationship varies internationally in magnitude and duration, and it is not independent of the government's financing decision.

Islam (1998) examined empirically the causal relationship between budget deficits and the trade deficits for Brazil from 1973:1 through 1991:4. Results confirmed the presence of bilateral causality between trade deficits and budget deficits.

According to Khalid and Guan (1999) the relationship between the budget and trade was more likely to occur in developing countries than developed ones.

Egwaikhide (1999) verified the above assertion when he used a macroeconomic model to examine the effects of budget deficits on the trade balance in Nigeria over the period 1973-93 and found that budget deficits arising from increased government spending adversely affected the balance of trade irrespective of whether it is money-financed or financed by external borrowing.

Piersanti (2000) utilized the Granger-Sims causality technique to investigate the relationship between the current account deficits and budget deficits for seventeen OECD countries over the period 1970-1997. Results strongly supported the view that current account deficits have been associated with large budget deficits during the 1970-1997 periods in most industrial countries.

Saleh (2006) empirically examined the long run linkage between the budget deficit and trade deficit in Lebanon for the period 1975-2003. The aim of the research was to test the Keynesian proposition and Ricardian Equivalence. The estimation technique used was the unrestricted error correction model using a cointegration test called the bounds test to examine whether the

twin deficits were cointegrated. Granger causality tests showed that causality ran from the trade deficit to the budget deficit and the relationship was positive and statistically significant. Saleh concluded that any policy measures to reduce the trade deficit in Lebanon could well assist in reducing the Lebanon budget deficit. The above findings are also supported by Mankiw (2006).

Enders and Bong-Soo (1990)'s empirical studies concluded that increases in government spending, regardless of the means of finance, can be expected to induce a current account deficit.

In his empirical studies, Normandin (1996) gauged the causal relationship between external and budget deficits by using Blanchard's overlapping generations model to test whether there is a positive relationship on one hand and the Ricardian equivalence (i.e there is no causal link between the twin deficits), on the other. The study found the relationship between the twin deficits to be significantly positive.

Abell (1990:81-96) used multivariate time series analysis to examine the linkages between the federal budget deficits and merchandise trade deficits. Using a vector autoregressive model it was found that budget deficits influenced trade deficits indirectly rather than directly. The twin deficits were found to be connected through the transmission mechanism of interest rates and exchange rates. The model indicated that reducing the size of the budget deficit could prove to be at least as effective as exchange rate intervention for the purpose of reducing the size of the merchandise trade deficit.

However, Feldstein (1992) argued that although the link between the US federal deficit and trade deficit in the 1980s was so clear that the two were popularly labeled the twin deficits, it is wrong to generalize from the American experience of the 1980s to

conclude that budget deficits and trade deficits are two sides of the same coin.

Mann (2002) similarly argues that focusing too much attention on current account balance is misleading because the current account is not a fundamental economic force in itself, but only one out of many factors of the general equilibrium, such as the domestic rate of savings and investment, economic growth and trade, international investment and capital flows, prices and rates of return and the exchange rate, and fiscal and monetary policy.

In summary, we conclude that most empirical evidence based on different estimation techniques have, in their majority, validated the view that a causality runs from the budget deficit to the trade deficit and the relationship is positive and significant. The phrase, (twin deficits) is thus derived from the bilateral causality between budget deficits and trade deficits. However, conclusions may be altered in the event that the effect of the budget deficit on trade deficit is blunted or neutralized by rising deficits of trading partners.

3.6 Budget Deficits and Exchange Rates

In a study of the deficit in Germany and the US for the period 1979-1995, Hakkio (1996) plotted a regression line relating the budget deficit to the exchange rate. The results yielded an upward sloping regression line, suggesting that both the dollar and the mark generally rose with the increase in the budget deficit. The slopes of the regression lines were 3.6 for the US and 0.5 for Germany. The study concluded that a positive relationship indeed existed between budget deficits and exchange rates in the two countries.

In another study of the relationship between the budget deficit and exchange rate for Finland and Sweden, Hakkio (1996)

found a downward sloping regression line showing that the Finnish Markka and Swedish Krona generally fell with increases in the budget deficit. The slopes were -2.4 for Finland and -0.8 for Sweden. Results indicated a negative relationship between the budget deficit and the exchange rate in the two countries.

Apergis (1998) examined the relationship between budget deficits and exchange rate in 8 OECD countries (Italy, Germany, Canada, UK, Switzerland, Belgium, Netherlands and France) for the period 1980-1995. Using quarterly data and the methodologies of cointegration, long run causality and Granger (short run) causality tests, he found strong empirical evidence in favour of the association between exchange rates and budget deficits although the results were again mixed with some showing a positive and others a negative association.

At the 1995 Jackson Hole Symposium whose theme was "Budget Deficits and Debt: Issues and Options", participants argued that the exchange rate could be strengthened by deficit reduction while others argued that it would be weakened (Craig and Hakio, 1996). As already pointed out, it is by no means not surprising to see that the empirical evidence on the relationship between budget deficits and exchange rate is inconclusive because in the first place the theoretical relationship is ambiguous.

Many researchers have thus concluded that there is no significant relationship between the budget deficit and exchange rate (Melzer, 1993). Other researchers have delved into random walk models in pursuit of answers to the empirical question on the relationship between budget deficits and exchange rates. For instance in 1983, Meese and Rogoff in a major study, concluded that a random walk model of exchange rates performs as well as any structural model.

Other studies have concentrated on the stationarity of real and nominal exchange rates and whether exchange rates and fundamental economic variables are cointegrated (Chinn, 1991). These studies have attempted to establish the existence of a long-run relationship between exchange rates and economic aggregates.

Humpage (1992) utilized the Engle-Granger Cointegration technique to test for the existence of a long-run relationship between the level of the U.S. federal budget deficit and the exchange rate during the period 1973-1991. Unlike many other studies, Humpage used the level of the deficit instead of deficit as a percentage of GDP. He argues that when the level of the deficit is very large, it could have substantially different effects on the exchange rate. This study found no evidence of a long-term relationship between common aggregate measures of U.S. fiscal policy and real long term interest rates, real dollar exchange rates, and real net exports.

Burney and Akhtar (1992) empirically examined the effects of budget deficits on the exchange rate for Pakistan over the period (1971-72) to (1989-90). The estimated results using the OLS method indicate that in the case of Pakistan, government budget deficits had a significant direct impact on the real exchange rate through the price level.

Hakkio (1996) used pooled annual data during the period (1979-1994) for eighteen OECD countries and regressed the real exchange rate on the budget deficit as a percentage of GDP. To estimate the indirect impact of a deficit reduction on the exchange rate, a country's inflation rate relative to the average OECD inflation rate, the stock of government debt (as a percentage of GDP) relative to the OECD average, and the change in government spending as a share of GDP are included in the regression line to

proxy the impact of expected inflation, risk premium, and the expected rate of return effect on the exchange rate. Hence, the way the government chooses to use these tools (cutting government spending or increasing tax rates) have important effects on the expected rate of return of domestic assets, thereby leading to changes in the demand for domestic assets and in turn to changes in the exchange rate.

The estimated results indicate that the direct impact of a deficit reduction in thirteen countries leads to a stronger currency, but in five countries the currency weakens as the deficit is reduced. Also, in all cases the indirect impacts of deficit reduction have the correct sign and are statistically significant.

However, Al-Eyd, Barrell and Pomerantz (2005) argued that the emergence of a sustained deficit did not automatically necessitate a fall in the exchange rate and fall in the exchange rate may not correct such a deficit. The authors further argued that deficits can exist if a currency moves above its sustainable real exchange rate and a real depreciation can remove such a deficit. Accordingly, the authors argued that deficits caused by exchange rate movements are likely to be more temporary than those that either emerge for long term structural reasons or result from structural imbalances in the economy.

Khan and Saul (1987) empirically examined the use of fiscal policies to sustain the effects of a nominal devaluation on the real exchange rate. They concluded that the extent of the change in the real exchange rate depends not only on the size of the devaluation and the degree of fiscal adjustment but also on the means by which the fiscal deficit is reduced. Furthermore, the change in the nominal exchange rate necessary to maintain the depreciation of the real exchange rate was deemed to depend on whether the fiscal deficit

is eliminated through tax revenue increases or by reducing state expenditure on traded and non-traded goods. In this instance, the required depreciation of the currency is bigger if the deficit is eliminated through taxation than the case if the deficit were lowered by reducing government spending.

The overall conclusions indicate that a deficit reduction leads to a stronger currency in the United States, Germany, France, Italy, and Canada. However, deficit reductions through tax increases and spending reductions have different effects on the currency of different countries. In general, in all countries under investigation, except for Japan, the UK, and Australia, cutting the deficits by spending cuts causes the currency to appreciate more than when taxes are increased. In Italy, revenue increases have a small impact on the exchange rate, but spending cuts are more effective. In Portugal and Norway, deficit reduction through tax increases weakens the currency, but spending cuts strengthen the currency (Shojai, 1999, pp. 61-62).

Real exchange rates showed little association with fiscal deficits in the empirical studies done by Easterly (1995). Dornbusch (1985) also supports the view that evidence on the relationship between the real exchange rate and deficits is ambiguous. However, empirical studies by Feldstein (1986), Throop (1989), Melvin, Schlangenhauf and Talu (1989) and Beck (1993) found a positive and significant relationship between fiscal expansion and the exchange rate. Mcmillin, and Douglas (1990), Koray and Chan (1991) and Cramer (1995) did not find a statistically significant relationship.

Bisignano and Hoover (1982) used a small country setting with static exchange rate expectations and concluded that budget deficits may appreciate or depreciate the exchange rate depending

on the relative importance of wealth effects and relative asset substitution effects. They argued that deficits are followed by tight monetary policy which causes the currency to appreciate.

All we can conclude from the analysis is that empirical models provide a mixed picture of how deficit reduction affects a currency. The direct impact of budget deficits can lead to currency depreciation; however, the indirect impact can overwhelm such exchange rate changes in the opposite direction. It would appear that the empirical studies do not shed any better light on this particular issue (the exchange rate) than theoretical postulations.

3.7 Budget Deficits and Interest Rates

In this section, we review empirical studies on the connection and causality between budget deficits and interest rates.

Feldstein and Eckstein (1970), Hoelscher (1986), and Cebula (1988; 1991) showed that federal deficits have a positive effect on nominal long-term interest rates, cause the slope of the yield curve to increase, and crowd out private investment. More recently, Knot and de Haan (1999) utilized the deficit announcement effect methodology to examine the relationship between budget deficits and interest rates in Germany over the period 1987-93. Their results suggested that the positive relationship between budget deficits and interest rates is due to fear that government debt may crowd out private investment (Knot and de Haan, 1999, p. 570).

Ewing and Yanochik (1999) examined the impact of federal budget deficits on the term structure of interest rates in Italy over the period 1977:1-1991:3. Using cointegration techniques, this study suggested that budget deficits increase the yield spread between long-term government bonds and the three-month Treasury bill rate.

Vamvoukas (2000) examined the linkage between budget deficits and interest rates in Greece over the time periods 1949-1994, 1953-1994 and 1957-1994. Within the methodological framework of cointegration, ECM strategy, and several diagnostic and specification tests, the empirical findings support the Keynesian model of a significant and positive relationship between budget deficits and interest rates.

Modeste (2000) utilized the loanable funds model of interest rate determination to investigate the relationship between budget deficits and interest rate movements. A basic tenet of that model is that interest rates would rise (or fall) as economic forces either increase (or decrease) the demand for loanable funds or reduce /increase the supply of such funds.

The methodology (loanable funds framework and error correction) was applied on Jamaican data over the period 1964-1996. This study found that the government's budget deficits exerted a significant positive effect on the long-term interest rate. Adding to this result, a major implication of this study is that budget deficits, to the extent that they force up interest rates, can cause "crowding out" of private investment. As a result, as the previous event occurs, one can expect capital formation to be retarded and long term growth to be inhibited (Modeste, 2000, pp. 676-677).

Cheng (1998:419-422) empirically investigated the causal link between deficit and interest rate in Japan. The Study employed the Engle-Granger two step procedure and found that neither budget deficits, short term interest rates, and prices in one model nor budget deficits and long term interest rates in the other, are cointegrated in Japan. The study found no causality between budget deficits and long term interest rates but detected feedback causality between the deficit and short term interest rates in Japan using

Hsiao's version of the Granger causality method with the aid of cointegration.

Vamvoukas (2002:31-36) investigated the empirical framework of both the Keynesian and Ricardian paradigms by applying SURE technique and impulse response functions. SURE results concluded that a bidirectional pattern of causality might exist between deficit and interest rates. Impulse response functions revealed that deficits and interest rates follow a joint feedback causality which was consistent with the Keynesian proposition that changes in interest rates are a response to positive movements in the budget deficits. This position was earlier on opposed by Garcia and Ramajo (1990:715-718) who found that budget deficits did not appear, in the case of Spain, to raise long run nominal interest rates during the sample period.

As a summation, empirical studies show that the government's budget deficit exerted a significant positive effect on the long term interest rate. A major implication is that, to the extent that they force up interest rates, deficits can crowd-out private investment. However, for this causal link to hold, the deficit must be incurred on recurrent rather than capital expenditure. The empirical findings on deficit and interest rates fail to make a clear distinction between nominal and real interest rates. In the absence of this clear distinction, any conclusion arrived at may not stand the test of empirical rigour.

3.8 Summary

This chapter examined the empirical relationships between the budget deficit and macroeconomic variables, namely, inflation, current account deficit, interest rate, exchange rate and growth. In short, empirical findings were as follows: A positive and significant relationship exists between monetized deficits and inflation; there is

a causal link between the budget deficit and trade deficit (the twin deficit); Bond financed deficits increase interest rates and crowds out private investment but we have to be careful to make a distinction between recurrent and capital expenditure. The relationship between the deficit and the exchange rate is ambiguous and finally we conclude that the relationship between the deficit and growth is non-linear and depends on the budget constraint- a corollary of this is that budgets do not need to balance (Adam and Bevan, 2004). *However, some of the empirical conclusions are contestable.* For example, the conclusion that budget deficits cause trade deficit without anticipating the counteracting impact of high deficits in trading partners and the conclusion that budget deficits have a positive impact on interest rates without making a distinction between real and nominal interest rates. We find the evidence on deficit and growth to be weak and inconclusive. However, it seems that evidence on deficits and inflation is convincing, depending on how they are financed.

CHAPTER 4

FISCAL DEFICITS AND ECONOMIC PERFORMANCE: The Experiences of Selected African Countries

4.1 Introduction

Chapter one clearly set out the methodology of this study, namely the exploratory, qualitative and comparative analysis methodological framework as opposed to quantitative methods. The justification is that this is a political economy and analytical study which goes beyond metrics to look at broader political, policy and institutional dynamics that have a bearing on the performance of developing countries. These factors cannot, however, be measured. Moreover, the reliability and validity of econometric results under hyperinflationary conditions such as those prevailing in Zimbabwe during the period of the study, is doubtful.

Chapters two and three reviewed the theoretical and empirical literature on deficits and macro-economic performance. The theoretical postulations and empirical findings provide the necessary conceptual background for Chapter four.

Chapter four employs an exploratory, qualitative and comparative analysis methodology to review the experiences of selected African countries in the execution of fiscal policy in order to understand the impact of fiscal policy on the performance of their economies.

The chapter begins by first reviewing the general economic performance of Sub-Saharan African (SSA) countries in order to get a broader perspective of the economic history of Sub-Saharan Africa. Economic policies of Sub-Saharan African countries are examined over the various historical epochs of these countries.

After 1980, African economies went through two major phases that are generally classified as follows:

- 1980-1999 - a period sometimes referred to as the two lost decades (Easterly, 2001) and;
- 1999-2008 – a period of the so-called economic renaissance (Delechat, Kovanen, and Wakemann(2008) and IMF(2000).

The above classification is however subject to contestation. But for purposes of this study, I shall stick to it, without prejudice.

This bird's eye view is informed by the literature on Sub-Saharan Africa (SSA) and in particular the World Bank (1994) report as well as Collier and Gunning (1999; 2006) and other literature on public finance. After this broad overview, a detailed focus will then be placed on the selected African countries, by looking at their experiences in matters of public finance management, fiscal performance and macroeconomic implications.

4.2 Sub-Saharan Africa

4.2.1 General overview of macro-economic performance in Sub-Saharan Africa before structural adjustment programmes

Economic performance in Sub-Saharan Africa started deteriorating in the mid 1970s (World Bank, 1994). By the early 1980s, the economic situation had worsened with further deteriorations in the terms of trade and sharply reduced access to international finance capital. The economic stagnation and decline in the 1970s and 1980s were also attributed to poor policies – both macro-economic, fiscal and sectoral (Collier and Gunning, 1999; 2006).

During the 1980s, per capita GDP in SSA declined by 1.3% per annum which was about 5% below the average of less developed countries in general. Between 1990 and 1994, the decline accelerated to 1.8% per annum, and the difference compared to other less developed countries jumped to 6.2% per annum (Collier and Gunning, 1999). In terms of domestic policies, overvalued exchange rates and large and prolonged budget deficits were considered detrimental and undermined the macroeconomic stability needed for long-term growth. It was argued that these wrong policies were associated with the development paradigm of the 1970s, which gave the state a prominent role in regulating economic activity under protectionist barriers (also see Killick, 1992).

Because of lack of domestic capital and entrepreneurship, the unwillingness to rely on foreign capital, and the underlying distrust of the market, almost all African countries chose to rely on the state-led development model. At the time, development economists encouraged this (Sen, 1982).

Import substitution industrialization was believed to be the key to rapid growth because of declining prices of primary commodities and the resultant decline in foreign exchange earnings. Agriculture, rather than being stoked as the engine of growth, was heavily taxed to provide the resources to build a modern industrial sector. Governments drew up 5-year economic development plans, created public enterprises and enacted regulations to control prices, restrict trade and allocate foreign exchange in pursuit of socio-economic goals.

Government intervention was supported by development economists who recognized the role of government in providing "social head capital" or "infrastructure" to facilitate economic

development (Krueger, 1990). Other economists justified government intervention in economic activity on the basis of market failures or structural rigidities that resulted in the lack of responsiveness to price signals. It was therefore concluded that governments should take a leading role in socio-economic development and take control of the commanding heights of the economy in order to compensate for market failures (Hirschman, 1981, Rosenstein-Rodan, 1984).

The public sector became over-extended as governments tried to build nation states and deliver on the promises of independence. The volatility of export receipts and thus of foreign exchange earnings and fiscal revenues complicated macro-economic management policies in post colonial Sub-Saharan Africa. Policies were poorly conceived and wrongly implemented (World Bank, 1998). This created a fertile ground for fiscal stress.

A look at some of the poorly conceived policies will drive the point home:

Overvalued exchange rates

In the 1970s and 1980s, overvalued exchange rates bred unofficial parallel markets for foreign exchange to an extent that Africa's parallel market premiums became by far the largest in the developing world (Nashashibi and Bazzoni, 1994). In the 1980s the average premium was almost 300%. Rough estimates indicate that a 10% premium is likely to reduce GDP growth by 0.4% a year and a 100% premium, GDP by 2% a year. For example, in the case of Ghana between 1974 and 1980, the parallel market premium of more than 200% explained a slow-down in GDP growth of about 3 percentage points a year (Killick, 1992).

Government Expenditure

Among the indicators of good fiscal policy are a small budget deficit and a low ratio of government consumption (that is current spending on goods and services) to GDP. In pre-structural adjustment Sub-Saharan Africa, consumption began to increase in the early 1960s and reached its peak of nearly 17% of GDP in the early 1980s, exceeding the ratio of other regions by 5% to 6%. That excess was instrumental in deterring growth (World Bank (1994)).

Studies showed that over the typical range of government expenditure, each 10 percentage point increase in the ratio of government consumption to GDP typically reduced GDP per capita growth by 1.2 percentage points (World Bank, 1994).

Inward-looking trade policy

This took the form of import substitution strategy, supplemented by widespread use of tariff and non-tariff barriers to reduce external competition, mainly in the manufacturing sector. A study by Dollar (1992) used the index of outward orientation to measure trade openness. The index showed Sub-Sahara's African countries as the least outward-oriented. Other studies revealed that out of a sample of 20 countries (high performing economies) with high non-tariff barriers, 11 were in the Sub-Saharan African region (Pritchett, 1991). This protection was another pervasive policy choice, because competition increases productivity, while restrictions increase input prices and the cost of capital, thereby choking growth.

Political Stability

Political and social stability are usually associated with higher rates of growth (Darro 1991, Fosu 1992). More than half the region's countries were rocked by internal strife, uprisings against

the government, and devastation from drought and famine. Average GDP growth for these countries was -0.5% a year from 1965 to 1985. By contrast, the region's 11 stable countries had an average growth rate of 1.4% (Hodd 1991).

Human capital

Countries with skilled personnel grew faster. Sub-Saharan Africa trailed behind other regions in social indicators, hence the low growth (World Bank, 1994).

Financial Sector

Financial strength is another determinant of growth. Countries with more developed financial sectors grew faster. Financial strength improved in Africa, for example, M2 as a share of GDP, increased from about 15% in the early 1970s to 20% in the mid 1980s. Financial and human development actually helped to stem the economic decline, not cause it.

Terms of trade

A hostile external environment (external shocks) worsened macro-economic adjustment in Sub-Saharan Africa. This was exacerbated by the failure to diversify commodity production, especially the tradable goods sector.

Implications

The evidence on Sub-Saharan Africa shows that poor policies clearly hurt Africa's long-term growth far more than a hostile external environment did. But according to the World Bank (1994) neither policy choices nor external factors explain all of the low growth. Cross country econometric analysis shows that Sub-Saharan Africa has grown more slowly than other regions even after differences in macro-economic policies, endowments, political

instability and external shocks are taken into account (Easterly and Levine 1993).

It is argued that other factors such as the bias against agriculture, extensive government intervention in the economy, weak infrastructure, and the difficulties of the political and social transition following independence, account for the residual difference in growth performance. The World Bank takes for instance, the bias against agriculture as perhaps the most important omitted variable in econometric analysis.

As Schiff and Valdes (1992) point out, most Africans live in rural areas and the region relies heavily on agriculture for foreign exchange. Yet agriculture has been heavily taxed, much more than in other regions. According to Akiyama and Larson (1989,) producers of agricultural exports were often forced to sell their crops to marketing boards that monopolized exports while they received real prices half those received by producers of similar crops in other countries. This stifled the region's agricultural growth.

Econometric analyses alone, does not fully explain Africa's low growth. Econometric policy indicators fail to capture the intricacies of policy intervention in the region such as the setting of prices, the nationalization of banks, price controls, rationing of foreign exchange, imposition of licenses, corruption and the creation state enterprises. None of these interventions nor their impact is easy to quantify because the required data are generally either unavailable or unreliable.

Yet another possible factor that econometrics neglects is ideology, which had been important in setting the policy agenda in African countries in the 1970s and 1980s. Classifying countries as African capitalists, African socialist populists and Afro-Marxists shows that the capitalists experienced the fastest growth between

1985 and 1980 (Yang 1988), with the exception of Congo, an Afro-Marxist country which did well due to the oil windfall, while some capitalist countries such as Zaire did not do well because of political and social instability.

All these factors played some role in Africa's poor revenue and growth performance. But we can only speculate about their relevance, because they are difficult to quantify and test rigorously (World Bank, 1994).

4.2.2 General-Economic Performance of Sub-Saharan Africa under Structural Adjustment Programmes (1980-1999)

As already discussed in the previous section, the macro-economic crisis in Sub-Saharan Africa started to manifest itself in the 1970s and early 1980s with the decline in export earnings while import demand remained almost unchanged. Official currencies were overvalued, existing alongside the parallel market whose premiums exceeded 100% (World Bank, 1994). In addition to these economic problems, fiscal deficits also increased by more than 7% of GDP, which was compounded by the debt crisis. Access to international credit became problematic.

The challenge was how to strike a balance between revenue and expenditure in order to avoid the pitfalls of budget deficits. Naturally, fiscal discipline called for fiscal probity and the tightening of credit policies and dealing with the overvalued real exchange rate. The idea of tight fiscal and credit policies was meant to cut overall spending in the economy. But to mitigate the recessionary impact of such contractionary policies, currencies had to be depreciated so as to increase production in the tradable sector. This was the beginning of structural adjustment.

In Africa, Ghana and Mauritius were among the first to take bold steps along these lines. However, structural adjustment failed,

as countries did not do enough to reduce their budget deficits and were reluctant to depreciate their currencies to restore competitiveness (Killick, 1992). This negatively affected economic growth in the first half of the 1980s. In this regard, examples of Ghana in the 1970s and Tanzania between 1980 and 1985, are instructive.

The dawn of the second half of the 1980s, however, saw adjusting Sub-Saharan African countries beginning to improve their macro-economic policies. Tighter fiscal and credit policies, accompanied by increased foreign financing started to bear fruits and helped improve the balance of payments and moved economies out of the import-compression phase of adjustment. The policy packages were more effective when they controlled inflation and realigned the exchange rate like for instance in Malawi (1982-84) and Tanzania (1983-1985).

Fiscal Reform

In the 1980s, African governments were already saddled with fiscal deficits arising from the high spending that had been triggered by the windfalls of commodity booms in the 1970s. Furthermore, the deficits were compounded by declining trade revenues arising from the decline in international commodity prices. Budget deficits (including grants) in excess of 7% of GDP were the norm because high budget deficits meant rapid money supply growth, high inflation and large current account deficits; this was hardly the basis for a sound macro-economic climate (Easterly and Schmidt – Hebbel 1991; Kignel and O’Connell 1993).

Between 1981 and 1986, half of the African countries implemented structural adjustment measures whose main focus was the reduction of budget deficits. Deficits were reduced from 7% of GDP to below 6.5% of GDP. These were called early adjusters.

Other African countries pursued fiscal probity much later, between 1990 and 1991, reducing their deficits from over 7% to 5.2% of GDP. These were called later adjusters (World Bank, 1994)

However, the median improvement in the deficits disguises differences among country groups. Five of the six countries with the largest reductions (more than 5%) – Burundi, Gambia, Malawi, Tanzania and Zambia – are low-income, flexible exchange rate countries. In contrast, middle-income countries with fixed exchange rates, and the oil exporters had their overall fiscal balances deteriorate, with Cameroon and Cote d’Ivoire having the largest increases in the deficits (World Bank, 1994).

Another measure of the fiscal balance is the so-called primary deficit (see chapter 2), calculated by deducting interest payments from the total deficit. Changes in the primary deficit are considered a better indicator of fiscal performance than changes in the overall deficit because fluctuations in external interest payments are largely beyond government control in the short-term. The primary deficit as a share of GDP improved in the adjusting countries, with a median decrease of almost 2%. This was more than the decrease in the overall fiscal deficit, because interest expenditure rose in most countries and partly offset efforts to reduce the overall fiscal balance. Improvements in the primary fiscal balance were larger for the low-income countries and those with flexible exchange rates than for the middle income countries and those with fixed exchange rates (Wetzel and Islam, 1991)

Despite the deficit reductions, the fiscal situation in Sub-Saharan Africa remained fragile. Most countries still relied heavily on foreign grants to avoid fiscal imbalances, and the median deficit excluding grants remained large – about 8% of GDP since the 1980s until in the late 1990s. Indeed the 1.3 percentage point increase in

external grants between the early 1980s and 1990 – 1991, contributed heavily to reducing the overall budget deficit during this period.

The reduction in budget deficits was helped by lower spending, with a median decline of 1 percentage point of GDP, despite an increase in interest payments of about 0.9% of GDP. Most of the cuts were in capital spending. The cuts were deeper for middle income and fixed exchange rate countries, and deepest for the oil exporters – not surprising because they started with bloated public investment programs. In the 1990s, the overall wage bill fell in Cameroon, Congo, Cote D’Ivoire, Gabon and Zimbabwe – countries with the largest wages bills as a percentage of GDP. All these were efforts to reduce government spending (World Bank, 1994).

Fiscal Stance

The overall budget deficit (including grants) was the criterion used by the World Bank (1994) to assess the countries’ fiscal stance. Countries with high deficits generally needed to improve their fiscal accounts to avoid inflation or crowding out domestic investment.

Fiscal Policy Stance (1990 – 1991)

The following table shows the rating of selected countries regarding their fiscal performance. The results are based on a survey by the World Bank (1994).

Table 3: Rating of fiscal performance for selected African countries

1 Good	2 Fair	3 Poor	4 Very Poor
Gambia	Burundi	Benin	Zimbabwe
Ghana	Burkina Faso	Kenya	Mozambique
Mauritania	Gabon	Madagascar	Zambia
Senegal	Malawi	Mali	Cameroon
Tanzania	Togo	Nigeria	Niger
		Rwanda	Nigeria
		Uganda	Sierra Leone

Notes:

- (1) A good rating indicates a budget surplus or an overall deficit including grants of less than 1.5% GDP.
- (2) Fair – deficit of 1.5 – 3.5% of GDP.
- (3) Poor – a deficit of 3.6 – 7.0%.
- (4) Very poor – a deficit of 7.1% or more.

Source: World Bank, 1994:48

The countries with a good rating depended on external grants. This shows how fragile public finances are in Africa and how quickly a fall in external assistance could destabilize them.

The World Bank Report (1994) stressed that:-

- In order to achieve fiscal balance and macro-economic stability, countries needed to focus on establishing or maintaining realistic exchange rates, keeping budget deficits low and inflation low, and increasing public sector savings. Keeping budget deficits small helps control inflation and avoids balance of payments problems. Public enterprises reforms are important if countries are to sustain their macro-economic gains.
- Building effective financial systems in Africa is bound to take time, given the lack of institutional and regulatory capacity and the difficulty of reforming the public sector.
- All aspects of public sector management require improvement, particularly budgeting, payroll management, investment planning and monitoring and tax collection.

- Re-allocating public spending towards basic services benefiting the poor is essential and in order to balance reforms that could weaken public finances such as higher spending on health, education and infrastructure – other expenditures must be reduced and the tax base broadened. The growing popular demands for more accountable and more transparent government must be heeded in order to improve fiscal discipline.
- In general, African countries under spent in the sectors that are a priority for development such as health and education, and overspent on wages, defense, and subsidies to public enterprises. The problem was compounded by the decline in tax revenues.

Table 4 Tax revenue in selected African countries (% of GDP)

	Total Tax Revenue	
	1986	1992
Burundi	14.4%	15.8%
The Gambia	17.6%	19.5%
Ghana	12.2%	10.0%
Kenya	19.6%	19.1%
Madagascar	8.6%	8.6%
Malawi	14.8%	16.9%
Mauritania	19.9%	16.5%
Mozambique	9.4%	21.7%
Niger	9.1%	9.0%
Senegal	14.6%	14.5%
Tanzania	15.3%	17.6%
Uganda	6.0%	6.1%

Source: World Bank (1994).

The overview of Africa's macroeconomic and fiscal policies clearly shows a readable pattern of a combination of external and domestic factors that slowed growth, increased public spending and precipitated the debt crisis. While it is true that external factors played a big role, it is also true that poor macroeconomic policies and other institutional factors equally contributed to Africa's overall dismal economic performance. Easterly (2008) pointed out that, fast and sustained growth does not happen simultaneously. It requires a long-term commitment by a country's political leaders and each country has specific characteristics and historical experiences that must be reflected in the leaders' growth strategy.

Krueger (1990) argues that by the 1970s and early 1980s, governments in most developing countries were mired down in economic policies that were manifestly unworkable. Krueger (1990) opines that government failures were more colossal than market failures (market failure is defined as being present when conditions for Pareto-optimality are not satisfied in ways in which an omniscient, selfless, social guardian government could costlessly correct).

Krueger (1990) argues that there were many failures, both of commission and omission. Failures of commission included exceptionally high cost public sector enterprises, like for example, state marketing boards which often served as a monopoly distribution network and also provided inputs (erratically and often heavily subsidized if not free) to farmers; state ownership of retail shops for the distribution of foods and other deemed essential products and state operations of mines and manufacturing activities. Moreover, government public sector deficits were fuelled by public sector enterprises, excessive investment programs and other government expenditures that led to high rates of inflation, with their attendant consequences for resource allocation, savings

behavior and the allocation of private investment. This view is supported by Tinbergen (1984), Cowen (1988), and Krueger and Tuncer (1982)

Failures of omission included deterioration of transport and communication facilities, maintenance of fixed nominal exchange rates in the face of rapid domestic inflation, buttressed by exchange controls and import licensing, nominal rates of interest which were well below inflation and credit rationing and failure to maintain existing infrastructural facilities (Krueger, 1990).

According to Krueger, as by-products of these failures, rampant corruption arose. And as such, all of these vices emerged in the context of pervasive government involvement in, and control over, economic activities. But other scholars argue that governments could still play a significant, targeted and purposive role in the development of the economy (see Stiglitz, 1988; Short, 1983; Streeten, 1984).

While the 1970s can be described as commodity boom years for most countries in SSA, regardless of the 1973/74 oil shocks, the period 1980 to 1999, however, is often referred to as the two lost decades (Easterly, 2001). As the foregoing paragraphs highlighted, poor macroeconomic performance manifested in many forms – poor economic growth, low private investment, low levels of foreign direct investment, price instability and nominal exchange rate instability, real exchange rate misalignment and poor distribution of the public budget (Naming and Schoeman, 2007).

In summary, in respect of the 'lost decades' we also found that several literature link poor macroeconomic performance to specific factors such a lack of openness to international trade (Sachs and Warner, 1997), overvalued exchange rates (Ghura and Grennes, 1993), a lack of financial deepening (Collier and Gunning,

1999), political instability (Collier and Gunning, 1999, Ghura and Hadjimichael 1995, Fosu 2001 and Ghura and Grennes, 1993), geographical problems (Easterly and Levine, 1997) and inadequate institutions and corruption (Sachs and Warner, 1997, Easterly, 2001).

The issue of export price volatility also played a pivotal role in SSA's poor macro-economic performance. As Bleaney and Greenaway (1998) pointed out, export price volatility harmed SSA's growth in the 1980s and 1990s due to over reliance on primary commodity exports compared to manufactures. This view is consistent with the Prebisch-Singer thesis which predicted that the prices of primary products, in the 1980s and 1990s, were on a long run downward trend relative to the price of manufactures. And because of the volatility of primary product prices, exporters of these products experienced greater instability of export revenues. Moreover, in a growth regression model of 83 countries over the period 1965-1990, Sachs and Warner (1997) found that the share of primary exports in GDP, had a significantly negative coefficient. Other scholars like Deaton (2000) also attributed Sub-Saharan Africa's poor economic performance to commodity price variability which emanated from flawed internal political and fiscal arrangements.

4.2.3 Sub-Saharan Africa's Economic Renaissance (1999 – 2008)

Sub-Saharan Africa's economic performance in the 1980s and 1990s was clearly disappointing, with much of the region unable to break away from paths of low or negative per capita incomes growth, high inflation and balance of payments difficulties. Nevertheless, after two decades of economic stagnation and little progress in poverty reduction, the seeds of an economic renaissance in Sub-Saharan Africa were sown. From 1999, Sub-

Saharan Africa's performance actually started to improve with real per capita incomes beginning to rise steadily. According to the IMF (2000), this renaissance reflected a new commitment by SSA countries to sound macroeconomic policies as well as windfalls of better terms of trade.

Table 5: Sub-Saharan Africa – selected economic indicators (2002 – 2007)

	2002	2003	2004	2005	2006	2007
Real GDP (%)	3.5	4.0	6.0	6.0	5.4	6.7
Exports (% of GDP)	32.4	33.8	36.0	39.3	42.1	40.6
Imports (% of GDP)	32.8	33.3	34.6	39.3	42.1	40.6
Gross Domestic Savings (% of GDP)	15.5	18.6	21.0	22.2	23.2	21.5
Gross Domestic Investment (% of GDP)	16.4	18.7	19.3	19.2	20.4	21.4
Fiscal Balance	-2.7	-2.2	-0.4	1.5	4.1	-0.1
Current Account (Oil Exporters)	-3.3	-2.5	-1.8	-0.6	-0.6	-1.7
Revenue (in months of import cover)	4.4	4.1	4.9	5.3	6.2	6.8

Sources: IMF African Department Data Base and World Economic Outlook (various issues).

Oil exporting SSA countries improved on their exports while oil importers benefited from debt relief and used their resources to make progress towards the realization of the Millennium Development Goals (MDGs). According to Maruping (2006), aid commitments to SSA countries improved, including actual disbursement, inclusive of debt relief. Debt relief became a reality when the World Bank and IMF approved the financing and implementation of the Multi-lateral Debt Relief Initiative starting July 2006. Seventeen countries benefited from this initiative, which entailed 100% debt cancellation. The benefiting countries were: Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Honduras, Madagascar, Mali, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia (Maruping, 2006). According to the IMF (2007), average growth in Sub-Saharan Africa for 2006 was 5%

and 6.7% in 2007 due to higher production by oil exporters, while oil importers grew by 5% in 2006, although some oil importers, including the West African Economic and Monetary Union (WAEMU) zone and post conflict countries failed to catch up to the regional average. Sub-Saharan Africa managed to preserve macroeconomic stability with policies intended to support and sustain the region's higher growth (IMF, 2007). The higher growth in the region was reinforced by both private external developments such as strong foreign demand, strong domestic investment and productivity gains supported by sound economic policies in most countries (IMF, 2007). As the IMF (2007) further observed, the trend growth performance inched toward the 7% rate target set out for Sub-Saharan Africa in order to achieve the income poverty Millennium Development Goal (MDG).

Table 6: Sub-Saharan Africa: Real GDP growth rates of strong performers

	1982-91	1991-94	1995-98	1999	2000	2001
	Average					
Botswana	10.8	4.0	6.3	7.3	8.5	7.1
Cameron	1.3	-3.1	4.6	4.4	4.2	5.3
Mali	2.1	1.8	4.7	1.1	3.8	5.6
Mozambique	0.1	3.2	8.6	8.8	6.1	10.4
Rwanda	1.5	-13.9	17.7	5.9	5.0	6.1
Tanzania	3.4	1.4	3.7	4.6	5.2	5.6
Uganda	2.4	0.5	3.7	2.1	3.3	4.3
Average	2.4	0.0	6.4	5.9	5.3	6.4
SSA Average	2.0	0.5	3.7	2.1	3.3	4.3

Source: World Economic Outlook, (various issues).

As the above table shows, strong growth was registered in the above selected sub-Saharan African countries between 1991 and 2001. During this period, the average growth rate increased from 2.0% between 1982-1991 to 4.3% in 2001. Rwanda, Mozambique and Botswana were the leading strong performers.

The World Bank (2006) points out that higher oil prices did not diminish economic growth in Sub-Saharan Africa and real GDP grew by 5.1% in 2005, only slightly below the 5.5% figure of 2004. Furthermore, growth in oil exporting countries continued to be buoyant with rates as high as 7.8% in 2007. However, this impressive performance was not repeated in 2008 due to constraints in oil supply in Chad, Equatorial Guinea and Nigeria. Overall, oil importing countries did very well and their economies grew by an average of 5% in 2005 compared to 4.9% in 2004.

The World Bank (2006) views the region's higher economic performance as not transitory but rather as a structural break from the past. The World Bank argued that a significant and durable improvement in the policy and institutional environment was evident among a growing number of SSA countries. Even the World Bank's Country Policy and Institutional Assessment (CPIA) scores for SSA shows an increase and the number of African countries with scores equal or greater than the threshold of 3.5 for good performance has also been rising.

Several African countries including Ghana, Uganda, Mozambique, Tanzania and Senegal have had higher growth accompanied by diversification of their economies and exports.

Table 7: Sub-Saharan average per capita GDP growth (1996 – 2005)

Little or no Progress Countries (20% of Africa Population)		Slow Growing Countries (16% of Africa Population)		Sustained growth Countries (36% of Africa Population)		Oil Countries (29% Africa Population)	
Swaziland	2.8	Namibia	4.0	Mozambique	8.4	Equatorial Guinea	20.9
Kenya	2.8	Zambia	3.6	Rwanda	7.5	Angola	7.9
Lesotho	2.7	Guinea	3.6	Cape Verde	6.5	Chad	7.8
Eritrea	2.2	Niger	3.5	Uganda	6.1	Sudan	6.4
Comoros	2.0	Togo	3.3	Mali	5.7	Nigeria	4.0
Seychelles	2.0	Madagascar	3.3	Botswana	5.7	Congo Republic	3.5
Ivory Coast	1.5	Malawi	3.2	Ethiopia	5.5	Gabon	1.7
Burundi	1.2	South Africa	3.1	Tanzania	5.4		
Sierra Leone	1.1	Sao Tome	3.1	Mauritius	4.9		
CAR	0.9			Mauritania	4.9		
Guinea Bissau	0.6			Benin	4.8		
DRC	0.0			Ghana	4.7		
Zimbabwe	-2.4			Senegal	4.6		
				Burkina Faso	4.6		
				Gambia	4.5		
				Cameron	4.5		
Simple Average	1.3		3.4		5.5		7.4
Median	1.5		3.3		5.1		6.4

Source: World Bank (2006)

As regards inflation, in recent years SSA made significant strides in reducing inflation by maintaining sound and prudent macroeconomic policies and managing the impact of external price shocks, which had boomerang effects on consumer prices in both oil exporting and importing countries. Despite the better policies, the price shocks resulted in SSA inflation going up slightly, returning to double digit levels at 10.8% in 2005, compared to 9.8% in 2004.

As a result of the higher commodity prices and aid flows, coupled with a weak US dollar, some African currencies appreciated significantly relative to a basket of currencies in real terms, bringing up renewed concerns about the potential negative impact on the

tradable sector (the Dutch Disease) in some of these countries (World Bank, 2006).

Chinese Influence

According to Zafar (2007) Sub-Saharan Africa's robust economic performance since 1999, has led to renewed Chinese interests in various spheres of investments, including the extractive sector. In 2006 trade between Africa and China totaled more than US\$50 billion with Chinese companies importing oil from Angola and Sudan, timber from Central Africa, copper from Zambia. Chinese investments have taken the form of investment in infrastructure, thereby bringing the much needed capital to Sub-Saharan Africa. The downside of Chinese investments is, however, often cited as the export of low cost textiles, which despite benefiting African consumers, nevertheless threaten to displace domestic production (World Bank, 2007). Others criticize China for posing a challenge to governance and macroeconomic management in Africa because of the potential Dutch Disease implications of commodity booms (Zafar, 2007).

Governance

Good governance has been at the epi-centre of macroeconomic policies in Sub-Saharan Africa since 1999. The IMF and World Bank now insist on good governance as a condition for balance of payments support. The nexus between governance and macroeconomic performance is well documented in the literature (Kaufman, 2002, Kraay and Mastruzzi, 2000, Naming and Schoeman, 2007).

Naming and Schoeman (2007) studied a panel of 28 African countries between 1990 and 2005 and found that countries with poor governance records allocated their budgets away from education, health and social welfare and tend to post poor economic

growth and investment outcomes. Moreover, Alesina (1999) argues that corrupt governments generally tend to receive less foreign aid. These views are supported by Collier and Gunning (1999).

Investment

According to Delechat and Kovanen (2008), after 1999 investors in SSA countries were attracted by the region's better macroeconomic performance and benefits of capital flows depended on better domestic institutions and stronger financial markets. Private capital inflows to Sub-Saharan Africa reached an estimated US\$50 billion in 2007. For the first time, private capital flows overtook aid flows in 2007. The rise in portfolio investment to the region has been impressive although about 90% of it went to South Africa while most of the remainder went to Ghana, Kenya, Tanzania, Uganda, Zambia, Mozambique and Angola in response to risk ratings and attractive yields (IMF, 2008). On the other hand Foreign Direct Investment (FDI) flows continued to go to resource rich countries led by Nigeria which in 2007 received 29.4% of FDI, Angola 5,2%, Chad 3.8%, Equatorial Guinea 9.1%, South Africa 18.2% and other Sub-Saharan African countries 34.2% (IMF, 2008).

The World Bank (2006) summarized the key developments in Sub-Saharan Africa and how they affected economic performance in 2006/7 as follows:

- The continuing strong economic performance of several countries in spite of the oil price shocks
- High commodity and export prices that ameliorated the impact of the higher oil prices in oil importing countries
- The increase in aid flows coupled with the announcement of significant debt relief, and

- Because of the high commodity prices and aid flows, the potential issue of the Dutch Disease (i.e exchange rate appreciation and its likely harmful consequences on the tradable sector).

The global financial crisis which started in the US sub-prime market (mortgage lending), and spread across Europe and Asia, is expected to trigger disinvestments in developing countries, including Sub-Saharan Africa. It is anticipated that the credit crunch will lead to the slowdown of private capital flows to SSA and this could harm SSA countries' growth prospects. The global financial crisis has reopened the debate on the efficacy and stability of free markets (Soros, 2008).

In summary, two major themes explain Africa's poor growth performance in the 1970s and 1980s – namely deteriorating terms of trade and poorly conceived macroeconomic policies. In the 1990s, early adjusting countries managed to control their deficit and inflation better than the so called late adjusters. However, beyond structural adjustment, in the 2000s, African countries began to register steady growth which spurred macroeconomic and fiscal balance. This so called renaissance was attributed to better macroeconomic policies, improved foreign direct investment and improved terms of trade. As a result, the deficit mode was slowed.

The following section (4.3) now looks in a little more detail, at specific country experiences regarding their handling of public finances and how this impacted on overall economic performance. The following section therefore looks at the fiscal stances pursued by selected African countries, beginning with Ghana.

4.3 Ghana

4.3.1 Introduction

In this case study, we are interested in the experiences of Ghana as the first African country to be independent from colonial administration. In the literature it is argued that in general, during colonial administration, budgets in developing countries remained in a surplus position because of the accumulation of huge foreign exchange reserves, favourable international commodity prices and robust economic growth rates which, nevertheless, was accompanied by a skewed income distribution pattern which excluded the majority of the people from the economic mainstream, making it possible to maintain public expenditures at much lower levels than revenues (Islam and Wetzel, 1991). But on the other hand, fiscal sustainability in colonial Africa was achieved more because of the absence of fiscal profligacy and state predatory policies and the curtailment of rent-seeking activities than the lack of socio-economic development programmes, per se. Therefore, in looking at Ghana, we are keen to see how a typical African government, the first to get black majority rule, managed its public sector and how this impacted on fiscal sustainability.

4.3.2 Political history

Ghana became the first African country to gain independence from Britain in 1957 under Dr Kwame Nkrumah (whose party was called Convention People's Party - CPP). Nkrumah ruled Ghana for close to a decade until he was deposed in a military coup in 1966 by Brigadier A. Afrifa (National Liberation Council) who ruled Ghana only for two years.

In 1969 an elected government led by K Busia (National Redemption Council) took office. However, in 1972, Busia was overthrown by I.K. Acheampong (Supreme Military Council), who

was later replaced by General Akuffo, also of the Military Council, in 1978.

In 1979, Flight-Lieutenant Jerry Rawlings staged an abortive coup. He and his supporters were rounded up and court marshaled. During the trial, Rawlings was so eloquent in articulating the cause of the army mutiny and given the publicity of his high profile trial, his junior officers were further incited to re-stage the coup in 1981, leading to the overthrow of Limann and his Provisional National Defence Council.

After taking over in 1981 through this successful coup, Rawlings introduced an IMF backed Economic Recovery Programme (ERP). He stepped down in 2000 and was replaced by the New National Party (NNP) of John Kufour.

This case study first briefly looks at the overall fiscal performance of the Ghanaian economy over this long and turbulent economic and political history. Thereafter, we again briefly focus specifically on the interaction of the budget deficit and macroeconomic variables such as inflation, exchange rate and trade deficit in post independent Ghana.

4.3.3 Government finances

Empirical studies of fiscal deficits in Ghana have revealed that Ghana's economic development program since independence in 1957 emphasized ambitious public investment and huge social expenditure as a panacea to economic growth (Islam and Wetzell, 1991). This development model, led to recurring fiscal deficits (Killick, 1982).

After independence, the Ghanaian state was characterized by bureaucracy. The government created national social security and national insurance schemes and established many state owned

enterprises, the biggest of which was the Cocoa Marketing Board. Apart from minerals and other agricultural products, Ghana relied heavily on cocoa for its foreign exchange earnings and trade revenues. Because of ambitious projects such as the Upper Volta Hydroelectric project and social expenditure, revenues failed to cope with expenditures and a funding gap occurred very early into Ghana's independence under Nkrumah. Under Nkrumah's administration, 65% of successive budgets went into recurrent expenditure (Killick, 1982). Several military regimes which ruled post Nkrumah Ghana were not only corrupt but lacked fiscal discipline. Huge public expenditure led to the deterioration of the fiscal position and the printing of money. For instance, General Acheampong's regime printed money to finance deficits and provoked external creditors (e.g. Britain) with his refusal to pay external debt obligations which the Ghanaian government owed. Poor fiscal management, compounded by the erosion of the resource base generated large budget deficits that fuelled inflation (Ghartey, 2000).

Studies by Islam and Wetzel (1991) examined the manner in which Ghana financed its deficits and how these affected the economy. They found that before the implementation of structural adjustment programs in 1983 under Jerry Rawlings, the preceding military governments that came after Kwame Nkrumah heavily relied on money creation for deficit financing due to the unavailability of external lending. This policy led to high inflation, negative real interest rates, an overvalued currency and the emergence of black markets. These factors further eroded the tax base and compounded the budget deficit.

Other studies (Gallup, Sachs and Mellinger, 1999) have argued that fiscal deficits in Ghana, however, had a negative effect on private consumption as public sector investment in completely

substituted private investment. However, the fiscal deficit actually had a significant negative effect on the external side as the official real exchange rate tended to appreciate, the trade balance worsened and the black market premium also increased.

By 1969, consolidated government expenditure was 19% of GDP and peaked to 26% of GDP in 1975/76. It dropped sharply thereafter to a minimum of 8% of GDP in 1983 due to improved cocoa export revenues. However from 1983 consolidated public sector expenditure rose and reached a plateau at about 14% of GDP before rising to 17% in 1987. It must be pointed out that like any other African country, Ghana received part of its revenue from taxes on international trade (in particular import and export duties).

Inflation averaged 24% per annum from 1988 to 1994 and accelerated sharply to 70% in 1995 (Nashashibi and Bazzani, 1998).

The percentage of total revenue and grants from indirect taxes averaged 66% over the period. Import duties and export taxes averaged 16% and 22% respectively while indirect taxes on goods and services averaged 27% of total revenue. In contrast, the percentage of total revenue and grants from indirect taxes and income and corporate taxes and PAYE averaged 21% (Chibber and Shafik, 1989).

With expenditure consistently more sizable than revenue over the two decades, the central government was constantly in deficit. The collapse of the economy in general meant that more and more people were moving away from the formal sector into the informal sector.

An overvalued Cedi (Ghanain currency) combined with the decline in cocoa production meant reduced exports and hence

reduced receipts due to lower import levels. The situation was compounded by the emergence of the black market in cocoa exports and other parallel market activities, which in general are not subject to taxation (Rimmer, 1989).

All these distortions had occurred during Nkrumah's later years in power and were exacerbated during the volatile periods of military rule from 1969, until Rawlings took over in 1983 and subsequently introduced the Economic Recovery Programme (ERP), which considerably improved central government finances and reduced the deficit. In 1986, the central government budget enjoyed a surplus for the first time in many years at about 0.5% of GDP. Thus, following the introduction of structural adjustment, the Ghanaian economy was dubbed "a star" economy in Africa South of the Sahara.

The balancing of the government budget was a key condition for IMF/World Bank support. Under Rawlings revenues increased from 5.6% of GDP to 13.6% of GDP in 1986. Massive sales of state enterprises such as Ashanti Gold Mines gave respite to the budget and yielded brief surpluses until 1992, when the budget deficit as a share of GDP rose to 5.2%. The improved revenue position was due to exchange rate and tax reforms. By adjusting the exchange rate from 2.75cedi/\$ in 1983 to 90cedi/\$ in 1986, this augmented the tax base of import and export duties by over 30 fold. Tax administration was improved and this increased the revenue flows.

However, typical of electoral politics, as the 1992 elections neared, fiscal discipline was thrown out of the window. The deficit moved from a surplus of 1.6% of GDP in 1991 to a deficit of 5% in 1992. Thereafter government expenditure rose rapidly surpassing Nkrumah's most lavish years (which was in 1965 at 25.8% of GDP)

in 1994. In 1996 VAT was introduced and there was massive rioting due to lack of proper public education.

The Rawlings government was forced to withdraw the VAT. However, it was reintroduced at a level of 10% in 1998 compared to the originally proposed rate of 17.5% in 1996. The introduction of VAT was done in order to raise revenue to meet the growing public expenditures. Government financed its deficit through central bank finance and the issuance of treasury bills, which were both highly inflationary.

Financing the Deficit

Prior to 1984, access to foreign borrowing was limited. External debt flows generally ranged between -0.74% and 1.62% of GDP and Ghana had to finance her deficits domestically. The principal financier was the Bank of Ghana. In the first years of the seventies, debt held by monetary authorities was relatively small. The debt increased to 3.25% of GDP in 1974 but over time government reliance on the central bank increased, as shown by the following deficit levels -

- 5% of GDP (1975)
- 8.23% of GDP (1976)
- 9.14% of GDP (1977)
- 9.37% of GDP (1978)

The deficit as a percentage of GDP dropped sharply to 0.13% in 1979, rose again to 3.2% in 1980 and 2.38% in 1981 before rising to 4.12% in 1983. In at least half the years considered, the financing provided by the central bank to the central government was greater than all other sources of domestic financing combined. Over the same period, parastatals also depended on the central bank for financing their quasi-fiscal operations.

The other notable source of finance for central government was the Social Security Fund, which was by law required to invest its surpluses in prescribed government assets (which in many years were considerable in government stock). Thus the Social Security Fund became a captive source of finance.

The reliance on borrowing from commercial and secondary banks was generally low at 2.02% of GDP and -0.59% respectively. Similarly, borrowing from the private sector and proceeds from the sale of public enterprises were not a significant source of finance for the Ghanaian government.

From 1994 onwards, the Ghanaian government borrowed from abroad. External borrowings increased from 4.8% of GDP in 1994. In addition to borrowing to augment tax revenues, government also began to run up arrears in payment of some of its bills internally. Government also received funds from the divestiture of parastatals. In 1995, proceeds from sale of parastatals amounted to 2.2% of GDP, rising to 5.2% of GDP in 1998. Economists argue that the divestiture helped in reducing the deficit, which would have grown to more than 10% of GDP without the proceeds from the disposal of parastatals (Green, 1996).

Despite these measures, government expenditure continued to surpass tax revenues. This placed the whole reform program in danger. Furthermore, domestic debt was compounded by external debt from increased external borrowing under Rawlings.

Table 8: Ghana: Debt Profile (1983 – 1995)

	Total Debt Stock (US\$m)	Debt Service/Exports (%)	Debt Service/Exports (%)	Total Debt/GNP (%)
1983	1.666	30.4	348.6	41.1
1984	1.963	21.6	318.6	45
1985	2.257	23.6	333.6	51
1986	2.767	28.3	343.6	49.4
1987	3.313	45.8	365.3	67.1
1988	3.128	56.6	324.2	61.8
1990	3.110	52.8	341.0	48.6
1995	2.788	48.9	342.1	61.9

Source: Global Development Finance (1999)

Debt rescheduling was done in 1987, 1991 and 1996. In 1999, Ghana qualified for the HIPC Initiative outlined at the Cologne summit in 1999 in terms of the major criteria of debt unsustainability.

With the Economic Recovery Program, access to external borrowing increased by 9.89% of GDP by 1987 when government substituted domestic borrowing with foreign borrowing. However, the damage had already been done. To the extent that borrowing from the central bank led to the increase in money supply growth that surpassed the increase in demand for money balances, such borrowing implied inflationary consequences. Financing the deficit by borrowing from the central bank inevitably pushed up money supply growth from 10% in 1990 to over 50% in 1992. Even an increase in the discount rate failed to stop increases in inflation and offset money supply growth and blunt the inflationary pressures.

The high inflation rates that Ghana experienced over the period thus implied negative real interest rates – both deposit and lending rates remained negative throughout the period. Financial repression compounded the situation. Negative real interest rates and taxes on financial intermediation reduced the return on assets

in the economy and thus reinforced any tendencies toward financial disintermediation (for example informal credit markets).

In addition to causing negative interest rates, the inflation that was engendered by money financing of the deficit led to the overvaluation of the official exchange rate, given the fixed nominal rate. This overvaluation affected Ghana's trade performance and increased the premium on Ghana's parallel market activity (defined as the black market exchange rate over the official exchange rate minus one). May (1985) estimated that parallel market activity reached 32.41% of the official market GDP in 1982. Furthermore, high inflation in Ghana adversely affected seignorage revenues in the sense that there was a Laffer curve effect where after a certain point an increase in the inflation rate caused reduction in seignorage revenues (Rimmer, 1989).

Islam and Wetzel (1991) assessed the overall interaction between the public sector deficit in Ghana and other underlying macro-economic and policy variables since independence in 1957 through the coup years up to the reforms introduced by Rawlings in 1983 and reached the following conclusions, namely that:

- For a long period in Ghana, inflation was found to contribute significantly to deficit movements. For example, the positive effect of the reduction in inflation reduced the deficit by 21.6% of GDP in 1984 whereas in 1983 the converse happened – inflation contributed to an increase in the deficit by 35.8% of GDP.
- Changes in real interest rate increased the deficit by 11.3% of GDP.
- The positive effect of GDP growth on tax bases contributed to the reduction in the deficit of 0.7% of GDP and the denominator effect (due to the fact that the deficit and every

budget item are expressed as ratios to GDP) reduced the budget deficit by 0.2% of GDP.

- Policy variables under the government's control were found generally not to have had as much impact on the deficit as the macro-economic variables had, except the large wage increase of 1985 which contributed to a 2.5% increase in the deficit. Other policy variables such as transfers and subsidies, government consumption and investment had little effect on the deficit.

4.3.4 Budget Deficits and Economic Mismanagement

In this section we now look at the relationship between the deficit and economic performance, especially whether the deficit had any effect on price stability, the exchange rate and trade position.

Budget Deficits and Inflation

The hallmark of Nkrumah's policies was a regime of expansionary fiscal policies in a bid to fund what he saw as the imperative of redistribution. Large government expenditures were pursued with the objective of promoting economic and social development. Riding on the success of cocoa exports, Nkrumah built schools, hospitals and dams (the most famous of which is the Upper Volta). The public service was expanded. Nkrumah created many loss making parastatals in the mid-1960s. Killick (1978) reports several measures of relative parastatal inefficiency, which included low productivity, low profitability and considerable overstaffing. The overly ambitious government expenditure program pushed the budget deficit to over 6% of GDP as a result of excess aggregate demand.

In contrast before independence, government expenditure budgets were set by the colonial governors, and strict financial

controls ensured that budgets were not overspent. The currency was the pound issued by the West African Currency Board, with a fixed exchange rate against the pound sterling. Nkrumah threw all these sound policies out of the fiscal window. By 1965, inflation under Nkrumah had reached 22%. By 1960, government expenditure as a share of GDP rose to 70%. In the early years budget deficits were financed by foreign borrowings, including the already mentioned draw down of foreign reserves. Later on the deficit was financed from domestic sources, initially by drawing on balances in the central bank, which were exhausted by 1961. Government thereafter issued bonds, thereby increasing its credit from the banking system to 12% of GDP (Killick, 1978)

When Nkrumah was deposed in a military coup by the National Liberation Council (NLC) in 1966, the NLC inherited budgetary and balance of payments problems which were not easy to reverse. Economic performance continued to decline. Revenue fell drastically and the budget deficit continued to run in excess of 5% of GDP up to 1969, when the deficit came down to 3.3% of GDP. Inflation dropped due to the reduction of the budget deficit, price controls and a bumper harvest.

In 1969, new elections were held and the Progress Party led by K.A. Busia won. Critics argue that Busia never went beyond his rhetoric to address fiscal indiscipline which had characterised the Nkrumah and NLC governments. Under the Progress Party, state owned enterprises continued to be a drain on the fiscus, especially the State Gold Mining Corporation and the Ghanaian Airways. With no substantial tightening of the fiscal belt, the excess demand pressure was not alleviated.

During the NRC rule, cocoa and gold exports performed well and this induced growth and economic stability, thereby stabilizing

inflation. In fact Ghanaians enjoyed a higher real per capita GDP in 1974 under the NRC government than they had ever experienced. But this was more to do with improved revenue streams than fiscal discipline.

The NRC revalued the cedi and returned to price controls. The NRC believed an economy could be run the same way as the military – by command rather than by incentives. Budgetary limits on government expenditures were often ignored. The budget deficit reached a record 11% of GDP during the NRC administration in 1976. The deficit was financed largely from domestic sources and not by international borrowing. This pushed money supply upwards and caused inflation to rise to over 100% in 1977.

Inflation, which was caused by the government deficit, contributed to the deterioration of government's own revenue base. In 1978, revenue amounted to a meager 7% of GDP. Roads, schools, communications and health facilities ceased to function in most parts of Ghana. General Akkuffo forced Achiempong to step down and he devalued the cedi but failed to stop rent seeking activities such that by 1979, the Ghanaian state had become dysfunctional.

When Rawlings took over after a failed coup first in 1979 and later a successful military coup in 1981, under the Armed Forces Revolutionary Council (AFRC), he launched an anti-inflation and anti-corruption drive that left a permanent imprint on the minds of all Ghanaians. Goods and property allegedly acquired by corrupt means were seized and alleged speculators or hoarders were beaten or shot. The anti-corruption campaign led to the execution of former army leaders, including Achiempong and Akuffo. It is said that the Rawlings regime went as far as burning the central Accra market in a bid to attack the symptoms of the high prices of essential

commodities, without of course tackling the huge government expenditure which was the source of the problem.

Before his second coup, Rawlings briefly surrendered power to an elected civilian government under Limann in September 1979. The Limann government failed to meet macroeconomic expectations. Inflation accelerated. At the heart of inflation was government's unwillingness to address excess demand in the economy. Government revenue dropped to 5% of GDP in 1981. CPI inflation which had dropped to 50% jumped to 120% again in 1981. This ineptitude by Limman to deal with the problems of excess demand, licensing control, state enterprises and price controls invited another coup from Rawlings in December 1981 when he installed his Provisional National Defense Council.

In 1983, Rawlings launched economic reforms with the support of the IMF and World Bank, having failed to eradicate corruption by force. The objective of reforms was to free up markets and eliminate the government budget deficit. In 1983, government expenditure at 11% of GDP was unsustainable. The state was no longer able to perform the most elementary functions and public sector wages lagged behind inflation. Many state-owned enterprises were shadows of their former selves and often financially bankrupt. Cocoa and mineral prices had also fallen. We now want to see whether these reforms had any impact on the budget deficit and inflation.

A key condition imposed by the IMF was the balancing of the government budget. During the Rawlings regime, GDP growth accelerated from 5.6% of GDP to 13.6% in 1986. This growth in GDP gave the government a room to maneuver. The Rawlings government further expanded government expenditure to over 13% of GDP. A combination of exchange rate reform and tax reforms

helped to improve revenues. By 1991, government deficit had been reduced to 1.6% of GDP suggesting that strict fiscal discipline had been followed. However, the following year (1992) elections were coming and Rawlings loosened fiscal policy, leading to a deficit of 5% of GDP. Thereafter government expenditures rose to 25.8% of GDP, even surpassing Nkrumah's most lavish year – 1965.

The choice for financing the deficit was a combination of printing money (borrowing from the central bank), borrowing from the public, borrowing from abroad and selling off parastatals. Financing the deficit from borrowing at the central bank pushed up money supply growth from 10% in 1990 to over 50% in 1992 and the current account deficit stood at 9.9% in 1993. The anticipation of another election in 1996 pushed up expenditure and net lending to one third of GDP. Rawlings tried to replace sales tax with VAT in 1995 in order to augment revenue but this did not help arrest declining revenues. VAT was withdrawn two months later after riots erupted.

Using Granger causality, impulse response functions, vector decompositions and sensitivity analysis, Ghartey (2000) concluded that in Ghana, deficits as a share of GDP were inflationary because they were financed by base money through money printing. Inflation was monetized, self sustaining and retarded economic growth (Ghartey, 2000). This evidence was corroborated by Ramsey (2005).

Budget Deficits and Trade Deficits

The exchange rate of Ghana's currency – the new cedi, which was created in 1967 – was fixed until April 1983. Several devaluations were done in the intervening 16 years to adjust the value of the new cedi relative to the US dollar or to gold. The fixed exchange rate system together with foreign currency rationing and

strict capital controls led to the development of a large black market in foreign exchange.

The parallel market exchange rate, which represents the marginal cost of foreign exchange, depreciated from 8.86 cedes to the dollar in 1978 to 76.56 cedes /dollar by 1983 while the official rate remained at 2.75 cedes/dollar. During the late 1970s and the early 1980s printing money financed Ghana's fiscal deficits. This led to higher inflation rates with Ghana suffering triple digit inflation in 1977, 1981, and 1983. There were two currency reforms, one in 1979 and another in 1982 in an attempt to deal with the effects of high inflation on currency values. The increase in government spending led to an increase in total domestic spending and worsened the trade balance.

High public sector expenditure contributed to Ghana's external sector problems and if Ghana had pursued more moderate fiscal and monetary policies, the economy might have done better and there could have been fewer black market activities.

Budget Deficits and Exchange Rates

This section looks at the impact of excess demand on the exchange rate.

Following independence in 1957, the Bank of Ghana was established as the central bank. Monetary policy became independent as the central bank began to issue currency and took over foreign exchange reserves from the West African Currency Board. However, Ghana still remained part of the sterling area which enabled free movements of imports and exports as well as capital inflows within the sterling area. Changes in the foreign assets were mirrored by changes in the domestic money stock. This situation changed in 1961 when monetary policy became

independent of the sterling area. Import licensing was introduced and foreign exchange reserves declined. The decline in foreign exchange reserves was triggered by government's lack of fiscal discipline (excess demand) as shown by Nkrumah's government failing to live within its means. The Volta dam cost 60% of Ghana's export earnings (Killick, 1978).

As pointed out above, from 1957 to 1960, excess demand was met from drawing down of foreign exchange reserves. With the tightening of the exchange controls and import licensing in 1961, inflation accelerated, while the exchange rate remained fixed. This implied a real appreciation of the currency. Exports fell sharply.

According to Killick (1978) the exchange rate cum import licensing policy contributed to the fiscal deterioration which in turn caused further real exchange rate depreciation – a chicken and egg situation. At the end of Nkrumah's rule, cocoa revenues dwindled, the budget deficit bloomed and the exchange rate became further overvalued and remained fixed. Exports dropped from 30% of GDP at independence to under 18% by 1965.

It can therefore be concluded that under Nkrumah, excess demand invariably affected the exchange rates through the run down of foreign exchange reserves, the introduction of import licences and the fixed exchange rate which appreciated the currency and led to the fall in exports.

When the National Liberation Council (NLC) ousted Nkrumah in 1966, the most pressing economic problem was the deteriorating balance of payments position. In spite of the use of import licensing and exchange controls, foreign exchange reserves were dwindling rapidly. All this had arisen from excess demand due to the previous regime's loose monetary and fiscal policies. By the end of 1966, net foreign assets in the monetary system were negative. The NLC tried

to reduce government expenditure in its first five years by slashing the capital budgets. By rescheduling short term debt the NLC government managed to ease balance of payments pressures (Islam and Wetzel, 1991)

In July 1967, the NLC government devalued the currency. A further devaluation was done under Busia in 1971 (Leith, 1974). In 1972, Ghana experienced another military coup. A new government under Colonel Achiempong took over and the National Redemption Council formed the government – a military junta (Huq, 1989)

When Rawlings took over, the budget deficit was 11% of GDP and the exchange rate was fixed. Export earnings had fallen to a puny 5% of GDP. Revenue from exports fell because duty was charged at the official rate when the parallel market rate had increased. Reforms introduced by Rawlings were meant to bring the exchange rate to its scarcity value in an environment of huge budget deficits and public spending. An imaginative scheme of export bonuses which was financed by import surcharges was introduced. This raised the official exchange rate from 2,75cedi/\$ which Akuffo had set to 25cedi/\$ roughly offsetting the cumulative inflation from 1978 through 1983 without creating a budgetary drain on government. In 1984, further devaluations were done taking the exchange rate to 50cedi/\$ then 90cedi/\$ in 1986 (May, 2002)

By the time Rawlings put himself forward as a candidate for the 1992 presidential elections, the parallel market had been eliminated by the opening of foreign exchange bureaus which bought forex at black market rates on a “no questions asked” basis. Thereafter a market determined exchange rate became widely accepted in Ghana. However, by 1992, the expanding government deficit and rising inflation spilled over into expectations

of rapid depreciation of the cedi in the foreign exchange market (Bank of Ghana, 1993).

Deficit and economic performance since 2000

Since 2000, Ghana's economic performance has improved and GDP grew at its fastest pace since more than a decade. In 2004, GDP grew by 5.8% on the back of a good agricultural season, and record cocoa production. The overall budget deficit narrowed to 3.6% of GDP in 2004. Revenue and grants performed well due to an increase in grants, new tax measures, and a strong growth imperative. As a result of good fiscal performance as shown by the domestic debt to GDP ratio, inflation declined by half to 11.8% by the end of 2004. The central bank's inflation target was 6% (IMF, 2005).

The external sector also improved significantly to a position where gross international reserves were built-up to US\$1.8billion, which was equivalent to 3.7 months of imports. Under Kuffor, a new managed exchange rate float was introduced (IMF, 2005).

Table 9: Ghana: Deficit since 2000

	2001	2002	2003	2004	2005	2006
Budget Deficit (% of GDP)	4.8	2.4	2.3	0.7	2.6	3.1
Real Effective Exchange Rate (cedi:USD)	0.6	-0.6	1.4	-1.0	0.8	1.4
Inflation (annual %)	32.9	14.8	26.7	12.6	14.3	15.0
Trade Balance (% of GDP)	-5.3	0.5	1.7	-2.7	-4.0	0.9

Source: IMF, 2007

The above table shows the progress made by Ghanaian authorities towards deficit reduction since 2000, apparently with the assistance of the IMF Technical Teams.

One of the key benchmarks emphasized by the IMF in their Article IV consultations is the question of fiscal consolidation. In 2000 Ghana suffered from a combination of terms of trade shocks arising from the fall in cocoa prices and high oil prices. Weak macroeconomic policies and poor management of state enterprises worsened the budgetary position. This led to a trade deficit of US\$900 million or 16% of GDP. Presidential and parliamentary elections also pushed up government spending. As a result the average inflation rate doubled and the nominal exchange rate depreciated by 50% as a result of lack of fiscal consolidation (IMF, 2002).

The budget deficit was financed from domestic sources resulting in annual broad money supply accelerating to 40% at end of 2000 up from 16% the previous year. Money supply growth was also a direct effect of the growth in credit to the private sector, public enterprises and government itself (IMF, 2002).

John Kufor's new government vowed to break the culture of budget deficits. The government set a deficit target of 4% of GDP and a domestic financing limit to the tune of 1.8% of GDP as well as seeking debt relief to meet fiscal and balance of payments gaps. Other measures implemented to cut the budget deficit included – introducing new taxes on petroleum products, levies on company profits, reduction in import tariff exemptions, cuts in domestically financed capital expenditure and a freeze on government consumption (outlays on goods and services).

The net present value of Ghana's external debt by end of 2000 was 557% of fiscal revenues and 154% of exports, compared with the estimated sustainable thresholds of 250% and 150% respectively. It is against this backdrop that Ghana applied and qualified for the HIPC Initiative.

In making its overall assessment, the Executive Board of the IMF (2000) pointed out that inappropriate management of public finances had compounded Ghana's poor economic performance, despite the external shocks. Weak fiscal and monetary policies at end of 2000, prior to elections, had led to a rise in inflation, a substantial depreciation in the exchange rate, a decline in foreign exchange reserves, and a significant rise in domestic and foreign debt as a share of GDP (IMF, 2002).

The IMF went on to recommend that parastatals operate on full cost recovery basis, and privatization, including petroleum, water and electricity tariff reviews. The IMF Directors urged restraint in public sector wages in order to strengthen the budget and reduce inflation. The IMF urged the new government to press ahead with its anti-corruption campaign in order to assist in fiscal recovery.

Table 10: Ghana: Selected Economic and Financial Indicators % (1996 – 2008)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Budget Balance (% of GDP)	-9.6	-11	-8.7	-8.0	-9.7	-9.6	-5.0	-4.4	-3.6	-3.0	-4.6	-4.4	-4.5
Current Account (% of GDP)	-3.1	-14	-5.0	11.5	-9.2	-6.5	1.0	1.7	-2.7	-7.0	-4.8	-3.7	-4.2
Real Effective Exchange Rate (Cedi to USD)	9.0	6.1	8.2	0.5	33	-9.6	1.9	2.4	-0.5	19.9	1.4	4.5	8.7
Inflation (%chg,pa avg)	32.7	20.8	15.8	13.8	40.5	25.0	24.8	23.6	11.8	14.8	10.9	9.8	10.5

Source: Ghana – IMF Article Consultations (various issues); EIU, 2009

On 18 May 2007, the Executive Board of the International Monetary Fund (IMF) concluded Article IV consultations in Ghana and found that due to sustained fiscal adjustment, inflation had fallen to 10.5% by end of 2006. In 2007, the fiscal deficit increased to 7.7% of GDP due to strong public sector wage pressures and a

nominal effective depreciation of the currency. In 2007, the government also came up with a supplementary budget due to revenue shortfalls caused by wages (in the health sector), subsidies and transfers to state owned enterprises in the energy sector. The Ghanaian government planned to introduce a fiscal responsibility law to curb expenditure in 2007.

In 2008, after years of austerity which saw inflation kept within lower limits and an average deficit of between 3.6% of GDP and 4.5% of GDP, there were fears that Ghana might turn back to overspending considering the December 2008, Presidential and Parliamentary elections. In many developing countries, election campaigns are characterized by populist measures such as inflationary wage increases and the loosening of fiscal policy in order to ingratiate voters. Nevertheless, the discovery of oil promises to bring new fortunes to this country provided that Ghana can avoid the "oil curse" and continue on its reform path, whose key planks have been macroeconomic and fiscal adjustment as well as poverty reduction (IMF, 2008).

4.3.5 Conclusion

In concluding the study on public sector financing in Ghana, we draw lessons from Islam and Wetzel (1991) and IMF (2008) and thus summarize as follows-

- Lack of access to external lending and weak domestic financial markets meant that the bulk of the public sector deficit in Ghana, after independence, was financed by money creation. Access to external lending allowed the government to substitute foreign financing for money creation after 1984, but money creation did not fall as much as one would have expected. In the mid seventies, the correlation between money creation and inflation was found to be high, suggesting

that fiscal deficits contributed to the high levels of inflation at the time.

- Inflation had a significant, negative influence on the demand for money and the demand for deposits. The domestic interest rate was not found to have any significant effect on either the demand for money or deposits. Perhaps this was due to the nature of Ghana's highly regulated financial markets.
- High rates of inflation in the late 1990s provided the Ghanaian government with seignorage revenues of only 1-2% of GDP greater than it would have received with a lower inflation rate of 20%.
- Private investment was negatively affected by public investment, thus indicating that some crowding out did occur in Ghana. The real interest rate was not found to have a significant influence on private investment.
- Public expenditure had a significant impact on the official real exchange rate, the trade balance and the black market premium. Increased public expenditure was found to have a negative effect on the trade balance. It was also found to have a negative effect on the official exchange rate (higher public expenditures tended to appreciate the real exchange rate). A rising public sector deficit along with stringent restrictions on foreign exchange transactions led to a very high black market premium.
- Excess aggregate demand interacted with a fixed exchange rate to create excess demand for foreign exchange. When the reserves got depleted, exchange control led to currency overvaluation, shrinking exports, declining imports, and falling government revenues.
- In recent years (2006 – 2008), with the assistance of the IMF, Ghana managed to reduce inflation and lower fiscal deficits and pursued tight monetary and fiscal policies. These policies

were pursued by President Rawlings and President John Kufour (2000-2008). However, the discovery of oil deposits may spur new aggregate demand which may increase the deficit hence the dangers posed by the “oil curse”.

- In the 2008 elections, President John Kufour lost to the opposition. It is too early to tell what the fiscal stance of the new Government will be. However, it is instructive to see that fiscal deficits were at the centre of macro-economic instability in Ghana since the days of Nkrumah. Moreover, political instability contributed to the deterioration in economic performance in Ghana as governments were changed so frequently until the late ascendancy of Jerry Rawlings in 1983.

4.4 Morocco

4.4.1 Introduction

Morocco, like other African countries, enjoyed an economic boom owing to phosphate revenues during the 1970s. Morocco maintained high interest rates and kept inflation subdued at single digit levels. Fiscal and macroeconomic stability was pursued although challenges still remained in areas like tax reform, public spending, information systems and financial liberalization.

However, as in Zambia, the tragedy was the failure to build up reserves that would act as deficit buffers when commodity prices fell. The phosphate boom of the 1970s triggered the rise in government spending and saw an unprecedented expansion of public investment. Faini (1991) noted that the sudden reversal of terms of trade in the 1970s emanating from a plunge in phosphate prices, prompted Morocco to borrow from external capital markets to maintain an unabated level of spending. This phenomenon is what development economists call “the resource curse” (Collier, 2008)

4.4.2 Fiscal Expenditure

The origins of the fiscal deficit in Morocco can be traced to the commodity (phosphate) boom of the mid 1970s, which coincided with rising government expenditure and an unprecedented expansion of public investment programs. The sudden reversal in the terms of trade in the late 1970s as a result of the plunge in phosphate prices and the second oil shock prompted Morocco to increasingly resort to external capital markets in order to maintain an unabated level of public expenditure.

In 1983, Morocco was plunged into a foreign exchange crisis as a result of worsening terms of trade, the rise in international interest rates and the severe drought from 1980-1983.

In response to this crisis, Morocco launched a medium term program of economic reforms at the behest of the IMF and World Bank. A comprehensive set of stabilization and structural adjustment measures were thus introduced. Since then, the overall budget and current account deficits were reduced from 9% and 12% of GDP in 1982 to 4.5% and 0.4% respectively in 1988 (Melo, 1990).

Furthermore, structural adjustment led to the reduction of inflation, which declined from 12.5% in 1984 to 2.3% in 1988 while GDP growth averaged 4.3%. Analysts have expressed surprise at the decline of inflation even against the backdrop of a 20% real depreciation during the eighties. However, studies have concluded that wage moderation and judicious monetary policies were instrumental in restraining inflation as monetary authorities remained firmly committed to eschew any inflationary financing of the budget deficit (Schmidt-Hebbel and Muller, 1990).

Budget Deficits

In the seventies, the budgetary situation in Morocco registered a continuous deterioration as the financial needs of the Treasury bludgeoned. In the early eighties, the fiscal repercussions of the fall in Morocco's terms of trade, the increasing burden of foreign debt attendant on the steep rise of international interest rates and the growing weariness of foreign commercial banks to provide continuing financing to the Treasury brought to the forefront the issue of fiscal sustainability.

The budget deficit averaged 3.2% in 1971-1974 and rose to 13% in 1976-1981 before declining to 8% in 1984-85. The budget deficit was measured on a cash basis. But according to Faini (1991), cash based measures of the deficit can be misleading. Faini argues that Treasury may resort to the use of financial arrears to cope with mounting financial difficulties. This is what happened in Morocco until 1982 when the government embarked on structural adjustment. A further correction in regard to interest payments is important in the correct measure of the deficit. In Morocco, interest payments steadily increased as a share of GDP, thereby compounding budget difficulties.

The table below shows the trend in central government expenditure between 1971 and 2005.

Table 11: Morocco: Central government expenditure as percentage of GDP (1971-2005)

Year	Current Expenditure	Capital Expenditure	Goods & Services	Interest	Subsidies
1971	14.12	3.72	12.51	1.01	0.60
1974	19.25	5.77	12.20	0.85	6.21
1977	18.58	18.93	14.44	1.50	2.63
1979	19.46	12.89	15.05	2.19	2.21
1981	24.60	12.33	15.42	3.88	5.30
1983	23.72	9.64	15.05	4.86	3.81
1984	24.00	8.09	13.63	6.08	4.29
1985	23.09	7.18	12.63	6.23	4.23
1986	20.62	3.61	12.20	5.92	2.50
1987	20.36	6.03	12.64	5.91	1.81
1988	20.31	6.34	12.17	6.01	2.13
1990	16.25	11.28	12.11	6.11	2.10
1995	22.49	13.10	12.80	4.99	1.81
2000	25.00	15.68	15.66	5.69	4.54
2005	31.26	7.90	18.22	6.75	6.23

Source: World Bank (various issues)

In the above table, expenditure on goods and services fell somewhat, reflecting mostly the drop in public employees real wages and the more sober trend in public employment. The share of subsidies in GDP also fell substantially, mainly because the decline in imported food prices reduced the need for government intervention. This is incidentally a good example of the direct impact of terms of trade fluctuations on the budget.

With the introduction of structural adjustment, public investment fell from 11.54% of GDP to 3.61% in 1987 and 1988. This reduction precipitated massive retrenchments of the civil service. The share of subsidies in GDP fell substantially, mainly because the decline in imported food prices reduced the need for

government intervention. The petroleum levy and VAT introduced in 1986 provided a revenue windfall as well as foreign exchange earnings from the export of phosphates (the main foreign exchange earner).

Deficit Financing

Regarding the financing, prior to 1983, foreign borrowing financed nearly 60% of the Treasury deficit. The availability of foreign finance came to an abrupt halt in 1983, precipitating a major payment crisis. The government was forced to rely to an unprecedented extent on Central Bank borrowing. At the same time government resorted to the accumulation of arrears as a source of involuntary finance from the private sector. This meant the delaying of payments for goods and services procured due to cash flow problems). In 1984, government started tapping non-financial sources of domestic financing. In the case of Morocco, the deficit was in the form of the primary deficit.

The Primary Deficit

The primary deficit was equal to 7.2% of GDP in 1983 and steadily declined to reach a surplus of 1.9% of GDP in 1988. The decline in the deficit was also facilitated by low and even negative real interest rates on domestic debt. This improvement was less significant due to the increased burden of nominal and real interest payments.

Furthermore, improvements in tax revenues especially after the introduction of VAT in 1986 helped to stabilize the Moroccan budget. The process of trade reform also positively affected government revenues as a special import tariff was increased from 5% to 12.5% in 1987. However, as already highlighted, terms of trade fluctuations negatively affected trade revenues as the

phosphate prices tumbled leading to a fall in tax and dividend payments to central government

Implications

The effect of the deficit on macroeconomic conditions largely depends on the method of its financing. Prior to 1983, foreign borrowing financed 60% of the treasury budget. However, the availability of foreign finances came to an end in 1983, thereby precipitating a payment crisis. The government was forced to rely on an unprecedented basis on borrowings from the central bank. In order to eschew inflation, central government shifted to non-inflationary sources of finance in 1984, including the direct sale of bonds and treasury bills to the private sector. Financial repression also helped to channel low cost finance to the Treasury.

4.4.3 Budget Deficits and Economic Performance

Despite the budget deficit rising (9% of GDP in 1982, 4.5% in 1988) as a result of international interest rates and terms of trade shocks as discussed above, it is interesting to note that historically, Morocco has had low inflation rates (e.g 6.2% in 1983). In achieving this, the Moroccan government was clever enough to concentrate on borrowing from the non banking sector in order to avoid inflationary implications.

The government also reduced its borrowing requirements by resorting to the accumulation of arrears as a source of involuntary finance from the private sector. Thus the Moroccan government successfully avoided the monetization of the deficit by tapping non-inflationary sources of domestic finance. Furthermore, government encouraged voluntary domestic lending by liberalizing domestic interest rates which helped shift private sector portfolios from currency to time deposits. At the same time, the ceiling introduced on credit allowed commercial banks to channel their financial

resources to the treasury again, thereby creating a dependable source of finance for government. Another non-inflationary strategy was the direct sales of Treasury bills and bonds to the non-bank sector. All these measures managed to eschew inflationary pressures.

In a sense, financial repression assisted the Moroccan government to access cheap funds from the bank (to a lesser extent) and non-banking sectors to finance its debt without risking inflationary shocks.

The other reason why inflation was subdued in Morocco during its structural adjustment period was that growth remained buoyant, Hence the notion that large deficits will foster inflation is at least contradicted in the Moroccan study. Even with a real depreciation of 20% in the 1980s, inflation still remained low. Scholars like Faini (1991) argued that in addition to the other measures discussed above, wage moderation and judicious monetary policy were instrumental in restraining inflation. Despite high deficits, Morocco is one country which managed to maintain macroeconomic and fiscal stability

In the 1990s and in recent years, the Moroccan economy has remained stable, with inflation and the budget deficit confined to single digit figures.

Budget Deficits and Exchange Rates

There is little evidence to suggest that the budget deficit affected the exchange rate or vice versa because, as already pointed out, Morocco did not run down its foreign exchange reserves because it was able to access international capital markets for assistance. Moreover, the exchange rate remained very competitive against other major currencies and a 20% devaluation

in 1983 helped to promote exports, and improve trade taxes. The rebound in the prices of phosphates in the 1990s and thereafter helped a great deal to keep the exchange rate strong and stable. Therefore, the budget deficit and its interaction with the exchange rate was inconsequential.

Budget Deficits and Trade Deficits

Morocco is one good example of a success story of fiscal management. Despite, the initially high budget deficits caused by the adverse impact of international prices and interest rates on borrowing, which tended to erode the revenue base, this was however, not a long lasting phenomenon and the trade surplus was restored in a short space of time. Since 1983, the government made great strides to maintain internal and external equilibria. The current account deficit was reduced from 12% of GDP in 1982 to 0.4% in 1988 and to a surplus position after 2000.

The comprehensive set of stabilization and structural adjustment measures introduced in collaboration with the IMF and World Bank since 1983 helped to mitigate the impact of deficits on the tradable sector.

Fiscal Consolidation

Morocco is still implementing IMF/World Bank backed economic reforms. As such every year the IMF sends its delegation of technical staff to Rabat, to do program assessment and monitoring and to give technical advice. In order to get an understanding of the most recent budgetary performance and fiscal policy in Morocco, we look at findings of IMF country teams since 2001.

In 2001, the Executive Board of the IMF concluded the Article IV consultation with Morocco. The Report (IMF, 2003) observed that

due to two successive years of drought, Morocco had continued to experience economic stagnation with GDP contracting 0.3% in 2000 after a negative growth rate of -0.7% in 1999. Inflation however, remained subdued at 2%. External reserves amounted to US\$4.8 billion and were expected to reach US\$6 billion, which is equivalent to 5.5 months import cover. The current account deficit widened to 1.5% of GDP in 2000, up from 0.5% in 1999 due to the increase in imports.

The fiscal deficit that stood at 3.4 % of GDP in 1996, 3.4% (1997), 2.5% (1998), 2.5% (1999) rose to 4.3% of GDP in 2000, due to excess demand, which was compounded by loose monetary policies as evidenced by the growth in broad money supply from 4.8% in 1996, to 9.0 % (1997), 10.3% (1999) and 8.4% in 2000. Tax revenues were blunted by a high wage bill, price subsidies for petroleum products and failure to realize proceeds from the privatization of Maroc Telecom in good time.

Table 12: Selected economic and financial indicators (1999 – 2007)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Real GDP %	-0.1	1.0	6.3	3.2	5.5	3.0	2.4	8.0	2.5
Inflation %	0.7	1.9	0.6	2.8	1.2	2.0	1.0	3.3	2.5
Current Account Balance	1.6	-0.4	3.8	0.6	1.8	1.3	2.4	3.4	1.8
Budget Balance	-4.5	-6.4	-5.8	-4.7	-5.5	-5.4	1.6	1.1	1.1
Exchange Rate: dirham/US\$	9.80	10.63	11.30	11.02	9.54	9.54	9.6	7.5	8.8
Budget Balance (plus privatization receipts)	-1.3	-6.4	0.3	-4.5	-2.7	-2.7	1.0	-2.0	0.4
Gross Official Reserves (US\$b)	5.7	4.8	8.4	10.1	13.6	15.2	16.08	19.97	23.61
Total Government Debt (%of GDP)	81.3	81.5	74.8	71.5	68.2	67.6	66.9	70.1	65.4
Domestic Gvt Debt (% of GDP)	45.6	47.3	45.9	48.2	49.7	51.4	63.7	58.2	58
Total external Debt (% of GDP)	56.1	53.9	46.9	43.7	36.2	31.7	25.4	23.3	22

Source: Bank Al-Maghrib (BAM): 2005

Because of fiscal discipline, between 2000 and 2007, Morocco has managed to avoid the inflationary financing of the deficit by

resorting to other non-inflationary instruments. As a result, the macroeconomic fundamentals remained stable.

The 2004 Article IV Consultation (IMF, 2005) concluded that Morocco had managed to maintain macro-economic stability, with inflation remaining low and the exchange rate stable. The external current account had moved into a surplus position since 2001, and external reserves had increased. Fiscal performance however had deteriorated badly due to the decline in revenues and the pressures emanating from the public sector wage bill. Security related expenditures increased after the Cassablanca bombings in May 2003. Total government debt increased dramatically thereby adversely impacting on other macroeconomic indicators.

According to the IMF (2007), fiscal policy remained geared toward medium-term fiscal consolidation. The progress achieved in this area during the last few years strengthened Morocco's economic performance. In the medium term, continued improvement of the public finances position opened up fiscal space, private sector confidence, and helped consolidate growth. In the short term, continued fiscal discipline, particularly for the wage bill, helped contain demand pressures

In their concluding statement of the 2007 Article IV Consultations in Morocco, the Executive Board concluded that the external position had further strengthened, the fiscal position had also improved as a result of improved tax performance and fiscal consolidation, especially the civil service reforms which reduced the wage bill, the proceeds from privatization and improvement in import revenues. The public debt went on a declining trend. Fiscal prudence helped to contain inflation to levels within the targeted range. Improvement in fiscal adjustment led to low inflation,

surplus current account position and a stable exchange rate, which are the critical pillars for macro-economic stability (IMF, 2008).

4.4.4 Conclusion

The key lesson from the Moroccan study is that not all deficits are inflationary. The Moroccan deficit proved sustainable due to its moderate size and the methods of its financing. Deficits are good and bad depending on their financing and their causes. Deficits arising from recurrent expenditure are normally problematic compared to deficits on capital projects which have a bearing on economic growth. All that the Moroccan story tells is that a moderate deficit, financed appropriately, is not necessarily a problem. We also see that political stability and good governance helped the situation in Morocco. Morocco is therefore a typical case of how to manage the deficit under capable leadership.

In the below section, we proceed to look at the macroeconomic effects of public sector financing in Zambia. The objective is to ascertain whether or not deficits impacted negatively on macroeconomic performance in Zambia. Of particular concern is the extent to which the development of the public sector, and nationalization affected fiscal balances. We also look at the post Kaunda policies and see whether they were sustainable, fiscally.

4.5 Zambia

4.5.1 Introduction

Zambia's economic history since independence can be divided into three periods, namely: (1) the period from 1964 to 1975 when high copper prices spurred economic expansion, nationalization of the economy and public expenditure growth; (2) 1975-1990 when copper prices began to fall, triggering macro-economic decline which was accompanied by poor fiscal performance and structural difficulties and lukewarm economic reforms; and (3) 1991 and

beyond when under President Chiluba radical structural and macroeconomic reforms were undertaken but without adequate attention to fiscal prudence and debt management (Kumbula, 2003).

4.5.2 Fiscal Expenditure

Zambia got its independence from Britain on 24 October 1964 under the leadership of Kenneth Kaunda. In the early years of independence, the Zambian economy prospered on the back of good copper prices and strong agricultural production. Prospects for economic robustness were high. Government increased its expenditure on infrastructural projects, education, health and social amenities. The economy registered impressive growth rates. Kaunda nationalized all foreign owned companies through the Mulungushi Economic Reforms of 1968 where government declared its intention to acquire equity holdings (51% or more) in a number of key foreign owned firms.

The first casualty of these predatory policies was Anglo-American Corporation whose assets were appropriated. Other foreign assets mainly in the mining sector were also seized. The Zambian Consolidated Copper Mines was formed at the peak of nationalization in Zambia (Saasa, 1996).

Ambitious economic and national development plans were put in place along the Soviet Union Model. Kaunda's high budgetary expenditures were short-lived. These had been propelled by copper revenues. By then Zambia was the world's fourth largest producer of copper. In 1973, a massive increase in oil prices was followed by a slump in the prices of copper resulting in a diminution of export earnings. In 1973, copper had accounted for 93% of all export earnings. This was reduced to half in 1975 due to the collapse of international prices of copper. By 1976, Zambia was in serious

balance-of-payments crisis leading to the abandonment of the third National Development Plan (1978-83). Inflation started to increase on the back of an overvalued exchange rate and excess liquidity of the copper booms. The budget deficit worsened and Kaunda resorted to external borrowing to bridge the gap created by the fall in copper revenues (Saasa, 1996).

Faced with this situation, especially high indebtedness, Kaunda turned to the IMF. The IMF recommended structural adjustment to reduce overdependence on copper. The proposed measures included: ending of price controls, devaluation of the kwacha, cut-backs in government expenditure, and cancellation of subsidies on food and fertilizer. Kaunda incurred the wrath of Zambians when he removed food subsidies. Public riots erupted after prices of basic foodstuffs increased following the removal of these subsidies.

Kaunda broke off the relationship with the IMF in May 1987 in a huff and introduced a homegrown version of economic reforms which he called the New Economic Recovery Program in 1988. But without external balance of payments support, this did not work. Macroeconomic instability worsened and Zambia rejoined the IMF in 1989. After the collapse of the Soviet Union and Eastern Europe in 1990, Kaunda was forced to make a major policy volte face by partially privatizing parastatals. At the same time Glasnost and Perestroika were being introduced in Russia in the last days of communism by Michael Gorbachev (Graham, 1992).

Kaunda had no choice except to introduce reforms since his philosophy of humanism was another way of African socialism based on the Soviet Union – he was left with no option except to introduce glasnost and perestroika in his own country. In 1991, Kaunda called

multi-party elections and lost to Chiluba's Movement for Multi-Party Democracy (MMD).

The analysis of the economic policy under Kaunda reveals a pattern of how public finances were mishandled during periods of economic boom. Public expenditure programs mainly of a recurrent nature were pursued without due regard to budgetary discipline. Import substitution meant that the country was insulated from competition and industries became inefficient. The kwacha remained fixed and overvalued, thereby making exports uncompetitive. High budgetary overruns precipitated successive budget deficits whose financing through first domestic financing caused inflationary pressures and second through external borrowing led to indebtedness and the now famous Zambian debt crisis. No wonder that in 1988, the IMF identified the need to diversify economic activities away from copper so as to create budgetary sustainability in the medium to long-term. This illustrates how the budget is such a central tool of economic policy that it can either reinforce economic prosperity or cause macroeconomic instability. In short, Zambia fell victim to Kaunda's economic populism and lived beyond its means. Living beyond its means led to budget deficits whose implications on economic performance have already been alluded to.

In the next section we look at whether Chiluba's economic policies made any difference in so far as fiscal discipline was concerned.

Economic policy under Chiluba

Under Chiluba's administration (1991-2001), government started with the rhetoric of privatization and for the first ten years failed dismally to put it into practice. It was not until 2000 when Zambia started privatization in earnest. Divestiture took place in

many state owned enterprises. Chiluba liberalized the exchange rate, maintained positive interest rates and embraced free market economics. By 2000, Chiluba had completely denationalized the assets of the Zambian Consolidated Copper Mines (ZCCM) and donors resumed balance of payments support (IMF, 2000).

In 2000 Zambia qualified for the HPIC debt relief after donors were satisfied by the reform program, (Mumba, 2005).

After 2005, new investor interest in copper mines emerged. The Chinese have become the major investors in the Zambian copper industry. This has rekindled hope in the prospects of turning around the fortunes of the Zambian economy. In February 2007, China and Zambia announced the creation of Chinese-Zambian Economic Partnership zone around the Chambishi copper mine. Although copper has once more taken center stage in the Zambian economy, concerns remain that the economy is not diversified enough to cope with a collapse in international copper prices.

4.5.3 Budget Deficits and Economic Performance

In the first period after independence (1964-1975), Zambia enjoyed a surplus despite the fact that the government borrowed from both the domestic and foreign sources to finance its expanding operations, which included nationalization, and ambitious infrastructural projects (Mwanza, 1996).

In the second period (1975-1990) domestic revenue receipts started to fall as a share of GDP because of balance of payments problems following the fall in international copper prices and the advent of the oil crisis. Government heavily borrowed from the domestic sector and foreign markets. External debt mounted, especially in the 1980s. Donors intervened to ameliorate the debt situation through debt relief measures (World Bank, 1990).

However, this was not successful due to the sometimes strained relations between the Zambian government and the IMF.

In the period 1990 and beyond, significant inflows of concessional assistance from bilateral sources increased following significant structural and economic reforms under Chiluba. However in 1991, there was an exceptionally high and pronounced spike in public expenditure and domestic borrowing (Dalamagasase, 1995).

Budgeting, fiscal discipline, public expenditure management and the effectiveness of public expenditure programmes declined over the decades as a consequence of repeated ad hoc adjustments to diminishing resources (Roberts, 2004). In addition medium-term expenditure programming was weak hence supplementary budgets were routine. Moreover, dysfunctional cash budgeting arrangements introduced in the 1990s blunted the thrust of public expenditure strategy (Fagernas, 2004).

Furthermore Zambia ran a consistent fiscal deficit since the 1970s. Public expenditure and net lending (mainly to parastatals) were sustained at high levels in excess of 30% of GDP up to the 1980s, reaching a plateau in 1991 at 60% of GDP (election year), and thereafter declined to 20%-25% of GDP from the mid 1990s onwards.

Revenues dropped in tandem with the fall of the copper prices from around 30% of GDP on average between 1965-1975 to below 20% in the mid 1980s before picking up to 20% in the 1990s following structural reforms.

In the years after independence there was a modest real GDP growth averaging 3.6% on the back of copper revenues and sharp increases in public and private consumption. The domestic financing (difference between revenue and expenditure) grew by 10.93%

(1972-74); 13.58% (1975-1979); 20.13% (1980-1984); 19.47% (1985-1989); 13.96% (1990-1994) and 31.13% (1995-2000) (GoZ, 2002).

In 1991, electoral politics led to the relaxation of fiscal discipline. Public expenditure increased from 28% of GDP in 1990 to 60% in 1991, giving rise to a fiscal deficit of 45% of GDP which was financed by domestic borrowing equivalent to 25% and foreign financing equivalent to 20% of GDP. The incoming Movement for Multi-Party Democracy (MMD) thus inherited a legacy of increased public debt and higher inflation and was soon to reap the hyperinflationary consequences (Kumbula, 2003).

In general, Zambia's fiscal accounts have been chronically in deficit since the early 1970s and there was routine recourse to inflationary domestic financing (printing money).

Table 13: Zambia Inflationary trends (1970 – 1999)

Year	Low Income Group (%)	High Income Group (%)
1970	10.1	8.5
1975	11.7	11.9
1980	14.0	10.4
1981	12.5	13.2
1982	19.6	11.7
1983	20.0	20.0
1984	37.5	35.1
1985	51.6	55.4
1986	21.0	21.0
1987	54.4	54.4
1988	63.1	62.5
1989	50.5	15.0
1990	32.0	80.0
1991	18.5	74.0
1997	31.0	55.0
1999	45.0	67.0

Source: Bank of Zambia (2003)

Budget Deficits and Exchange rates

At independence and up to early 1980s, Zambia maintained a fixed exchange rate. The Kwacha was highly overvalued. Zambia boasted of huge foreign reserves as a result of copper exports. However, the resurgence of the budget constraints following adverse shocks of falling terms of trade and a rising debt service burden, led to the devaluation of the Kwacha in the late 1980s (Carlsson, 1996.)

Successive agreements with the IMF committed Zambia to restrain public expenditure, to limit its borrowing and to introduce foreign exchange auctioning in 1986. However, the foreign exchange auctioning system was abandoned as it failed to meet the private sectors' demand for foreign exchange and was accompanied by the revaluation of the Kwacha in 1987.

Structural adjustment and economic reforms since 1991 under President Chiluba, led to the liberalization of foreign

exchange, the introduction of bureau de changes, the wholesale privatization of parastatals, civil service reforms and increased donor support. This reduced the budget deficit and enabled the floatation of the kwacha as a freely tradable currency on the inter-bank market.

Table 14: Zambia: Exchange Rate Movements (1970 – 2004)

Year	US\$:Kwacha
1970	1.40
1975	1.55
1980	1.27
1981	1.15
1982	1.08
1983	0.80
1984	0.56
1985	0.37
1986	0.16
1987	0.05
1988	0.12
1990	0.07
1991	0.03
2000	3.11
2001	3.61
2002	4.31
2003	4.73
2004	4.78

Source: IMF International Financial Statistics (Various Issues)

After the year 2000, the exchange rate continued to depreciate against the dollar from 3.111 in 2000 to 4779 in 2004 as a result of the liberalization of the exchange rate.

Budget Deficits and Trade Deficits

From 1964 to 1974, Zambia enjoyed a trade surplus and a positive balance in factor service payments and current transfers. During this period aid receipts were low and most external financing of the balance of payments were on commercial terms. However, with the fall in copper revenues, the budget deficit increased and external debt to the tune of US\$5.8 billion was accumulated. The current account stood at 8% of GDP between 1975 and 1990.

Falling revenues prompted heavy borrowing from bilateral and multilateral sources and in the 1990s, Zambia's indebtedness peaked. Fortunately the HIPC Initiative of the 1990s considerably reduced Zambia's debt burden (Mwanza, 1996)

However, critics still argue that debt relief did not completely eradicate the debt stock which stood at US\$6 billion as at 2006 (Evans, 2008). Be this as it may, Zambia's balance of payments situation was less prone to crisis than was the case in the 1980s and perhaps early 1990s.

The overall macroeconomic picture in the late 1990s is illustrated below. A look at the government accounts will show the trend gap between revenues and expenditures over a period of time and how other macroeconomic indicators tended to move in sympathy, in the same direction.

Table 15: Zambia: Economic and financial indicators (1995 – 1999)

	1995	1996	1997	1998	1999
Output and prices (change in percent)					
Real GDP	-2.3	6.4	3.5	-2.0	4.0
Consumer prices (period average)	34.9	43.1	24.4	24.5	21.6
Investment and savings (% of GDP)					
Gross Investment	13.1	14.8	13.6	14.4	17.6
Public Investment	6.6	6.0	5.4	7.7	8.5
Private Investment	6.5	8.7	8.2	6.7	9.0
Gross domestic savings	7.3	8.5	8.1	5.4	5.1
Public Domestic savings	3.6	3.5	3.7	1.5	0.5
Private domestic savings	3.7	5.0	4.4	3.8	4.6
Central Government Finance (% of GDP)					
Total Revenue and Grants	29.1	26.8	24.8	24.5	27.8
Total Expenditure and net lending	32.9	29.4	26.8	28.8	31.0
Overall government deficit (excluding grants)	-13.0	8.7	-7.0	-10.6	-12.3
Overall government deficit (including grants)	-3.8	-2.6	-1.9	-4.3	-3.2
Primary balance (including grants)	4.3	2.2	2.2	-1.0	-0.9
Total domestic public debt outstanding	....	11.7	10.0	14.3	10.0
Money and Credit					
Broad money (end-year, percent change)	55.3	34.4	23.9	18.5	20.4
Treasury bill yield (91 days; period average, in percent)	....	52.5	30.6	26.6	30.7
External sector (% of GDP)					
Current account (including official transfers)	-4.2	-3.7	-6.1	-8.1	-8.9
Current account (excluding official transfers)	-13.4	-13.0	-11.1	-15.2	-19.8
Total foreign public debt outstanding	197	210	179	197	221
Exchange rates					
Zambian kwachas per U.S. dollar (period average)	1865.9	1,207.5	1,341.6	1,861.8	....
Real effective exchange rate (1995 = 100)	100.0	104.6	125.3	114.4	....

Sources: IMF (2002)

Recent budgetary challenges in Zambia are succinctly revealed through IMF's Public Information Notices (PIN) which covers annual (articles) of consultation. Under article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of directors and this summary is transmitted to the country's authorities.

Budget Deficits, Macroeconomic Policy and Structural Reforms beyond 2000

Under the auspices of the IMF, Zambia improved her economic performance significantly in the four years 2000 to 2003, with an average growth rate of 4%. This reversed the two decades of decline which had seen inflation reaching an average of 50% (IMF, 2005).

In 2002, the country experienced a severe drought and the mining sector performed badly. However real GDP grew by 3 percent although inflation rose to 26.7% in the twelve months to December 2002 due to the drought-induced food shortages. The overall budget deficit was reduced from 8.1% of GDP to 6.3% in 2001. The current account deficit, after grants, narrowed to 6.5 percent of GDP from 10.8 percent in 2001, despite a sharp slowdown in the growth of copper exports. International reserves at the bank of Zambia rose to 2.2 months of imports in 2002 from 0.9 month at the end of 2001 (IMF, 2005).

In 2003 the budgetary position deteriorated as a result of civil service wage increases and housing allowances which were awarded in April the same year. This caused the IMF to revise its staff monitored program, which had to be modified to partially accommodate the wage increases without increasing inflation while at the same time maintaining expenditure on poverty reduction programs in the new Poverty Reduction and Growth Facility (PRGF). According to the IMF, the overall fiscal deficit (including grants) and domestic financing were estimated to have exceeded target by 1½ percent of GDP. This reflected large unbudgeted security-related spending and payment of retrenchment benefits and wage arrears of 0.8 percent of GDP to facilitate the sale in December 2003 of the Luanshya Mine. Expenditures on poverty reducing projects again fell short of budgeted levels. To contain the wage bill, the government reached agreements with some unions to reduce housing allowances awarded earlier in the year by two-thirds. Domestic arrears continued to accumulate (Mumba, 2005).

Despite the fiscal setbacks, growth improved and inflation declined in 2003, aided by a recovery in agricultural production. The increase in real GDP in 2003 was estimated at 4.2 percent, while the 12-month inflation rate of 17.2 percent in December 2003 was the lowest since 1982.

Broad money supply increased by 23.4 percent during 2003, compared with a target of 17 percent in the economic blueprint, largely because of the widening fiscal deficit. In late October 2003, the Bank of Zambia eased monetary policy by lowering the cash legal reserve requirements from 17.5 percent to 14 percent with a view to providing banks with additional liquidity for lending to the agricultural sector and other production sectors. As a result, interest rates on treasury bills, which had remained in the range of

30 – 35 percent for most of the year, declined sharply to around 20 percent in December 2003 (World Bank, 2006).

In regard to the exchange rate, the relatively stable trend in the real effective exchange rate since the mid-990s continued in 2003 and supported the growth of non-traditional exports. The nominal effective exchange rate depreciated by 15 percent, in 2004

Reflecting a sharp increase in copper prices and further growth in non-traditional exports, the current account deficit (after grants) and overall balance of payments deficit narrowed to 5.9 percent and 7.6 percent of GDP respectively.

According to the IMF (2004) progress in implementing structural reforms was mixed during 2003. A medium-term expenditure framework (MTEF) was discussed with stakeholders in preparation of the 2004 budget. The Bank of Zambia introduced an inter-bank foreign exchange market; completed a draft Financial Sector Development Plan (FSDP), and made some progress toward developing plans to deal with the insolvent non-bank financial institutions. However, effectiveness of the strengthened commitment control system was undermined by unanticipated spending decisions. Delays were also experienced in the procurement of hardware and software for an integrated financial management and information system (IFMIS) and the preparation of a multi-year plan for clearing domestic arrears. Negotiations were initiated with the preferred bidder for the sale of 49 percent shares and management rights of Zambia National Commercial Bank (GoZ, 2006).

As the IMF (2004) observed, Zambia's mixed record of implementation was indicative of incomplete program ownership, limited capacity and lapses in co-ordination.

Against this background, IMF has been emphasizing the need for a determined implementation of prudent macro-economic policies and structural reforms over the medium term to boost economic growth, reduce poverty and achieve the Millennium Development Goals (World Bank, 2007). Of particular importance was fiscal adjustment to achieve fiscal sustainability, increase spending on poverty reduction and free up resources to support private investment. IMF also encouraged the authorities to take steps to diversify the sources of economic growth and exports with particular emphasis on agricultural development and exports. IMF urged the authorities to accelerate efforts to meet the HIPC Initiative completion point triggers, as this was essential for debt sustainability and poverty reduction.

In 2004, the Zambian parliament passed a budget which aimed to sharply reduce domestic borrowing in order to contain the domestic debt and interest payments. The IMF pointed out that expenditure restraint should be the main basis of fiscal adjustment, and urged authorities to ensure that the wage bill was held to 8 percent of GDP as budgeted to provide more room for priority expenditure. However, the IMF welcomed the emphasis on measures to broaden the base of the value added tax system and simplify its administration and to streamline exemptions (IMF, 2006).

In addition, the IMF also welcomed the progress made in strengthening the expenditure commitment control system. To ensure further progress, the IMF recommended that the system be backed by tight enforcement of procedures, including sanctions against officials responsible for overspending and unauthorized re-allocation of funds, and a firm commitment to avoid unbudgeted spending. They stressed that the Ministry of Finance and National

Planning needed to receive full political backing for strict adherence to the budget and avoidance of ad hoc spending.

In order to help the Zambian government in managing the fiscus, the IMF recommended the development of a medium-term expenditure framework as an important step towards the preparation of more realistic budgets and the setting of expenditure priorities that were consistent with the goals of the PRSP. In this regard, they welcomed the intention to contain the government wage bill over the medium term. They considered that development of a medium-term strategy to “right-size” government operations and complete the pay reform would be essential to allow priority poverty-reducing expenditure to increase. The IMF together with the World Bank have been working with the Zambian authorities on the design of further reforms to reduce expenditure.

On monetary policy, since 2000, the IMF has been urging the Zambian authorities to monitor monetary developments closely particularly in light of the reduction in interest rates, and to tighten monetary policy, if necessary based on a more ambitious inflation target. They observed that a sustained reduction in interest rates would require a durable reduction in government borrowing and inflation, as well as greater efficiency in the financial sector. They supported maintenance of the flexible exchange rate system to allow adjustment to changes in Zambia’s external circumstances. They welcomed the introduction of the broad-based inter-bank foreign exchange market (The Economist, 2001).

Furthermore, the IMF noted that the financial system was generally sound. They considered the completion of the Financial Sector Development Plan to be a useful first step toward addressing the concerns identified in the 2002 Financial System Stability Assessment. They encouraged the authorities to prioritize the

reforms to ensure that urgent issues such as the insolvency of the non-bank financial institutions were addressed in 2004. IMF considered the privatization of the Zambia National Commercial Bank to be an important element of financial sector stability and fiscal sustainability.

Private sector development and foreign investment in order to accelerate economic growth has been one of the key planks in the IMF advice. IMF encouraged the buy-in from the private sector on policy formulation and legislative review. IMF advised on the need for public and private sector partnerships especially in areas of strategic investment such as the Konkola Copper Mines and the commercialization of the electricity company to enhance efficiency and pre-empt potential strains on the budget. IMF advised the government to improve governance through an anti-corruption drive and the enhancement of transparency and accountability in government operations, including the commitment to adhere to budgetary procedures (IMF, 2005).

In addition, efforts to privatize loss making parastatals improved revenues. Revenue improvement was also augmented by the resurgence in copper prices. As a result, the budget deficit was kept within reasonable limits. Inflation was reduced to 15.9%. Real GDP grew by an average of 4.5% per annum and the fiscal deficit stood at 1.7% of GDP in 2007 compared to 6.6% in 2003. Zambia's debt sustainability was achieved through the HIPC status. After years of monetary expansion, the Bank of Zambia maintained tight monetary policy. In addition, the external sector performed well following the rebound of copper prices in 2005. There was also an improvement in the public sector management system, including the introduction of a medium term expenditure framework in the budget making process (GoZ, 2006).

Table 16: Zambia: Selected economic indicators (2001 – 2007)

	2001	2002	2003	2004	2005	2006	2007
Budget Balance (% of GDP)	-8.1	-6.3	-6.6	-1.7	-2.5	3.0	5.0
Inflation (%)	21.4	22.2	21.4	18	18.3	15.2	14.0
Exchange Rate: Kwacha/US\$	-7.7	-19.3	-14.1	-2.6	1.3	2.8	1.9
Trade Balance (%)	-13.9	-9.2	-9.6	-5.4	-6.0	-8.3	-9.7

Source: Bank of Zambia (various issues)

4.5.4 Conclusion

The overall economic outlook is that Zambia's macroeconomic stabilization will continue to hinge on external budgetary support, debt relief initiatives and structural reforms. Reliance on external budget support has enabled Zambia to maintain fiscal sustainability. But the problem with over dependence on donor support is that once certain agreed conditionalities are not met, there is a danger of donor pull out. This will affect the national budget and compound the deficit. Zambia needs structural reforms in order to diversify its economic activities and move away from over dependence on copper revenues. Other sectors like manufacturing, agriculture, tourism and services need to be developed so as to expand the domestic revenue base.

The review has shown that Zambia's economy suffered from the deficit during the rule of Kaunda and Chiluba. During Kaunda's days, nationalization led to the bleeding of state coffers and growing fiscal deficit which was harmful to the economy. During Chiluba's rule, corruption and rent-seeking activities brought the economy to its knees. Zambia eventually became a HIPC case. After losing power, Chiluba went through a long trial for corruption. We therefore conclude that fiscal deficits and bad governance had a negative impact on the Zambian economy.

4.6 Botswana

4.6.1 Introduction

Botswana is a good example of how macro-economic stability can translate into fiscal stability through a balanced budget or more often a surplus budget. Macroeconomic stability refers to a situation where macroeconomic fundamentals (or key variables) are within an acceptable ball park (as benchmarked by international economic standards). For example, the Maastricht Treaty sets a manageable budget deficit as a figure around 5% of GDP. This is the general target, which all European Union states strive to achieve.

On the other hand, the IMF views a single digit inflation figure as appropriate for a stable economy. An average real economic growth rate of least 3-5% would indicate a buoyant economy. A stable exchange rate, which is determined by forces of demand and supply (free float) would also be regarded as competitive as opposed to a fixed exchange rate whose rate is pegged by the central bank. Using all these criteria, Botswana passes the test.

4.6.2 Public Finances

At independence in 1966, Botswana was one of the poorest countries in the world (Guest, 2005). Botswana depended on foreign aid which virtually funded all government investments and recurrent expenditure. In 1971, foreign aid accounted for 98% of state revenue until diamonds were discovered the same year and Botswana's fortunes changed.

Diamond revenue was used in infrastructural development, education and health. The private sector was allowed to grow unmolested and foreign investors poured into Botswana, taking investments in key sectors of the economy (especially mining) in partnership with the government. Notable investments included the diamond mining firms and safaris in the Okavango Delta. Economic

aid fuelled growth and the diamond trade surplus was invested in the building up of reserves. Public expenditure was kept within budgetary limits, hence avoiding fiscal overruns.

Unlike other failed states, like Zambia, which ran into debt problems as a result of lack of fiscal probity, high public expenditure overruns and external borrowing, Botswana managed to look after its economy so well that it progressed from a lowly developing country to a middle income country according to the World Bank. In this regard, Botswana never suffered from the crisis usually emanating from an unbalanced budget. As a result, the problems of high inflation, fixed exchange rate and balance of payments associated with excess demand have never been an issue in Botswana. Botswana is thus a typical case of macroeconomic stability whose main trajectory was good fiscal policy.

Guest (2005) interrogated the reasons why Zambia and Botswana, which got independence almost at the same time (with a negligible two year difference), depended on aid initially and were endowed with rich minerals, ended up with fundamentally different economies. Guest (2005) argued that aid helped Botswana out of poverty but was wasted in Zambia. He goes on to argue that what mattered was that Botswana had good economic policies, soundly administered, whereas Zambia did not. In his comparative economic assessment of the two countries, Guest (2005) gave Botswana an "A" grade (denoting successful economic policies) and Zambia an "F" grade (denoting failed economic policies).

Despite its very small population of 1.4 million people, Botswana's economic record has attracted worldwide attention. The praise that has often accompanied analysis of Botswana's economic progress is well deserved. Starting from a GDP of US\$ 50 million (in current terms) at independence in 1966, the level of GDP rose

rapidly to US \$3 700 million by 1992. Data from the 1991 and 1994 World Development Reports (1991&1994) suggest that on average, Botswana was the world's fastest growing economy over the period 1965 to 1992. It achieved average growth rates of 13.9% and 10.1% during the periods 1975-80 and 1980-92 respectively, compared with a world average of 4.1% and 3.0% respectively.

When compared with the performance of sub-Saharan Africa, which experienced growth rates of 4.2% and 1.8% over the respective periods, Botswana's experience becomes even more startling. Botswana's per capita income, which stood at US\$ 2 790 in 2005 was the second highest for sub-Saharan Africa (exceeding South Africa's US \$2 670), only behind oil-rich Gabon's (US \$4 450). The weighted average for sub-Saharan Africa was only US \$ 530 (2005). Its per capita GNP growth rate of 8.5% (1995-2005) was much higher than the weighted average of 0.3% for sub-Saharan Africa over the same period (Kanyenze, 1996)

Public Finance Management

The government's sound and effective management of its budget has been widely acclaimed (World Bank 1985, 2006, Lewis et.al 1990, Harvey, 1992; SAPEM, 1993; Southern Africa Economist: 1999, among others). The country has pursued a strong market-oriented development strategy, with very limited public ownership. This was complemented by liberal exchange control measures, freely available import licenses and little control of the private sector. Development planning was used as a central part of macroeconomic management. Economic Plans sought to define government's future expenditure and set out government's revenue path. Once parliament had passed these plans, no public

department could exceed set expenditure targets without the approval of parliament.

Sources of government revenue were closely associated with the performance of minerals, and in particular the diamond sector. The expansion of diamond production through the opening of Jwaneng Mine in 1981, coupled with favorable prices, accelerated the inflow of revenue to government. Mineral revenue accelerated markedly from a nominal rate of 46.4% of GDP during 1982/83 – 1990/91, decelerated to an average growth rate of only 1.9% for the period 1991/92-1994/95 before peaking to 45% of GDP after 1999. Likewise, tax revenues, which were at a level of 33.1% of GDP, continued to be steady. This boosted surplus reserves which were later to be used as a buffer against rising government expenditure in the later years (Kanyenze, 1996).

On the other hand government expenditure, increased at an annual average rate of 27.4% since the 1980s, though decelerating to a level of 14.5% for the period after 2000. However, the slow-down in expenditure growth was not as pronounced as that for revenue. The bulk of recurrent expenditure was allocated for general public service, which included general administration and public order and safety. Education continued to receive the second highest vote, which represented 23.1% of recurrent expenditure since independence. The most important point is that expenditure was kept within the realm of the diamond revenue base (World Bank, 2002).

Botswana rapidly increased public expenditure (including infrastructure). Consequently, net primary school enrolment increased significantly from 58% in 1975 to 97% in 1988 and down to 91% in 2005 (World Bank: 2005). The primary pupil/teacher ratio decreased sharply from 40 in 1965 to 30 by 1991. In

contrast, the weighted average primary pupil/teacher ratio for Sub-Saharan Africa decreased only from 42 in 1965 to 41 by 2005. The government also heavily invested in primary health care and other social sectors. However, all this was being done within the budgetary limits.

However, in 1982/83 due to drought, the budget slipped into deficit but thereafter the budget maintained a remarkable improvement from this deficit position in 1982/83 to an overall surplus after 1995. Botswana's prudent and effective use of its mineral revenues has been widely acclaimed. In fact, she has been able to manage her mineral resources in such a way that it avoided the so-called "Dutch Disease" commonly associated with mineral based development. In most mineral-based economies, quick and often unproductive spending of revenue often results in the real appreciation of the domestic currency, rendering the economy uncompetitive on the world markets, as happened in the case of Zambia (Kanyenze, 1996).

However, in more recent years, government appears to have allowed spending to increase gradually. Salkin (2005) argues that misplaced priorities, mismanagement and wasteful spending that have been evident in recent years echo the litany of causes for failure that have been identified in other developing countries.

Harvey (1992) quotes examples of the adoption of projects with low or negative economic return, poor planning and implementation of development projects. He observed that overspending became a problem, with actual expenditure representing 91% of estimates in 1986, rising to 115% (1987) and 132% (1988) before falling to 123% (1989) and 119% (1990). The 1994 budget speech conceded that development expenditure had

expanded so quickly that government's capacity was overstretched, resulting in poor quality and inefficiency.

It also noted that ministries found that approval of supplementary budgets was less complex, resulting in excessive supplementary requests. These issues were addressed in the Mid-Term Review of NDP 7 (GoB, 1994). Apart from falling mineral revenues, the issue of economic management in recent years has featured as one of the constraints on achieving high growth rates.

The dearth of sufficient skilled human resources to implement, monitor and run development programmes led the government to reduce these programmes to a manageable level. According to the IMF (2007), inadequate supervision of staff often combined with excessive workloads and the lack of proper motivation to keep productivity up, affected the implementation of these development programs. In addition, many service departments were trying to manage huge amounts of data using manual technology that was inadequate to the task (GoB, 2005). Unfortunately, this problem arose at a time when government's managerial capacity was most required, especially in view of the growing unemployment problem and the need to find alternative sectors that could take over from mining as the engine of growth.

In 2003, the Minister of Finance – Baledzi Gaolathe – presented a belt tightening budget, whose growth forecast was 5%, which, compared to the historical growth rates, was below average. A 20% civil service salary increase and the leave encashment policy introduced in 2002 worsened the budget and led to a deficit of 6% of GDP. Suppressed diamond market conditions resulted in revenue shortfalls.

Botswana's main revenue sources continued to be dominated by minerals (mainly diamond revenues), grants, VAT, customs and

excise duties and grants, while expenditure was comprised of total expenditure of central government and net lending.

In the 2004/5 budget, the proposed outcome was a balanced budget (including a small contingent surplus of P206 million) with total revenues and grants of P17.54 billion and total expenditures and net lending of P17.33 billion.

Notwithstanding its stable economy, economic development in Botswana still requires an even more adroit management of the economy. As the former President, Festus Mogae, had conceded "... we still have a long way to go on the path to development. There are still far too many Batswana without adequate incomes and our economy is relatively undiversified and vulnerable to extreme fluctuations due to climate conditions and swings in international markets for our mineral and non-traditional exports"(GoB,2004).

All in all, the discovery of diamonds in the early 1970s led to the rapid growth of a small modern economy, co-existing with a relatively backward large rural sector. This resulted in the development of a dualistic economy. It has been estimated that half of the rural population (the rural sector accounts for about 76% of total population) lives in poverty (World Bank 2008). Cattle rearing, the mainstay of the rural economy is heavily concentrated with an estimated 5% of the rural household, accounting for half the national herd.

About three quarters of the rural households depend on arable farming, growing mainly maize and sorghum for their livelihood. Yields are however very low and unpredictable due to low rainfall and recurrent droughts. It may therefore not be surprising that at an annual average figure of 8.8%, Botswana has one of the highest rates of urbanization in the world (it comes second after Mozambique) (World Bank, 2008).

On the other hand, Botswana has one of the worst income patterns in the world. Recent statistics show that the top 10% accounts for 42.9% of total income, with the lowest 20% responsible for only 2.1% (World Bank: 2005). In fact, some observers have noted that Botswana has been able to achieve high rates of growth without addressing issues of equity. Due to heavy reliance on market forces, observers argue that the case of Botswana does illustrate the limits of the market in terms of achieving equity (Mhone, 1993, Cokorinos, 1993, ILO SATEP: 1987). However, issues of equity cannot be adequately addressed outside the framework of a growing economy. In this respect, the failure to diversify the economy away from heavy reliance on diamond sector and beef industry constitutes the most fundamental structural bottleneck that undermines future growth. Government is aware of this constraint and has suggested that the diversification of the economy should involve a shift towards the industrial, manufacturing and tourist industries (GoB, various issues)

Although the tourist industry has been identified as a possible alternative way of diversifying the economy, its potential is limited. The current focus on high cost tourism, geared towards preserving the fragile natural beauty (the Okavango Delta), entails limited scope for substantial growth in tourism. Exporting financial services to the sub-region also features among the alternative ways of diversifying the economy (Bank of Botswana 1993).

Government's economic and fiscal policy has been characterized by a strong reliance on private sector growth to sustain employment creation and provide increased government revenue. To achieve this goal a policy of low direct taxation and subsidies for job creation in the manufacturing and tourism sectors has been implemented.

The continuous increases in diamond revenue ensured budget surpluses between 1983 and 1997. However, in 1998 a mixture of falling diamond revenue and the culmination of three years of sharp rises in expenditure meant that a deficit was unavoidable. The deficit was financed from the government's large savings and posed no threat to economic stability. Otherwise, the Botswana budget is almost always in surplus.

However, excess liquidity in the economy remains a major concern due to the country's large reserves and the inflow of foreign exchange.

Fiscal Sustainability

According to various IMF Article IV Consultations held since 2000, Botswana continues to be rated as one of the best performing economies despite emerging budgetary challenges. Botswana is a country which has evolved from one of the poorest countries in the world to a middle income country with the highest sovereign credit rating in Africa. This success has been attributed to sound economic policies, especially in managing its fiscal surplus derived from its diamonds over more than 35 years, underpinned by a fledging democracy. Botswana still heavily depends on the diamond sector, which accounts for a third of GDP and 70% of export earnings. This is the reason why in 2003 Botswana launched its Ninth National Development Plan for the period 2003/04-2008/9 with much emphasis on economic diversification as a strategy for fiscal sustainability.

Continued fiscal consolidation saw inflation further declining in 2004 from over 12% in June to 6.4% in December. Good fiscal management was accompanied by tight monetary policies. However, the IMF (2005) warned against the rise in poverty and HIV/AIDS and the likely impact on the budget in future.

Table 17: Botswana: Selected economic and financial indicators: 1999 – 2008

Indicators	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Budget Balance (%)	5.9	9.2	-3.3	-4.3	-0.8	-4.1	-1.7	2.2	1.9	2.0
Inflation (%)	7.8	8.5	6.6	8.0	9.3	7.8	6.5	5.9	6.0	7.6
Exchange Rate Pula/US\$	4.6	5.1	5.8	6.3	4.9	0.21	4.8	5.3	6.9	4.8
Trade Balance (\$m US)	619	546.7	600.7	616.7	812.7	892.5	917	876.0	599.1	755.8

Source: Bank of Botswana and IMF (various issues)

The above table shows growing pressure on the budget since 2002, when the budget churned out successive deficits, though of smaller dimensions. Analysts have attributed the emerging deficit to socio-economic development challenges facing Botswana in the 21st century, chief among which is the failure of the growth trickle down mechanism and funding challenges emerging from the HIV/AIDS scourge – all this seen against the decline in diamond revenue and the slow progress in the diversification of the economy away from diamond dependence towards tourism, services and manufacturing.

4.6.3 Conclusion

The Botswana study confirms the view that the budget is an important tool for macroeconomic and fiscal stability. By managing its budget surpluses prudently, Botswana was able to avoid the catastrophe of fiscal deficits which other African countries like Zambia and Ghana experienced as a result of over reliance on mineral or commodity booms. Unlike these failed states, Botswana carefully managed the revenue bubble making sure that when it burst, the economy would not suffer.

Because of budget surpluses that were enjoyed for 16 years up to 1998, key economic indicators such as inflation, the exchange rate and the terms of trade remained stable and posed no threat to macroeconomic stability, stable growth and fiscal balance. The

Botswana study demonstrates the catalytic effect of a stable democracy towards the robust performance of the economy.

4.7 Summary and Conclusions

In this chapter, we started by reviewing the literature on the development paths chosen by African countries in their post colonial eras. This chapter has established that in general, African governments were buoyed by initial years of commodity booms in their early years of independence. However, the lack of diversification and overdependence on a single commodity exposed these countries to the vagaries of international terms of trade shocks.

We have also seen how in the early years of independence, African governments maintained economic distortions shown by fixed exchange rates, overvalued currencies and import controls. These policies bred high budget deficits and caused severe deterioration in macro-economic stability.

In order to finance the unsustainable deficits, some governments, like for example Zambia and Ghana, resorted to inflationary financing by heavily relying on central bank financing of the deficit and external borrowing. This increased money supply growth, further putting more pressure on excess demand and led to more inflationary pressures. External borrowing worsened the economic performance of these countries.

On the other hand, overvalued exchange rates in the cases of Ghana and Zambia led to serious terms of trade problems as exports were uncompetitive and trade taxes were diminished.

We conclude that in the cases of Zambia and Ghana, abundant resources in the first instance, triggered poor public

finance management, thereby adversely affecting macro-economic performance – the so-called resource curse.

In contrast, in the cases of Botswana and Morocco, we saw two classical examples of good fiscal probity and the abundant benefits derived from the maintenance of a balanced budget in Botswana and, in the case of the latter, financing the deficit from non-bank sources. In the case of Botswana, it is instructive to note the sustained surplus position of the government budget, throughout its economic history since independence, with the exception of 1998 and intermittently after 2000. We conclude that a sound fiscal balance is definitely a key sine qua non for a stable economy.

Overall, the comparative studies of Ghana, Zambia, Morocco and Botswana show how important the public sector is. Poor management of public finances has far reaching implications on macroeconomic stability and fiscal balance. The deficit (and how it is financed) emerges as a central theme in understanding the macroeconomic challenges commonly faced by developing countries whose revenues always lag behind expenditures.

The comparative and qualitative reviews of the experiences of Ghana, Morocco, Zambia and Botswana have helped us appreciate pervasive effects of high public expenditure and its implication on macroeconomic performance. We can also clearly see the nexus between governance and macro-economic stability.

In the following section, we now look at the Zimbabwe Case Study.

CHAPTER 5

The Experiences of Zimbabwe (1980 – 2008)

5.1 Introduction

In chapter four, a comparative study of budget deficits and macroeconomic performance was done, first for Sub-Saharan Africa in general and then for a number of selected African countries, in particular. We saw that African countries in the post colonial era started off on a sound economic footing, registering positive economic growth rates usually on the back of commodity booms. Revenue windfalls were used for social expenditure and ambitious infrastructural development projects until the exhaustion of these revenues. To make up for the revenue gaps, governments either borrowed on the domestic and external markets or printed money to finance their deficits.

Fiscal imbalances arising out of public expenditure had adverse effects on macroeconomic performance in varying degrees. However, other non-economic factors such as corruption and poor governance also significantly contributed to economic slow-down. Botswana was able to use its budget surpluses prudently since independence in 1966. However, it has to deal with the over-dependence on diamonds, whose prices in recent years have been volatile on the international market, the HIV/AIDs pandemic and growing poverty, whose budgetary implications pose great challenges for the future economic prospects of Botswana. As for Morocco, high budget deficits did not affect macroeconomic stability as inflation remained in the single digit zone. This was due to the fact that borrowing was confined to non-inflationary sources of finance.

The experiences of Ghana and Zambia showed us the extent to which the lack of fiscal consolidation and excess demand posed

dangers for macroeconomic performance in these countries. Studies of these countries showed us there was a connection between fiscal imbalances and macroeconomic performance. In the case of Zambia, fiscal imbalances were worsened by external indebtedness. Both Zambia and Ghana became successful candidates of the Highly Indebted Poor Countries (HIPC) Initiative. Overall, we deduced from the comparative studies that there was a connection between poor public sector financial management and macroeconomic performance.

Following these comparative experiences, we now do a case study of Zimbabwe. The purpose of this chapter is to review the political and economic history of Zimbabwe, track the budget deficit and its occurrence, and examine its cumulative effect on the performance of the Zimbabwean economy between 1980-2008.

5.2 Political Background

Zimbabwe became independent on 18th April 1980 after the Lancaster House negotiated settlement (in Britain) that culminated in the Lancaster House Constitution, which many observers regarded as a ceasefire and power transfer document. The Lancaster House Agreement brought an end to the war which had intensified in the then Rhodesia especially after 1972 when guerilla infiltration from the north east, south east and northwest of the country from Mozambique, Botswana and Zambia, almost crippled the Rhodesian economy. This economy was already reeling from sanctions imposed after the then Rhodesian Prime Minister, Ian Douglas Smith, had declared the Unilateral Declaration of Independence (UDI) 11 November 1965 (Stiff, 2006).

After Lancaster, the country was briefly ruled by a British Governor, Lord Christopher Soames, who had been dispatched by the British Foreign Secretary, Lord Carrington, to oversee the

ceasefire and the organizing of free and fair elections in Rhodesia, which were held in March 1980 and won by Robert Mugabe's ZANU PF party with 57 seats out of the 80 contested seats. However, 20 seats were reserved for whites.

On 18 April 1980, foreign heads of states and governments came to the then Salisbury to witness the swearing-in of the new Prime Minister (Robert Mugabe) and the lowering of the Union Jack and the hoisting of a new Zimbabwe flag. Among the dignitaries who attended the ceremony was Julius Nyerere, the late Tanzanian President who advised the then Prime Minister Robert Mugabe that he had inherited the jewel of Africa and should look after it.

Indeed, the new black government had inherited a jewel – the robust economy, which despite sanctions, had a low budget deficit, good infrastructure, single digit inflation, a strong currency, a highly educated labour force and a relatively developed industry. During UDI, the Salisbury regime developed the manufacturing sector to robust levels, only second to South Africa (Mandaza, 1986). However, in my view the economy was still very fragile given the fact that the import substitution policy pursued by the UDI government had created competition barriers and the manufacturing sector remained highly uncompetitive and inefficient. The economy remained inward looking and badly needed injection of new capital and international credit lines. The robustness of the Rhodesian economy can therefore not be exaggerated because it was a war economy sanctions. Moreover the Rhodesian economy had evolved as essentially an enclave economy designed to cater for a minority population. The opening up of the economy so the majority could access social services would eventually put pressure on the economy in the ensuing post independence years and cause the fiscal deficit to increase.

5.3 Overview

This Chapter is a case study of how the post colonial authorities mishandled the public finances of the country and how this impacted on macro-economic performance in Zimbabwe between 1980 and 2008. Data beyond 2008 was not available due to the economic crisis which also affected the ability of statistical agencies to collate and publish up-to-date information on Zimbabwe.

For the purpose of this study, the economic history of Zimbabwe is *periodized* as follows:

Economic Dirigisme (1980-1988)

- This part deals with the *early independence period of dirigisme (1980-1988)* which was characterized by a *command economy and independence euphoria*. The new government sought to address historical socio-economic imbalances, especially the rural-urban divide in terms of education, health, and other amenities. This period saw massive public expenditure on defence, health, education and public service. Massive public spending was done on the public sector employment, public sector investment programs, transfers/subsidies and expenditure on other goods and services. Government maintained the policies used by Smith to bust sanctions. The state already had a huge stock of public companies (98). The new government added to this by buying out more private companies. Zimbabwe's involvement in the Mozambican civil war and the Gukurahundi¹ in Matebeleland in the early 1980s gradually put pressure on the fiscus, thereby sowing seeds of budgetary deficits in the ensuing years. In this 1980-1988 period, ZANU (PF) followed

¹ A brutal military operation to suppress insurgency in the western region of Zimbabwe which is dominated by the Ndebele tribe.

a Marxist-Leninist ideological rhetoric, which tended to give a more populist and statist developmental paradigm. In this regard, government followed Development Planning models and rolled out development plans, such as the Growth with Equity, Transitional National Development Plan and a series of Five-Year National Development Plans. The first section concludes that between 1980 and 1988, dirigist and populist policies sowed the seeds of perennial fiscal imbalances for the later years. Government incurred fiscal deficits arising from challenges of transformation, reconstruction and state security.

Market based reforms (1989-1996)

- The second part looks at the *period 1989-1996, which can generally be referred to as the period of market based reforms*, which was marked by the introduction of IMF and World Bank Economic Structural Adjustment Programmes (commonly referred to in Zimbabwe as ESAP) in 1991. The ESAP period saw a further deterioration in fiscal and macro-economic performance, which the IMF in its various Article 1V consultations blamed on “lack of fiscal consolidation” on the part of government and its half hearted implementation of economic and institutional reforms (IMF, 2006). In our opinion, the IMF was partly to blame for the failure to control excess expenditure. Year in and year out, the IMF would dispatch its technical assistance teams to provide advice on how the government could reduce expenditure. The IMF saw the fiscal position deteriorating over its watch. During this period, the fiscal deficit became unsustainably high (at 8% of GDP) and the IMF suspended balance of payments support to Zimbabwe in 1998 because of fiscal unsustainability and payment arrears. ESAP was replaced by the Zimbabwe

Program for Economic and Social Transformation (ZIMPREST) in 1996 - which government officials touted as homegrown, but in reality was never implemented. In 1997, the Zimbabwean dollar crashed following the payment of unbudgeted gratuities to the restive war veterans. The market was hit by the speculation that the move would spark a general depreciation of the Zimbabwean dollar and there was a rush to hold money in foreign currency as opposed to the local currency.

Failed Controls (1997-2003)

- The study looks at the period (1997-2003) as a period of failed controls as government attempted to go back to pre-ESAP command policies, with disastrous consequences. On the political front, this period saw the military participation by Zimbabwe in the DRC war (1998). The period was also marked by the suspension of balance of payments support to Zimbabwe, thereby precipitating a foreign exchange crisis. The period saw the launch on 11 September 1999 of a formidable opposition party in Zimbabwe, the Movement for Democratic Change (MDC) led by Morgan Tsvangirai, a trade unionist turned politician, which nearly grabbed power in the 2000 Parliamentary Elections, were it not because of alleged massive violence and electoral irregularities. The elections were declared not free and fair by Commonwealth Observers, the European Union and the SADC Parliamentary Forum. This led to the international isolation of Zimbabwe and the imposition of economic and targeted sanctions, which took the form of travel bans for individuals on account of human rights violations and the freezing of ZANU (PF) officials' assets. This period marked the beginning of the worst phase in the history of Zimbabwe, when the country registered consecutive

negative growth rates as a result of the decimation of the agricultural sector following violent land invasions of 2000 which displaced 4500 white farmers and repossessed 15 million hectares of land which were parceled to ZANU (PF) loyalists in a dual resettlement program dubbed A1 and A2 resettlement.

Chaos (2004-2008)

- The last part of the study dwells on the period (2004 to 2008) - *a period of chaos*. During this period, fiscal performance worsened especially after 2004 when the new Governor of the Reserve Bank, embarked on disastrous quasi fiscal operations, which saw the Reserve Bank resorting to the printing press and advancing concessionary finances to various sectors of the economy (without due diligence), bailing out loss making parastatals, importing fertilizers, tractors and agricultural equipment, all of which were outside the Reserve Bank's core business.

The Reserve Bank financed government deficit by printing money and the President of Zimbabwe praised the Governor for being a practical man who did not stick to "textbook economics". The bank even printed money to buy foreign exchange on the black market to meet external debt obligations and government's day-to-day budgetary requirements. The Treasury had virtually collapsed.

This section reveals that although the budget deficit negatively impacted on inflation, the exchange rate, interest rates and trade balance, overall, the economic meltdown, especially after 2000, was also exacerbated by corruption and governance issues. These other factors played a significant role in the decimation of the economy but are however not measurable. The section deals with

these issues beyond the economic discussion on the implication of the budget deficit on macro-economic performance.

Data

The statistical nominal data used in the study is based on Zimbabwean dollars. The nominal figures especially after year 2000 and beyond 2008 (until the introduction of multiple currencies in November 2008) are soft data. This is the usual problem associated with hyperinflationary economies. Hyperinflation is defined as rates of inflation (month-on-month) above 50% (Hanke, 2010). However, for Zimbabwe this definition is too simplistic because inflation reached million percent in 2008 and became immeasurable thereafter. The combination of a grey market of foreign exchange and hyperinflation made conversions of nominal to real inflation figures impossible. The data used is more useful on indicating nominal trends.

Zimbabwe's Public Finances

The purpose of this section is to briefly explain the nature of the public sector in Zimbabwe. A proper understanding of the public sector is necessary as it has implications on the various dimensions of fiscal deficits. The Zimbabwean public sector is comprised of the non-financial public sector (the aggregate of public enterprises and local authorities) on the one hand, and the financial public sector (central bank, government controlled financial institutions, including the post office and savings bank, Zimbabwe development bank, industrial development corporation and other allied bodies). The structure fits very well into the IMF classification. The latter did not present significant deficits or losses at least in the 1980s and 1990s because they did not delve into quasi-fiscal activities.

Taxation

Direct taxes on incomes and profits and indirect taxes on goods and services, including customs and excise duty, fees, VAT, sales and recoveries, miscellaneous taxes and grants are the main sources of revenue in Zimbabwe. However, direct grants were stopped after 2000 because of political differences with bilateral and multilateral partners. Development partners preferred to work with non-governmental organizations and civil society.

On the expenditure side, most expenditure is on recurrent items such employment costs and public consumption, interest payments, subsidies and transfers (GoZ, 2000).

Since 1980, government has been borrowing heavily to finance its budget deficit. Capital expenditure ranged from year to year between 6% and 10% of the total expenditure (GoZ, 2000).

The legal and institutional framework of public finance management in Zimbabwe is set out in the Constitution. **The Constitution of Zimbabwe** sets out broad principles on which public finances operate. **Chapter X1** presents the two constitutional principles of public finance management, namely that:

- All revenues from whatever source are paid into one Consolidated Revenue Fund (CRF) (section 1)
- No moneys can be paid out of the CRF without the authority of an Act of Parliament (section 102)

The Constitution requires the Minister of Finance to present to Parliament a budget of the estimated expenditures within 30 days of the announcement of each financial year. It also sets out Presidential powers prior to the promulgation of the Appropriation Act, and for the meeting of urgent and unforeseen expenditures.

The effect of these provisions is to bring all government expenditure under the control of parliament (Constitution of Zimbabwe)

Parliament authorizes yearly expenditures. It exercises this power by passing enabling legislation and leaving the executive to manage public affairs within the legal framework laid down. Parliament exercises its budgetary oversight role largely through Committees which carry out regular enquiries into ministries' expenditures. The most prominent Committee on expenditure management is the Public Accounts Select Committee (PAC). The PAC carries a critical examination of and investigations into reports made by the Comptroller and Auditor General of unnecessary, wasteful or excessive expenditure of public money or state property. The functions of this Committee are to ensure that funds for each financial year have been applied to the purposes intended by Parliament (Constitution Of Zimbabwe).

The PAC has the power to call for persons, papers or records based on the Privileges Immunities and Powers of Parliament Act. In carrying out his/her duties, the Comptroller and Auditor General(C&AG) is not subject to the direction or control of any person or authority except the House of Assembly.

After examining the accounts submitted to him/her by the various ministries and departments, the C&AG prepares and submits to the Minister of Finance a report on his/her examination and audit of the public accounts for onward transmission to the House of Assembly.

Section 20 of the Audit and Exchequer Act appoints Treasury as the manager of Public Funds. Treasury issues Treasury Instructions which set out the broad principles to be followed in the control of the Public Finances and an Accounting Procedures Manual for guidance to officers in their day to day accounting functions.

Treasury also issues circulars from time to time and is empowered to require Accounting Officers to issue written departmental instructions that expand on Treasury Instructions, which relate to the particular operations of the ministry concerned. The Accounting Officer is normally the most senior public servant in a Ministry and is held personally accountable to Parliament for proper budget administration and financial control. Instructions of Accounting Officers are deemed to have the same force of law as a statutory instrument. They are responsible for ensuring that adequate controls of the votes of their ministries or departments are introduced and that all instructions relating to the votes are complied with (GoZ, 1996).

However, the above constitutional safeguards were never followed as government incurred unauthorized expenditure most of the time and thereafter tabled supplementary budgets almost annually until 2009. It is therefore not surprising that the deficit continued to grow.

5.4 The Genesis of Budget Deficits in Zimbabwe (1980-1988)

5.4.1 Growth with Equity

For analytical purposes, we start by looking at the early post independence period which we hereby refer to as the period of dirigisme. The new government pursued socialist policies, while receiving international aid. The period 1980-1988 was characterized by high public spending and a growing fiscal deficit that were a result of expenditure on ambitious post colonial socio-economic programs (transformation, reconstruction and growth with equity). These programs and expansionist policies were later to sow the seeds of future macro-economic and fiscal imbalance. (Davies, 2005). However, the jury is still out whether the new black government had an option. The colonial economy was an enclave

economy catering for a few whites and a small black middle-class. Growth had not been inclusive hence the justification to embark on redistribution. In other words, the key imperator was the political capital to be gained although at the expense of macroeconomic stability.

Zimbabwe's economic prospects in the first two years of independence (1980-1981), looked very promising. The international political isolation caused by the Unilateral Declaration of Independence (UDI) by the settler regime in 1965 had ended with the advent of majority rule in April 1980 (Mandaza, 1986). *The new government inherited one of the most structurally developed economies and effective state systems in Africa (Bradford, 2002).*

According to Morande and Schmidt-Hebbel (1991), during the end of the first post independence decade, Zimbabwe had the uncommon combination of a high public deficit, a balanced current account and low levels of investment and growth. Despite a surplus on the current account, the public sector ran deficits exceeding 10% of GDP since 1981. Inflation remained manageable and interest rates were repressed but rose steadily after partial financial liberalization in 1987 and domestic public debt stocks increased. Morande and Schmidt-Hebbel (1991: 1) pointed out that "heavy public spending crowded out private consumption and investment in the 1980s. The private saving rate is a staggering 20% of GDP which finances all of Zimbabwe's investment. Public deficits must be reduced to ensure a sustainable path for public debt". However, in my view, the fact that inflation remained manageable demonstrates the fact that the impact of high public deficits were blunted by the restraint in the monetization of the deficit hence the reason why perhaps the impact was more pronounced on the interest rates which tended to crowd out private consumption and investment. It is debatable to say that all of Zimbabwe's investment was financed

by private savings alone. Indeed government also borrowed to finance public sector investment programs (PSIP).

Because of the historical imbalances and the lopsided nature of the inherited economy, the new government enunciated a macro-economic policy framework based on the twin objectives of Growth and Equity (1981). The Growth with Equity program was pursued from the middle of 1980 to 1982. This period saw the Zimbabwe economy experiencing economic boom. According to Kadhani (1986) this upswing in economic activity can be attributed to the following:

- Once-off terms of trade gain with the lifting of sanctions.
- Renewed access to sources of borrowed external finance.
- A significant capacity underutilization of 25%, which could potentially be reactivated with the influence of foreign investment.
- Exceptionally good rains in the 1980 and 1981 seasons, which impacted favorably on the agricultural production.
- The relaxation of both budgetary and external account controls in sharp contrast to the tight reins exercised in the period 1973 to 1979.

GDP grew by 11% (1980) and 12% (1981). Employment grew by 3% in 1981. Because of the lifting of sanctions and the inflow of foreign capital, capacity utilization rose from 76% in 1979 to 83% (1980), 95% (1981) before slightly declining to 91% in 1982. Gross capital fixed formation rose from 13.7% in 1979 to 14.8% (1980), 15.5% (1981) and 17.5% (1982). In short, the economy was buoyant (Kadhani, 1986). In my own opinion, this analysis glosses over the role played by infrastructural rehabilitation during the dirigisme years, especially in the transport and communications sub-sectors. The other factor that contributed to good economic

prospects was the aggregate demand generated by an emerging black middle class and the participation by more black Zimbabweans in the mainstream of the economy (increased aggregate demand).

However, this positive outlook gave the false impression that the economy would continue to grow and that government would continue its equity objectives at the expense of efficiency. As Jenkins (1997) correctly pointed out, the government's difficulty in discerning the macroeconomic limitations on new initiatives was greatly increased by the unusual circumstances of the first two years. These unusual circumstances are classified by Jenkins (1997) as follows: a commodity boom, promises of more aid than eventually arrived, expectations of a peace dividend which did not come, initial high rates of economic growth (12% in 1981) and initially low foreign debt.

As Jenkins (1997) notes, all of these circumstances created unrealistic expectations, concealing the probability that the government's plans would be impossible to finance. However, Jenkins's assertions can be challenged. It can be argued that government knew the implications of pursuing its plans but chose to go ahead because it was politically expedient to do so. The consequences of not addressing the historical imbalances would as well have been too ghastly to contemplate. We argue that government faced very limited options in this instance. Moreover, it is not entirely correct to say that aid did not come. Zimbabwe was one of the best investment destinations in the years following independence and massive aid flowed into the country. The problem was that of aid effectiveness.

However, Jenkins's analysis is important because it tells us why the new government went on to embark on nearly a decade of

free education, free health, and infrastructural development without due regard to the constraints imposed by the budget under its Growth with Equity (1981) policy.

In the following section, we look at the fiscal and macro-economic implications of the subsequent economic plans that were unveiled during the dirigisme era (1980 – 1988). These plans provided the trajectory for pursuing development and expansionary objectives based on growth with equity. In order to mobilize resources to finance its ambitious development plans,

ZIMCORD

Zimbabwe hosted an Investment Conference in 1981. The conference was dubbed the “Zimbabwe Conference on Reconstruction and Development (ZIMCORD)”. ZIMCORD facilitated Zimbabwe’s open access to world trade, finance and capital markets. About 45 countries or organizations participated and approximately ZW\$1.2 billion was pledged. The significance of ZIMCORD was that it was to contribute a third of the financial requirements of the Transitional National Development Plan (TNDP). A total of (ZW\$6.1billion was needed to finance the plan). It is significant to note that not all of the pledged foreign aid materialized.

This meant that government counted its chicks before the eggs were hatched and in anticipation, engaged in huge socio-economic developmental projects without the requisite resource back-up. This proved suicidal as the macroeconomic consequences of living beyond the budget became unsustainable while on the other hand, government remained unwilling (or politically unable) to engage in fiscal adjustment.

Government's development policy trajectory during the period of economic dirigisme was also set out in the Transitional National Development Plan and the First Five Year National Development Plan (Vol. 1 and 2). It is therefore imperative to understand these policy documents as they shaped the expansionist developmental paradigm in the first post independence decade.

5.4.2 Transitional National Development Plan (TNDP): 1982-1984

Unlike the Growth with Equity policy whose thrust was redistribution, the TNDP's emphasis was on Transformation (Kadhani, 1986). Unfortunately, the TNDP period saw the economy entering a down swing phase.

The objectives of the TNDP were as follows:

- Completing the program of post-war reconstruction
- Generating sufficient growth to facilitate a rapid restoration of income levels, particularly at the lower end
- Redressing the social imbalances that had characterized the pre-independence political order
- Resettlement of 162 000 families (Mandaza, 1986)

The TNDP aimed to achieve an 8% annual growth rate and a 3% annual growth rate in employment. Gross fixed capital formation (GFCF) was expected to rise from 19% of GDP in the fiscal year 1981/82 to 23% in 1984/85 while domestic savings were forecast to rise from 17% in 1981/82 to 27% in 1984/85. In addition, 37.5% of GFCF was expected to be funded from net external resource inflows in the form of loans, grants and direct investment, especially after the much publicized Zimbabwe Conference on Reconstruction and Development (ZIMCORD) (Jenkins, 1997). However, in my view, the setting up of macro-economic targets without an implementation matrix reduced these

targets to wish lists. This was the major weakness of post-independence development planning. Without an implementation matrix, it is not possible to commit resources to the plan. In the end, the budget became the key economic policy instrument with no bearing to the plan.

During the TNDP years, actual performance fell below planned targets. GDP registered a negative growth rate of -2% in 1982 and - 2.5% in 1983, with a slight recovery in 1984 to 1.3%. Employment fell by 2.5% in 1983 against a population growth rate of 3.5%.

The economic downswing of the TNDP years (1982-1984) manifested itself through bottlenecks, job losses, sharp reduction in government revenue and a rapid escalation in pressure on the current account of the balance of payments. This had far reaching budgetary implications.

After the TNDP, government abandoned the growth objective and pursued social programmes (education and health) on a planned course more by virtue of the political momentum they generated than as components of a consistent development framework (Kadhani, 1986). This in essence marked the rise in government expenditure and the growth of the deficit. Social development particularly in health and education and skills formation and service sectors grew by 4.2% per annum compared to 1.4% in the "real" sector, but in both cases still falling short of the 8% overall target. The expansion of social services also had significant employment increasing effects in the public sector. However, this was done against the backdrop of sluggish growth and increasing inflation.

This wide divergence between plan and performance can be explained by the budgetary process which was inescapably skewed

in favor of non-discretionary expenditure as opposed to investment in the real productive sectors of the economy, thereby laying the seeds of domestic debt accumulation and macro-economic disequilibria. Analysts cited the drought, the world recession and the progressive deterioration in investment activity as causes of the failure of the TNDP.

5.4.3 Short Term Stabilization (1985-1988)

After the TNDP, the economy started to heat up as government revenues were stretched to the limit in a bid to fund the ambitious development agenda without the much promised foreign aid. Moreover, drought and terms of trade shocks made things worse. The realities of the destabilizing effects of public spending dawned.

According to Jenkins (1997), some of the policies implemented after independence and aimed at redistributing resources or alleviating poverty were unsuccessful or had perverse effects, creating distortions which pushed the economy towards macroeconomic instability.

With the suspension of the TNDP, the economic crisis was reduced to a financial management level where an attempt at short-term economic stabilization was made. This entailed budgetary squeezes in order to restore fiscal balance. The government also started negotiations with the IMF in order to get balance of payments assistance. The deficit on current account had risen from \$156.7m in 1980 to \$532.9m in 1984. As early as 1982, the IMF had observed that the deficit had been the result of excessive government expenditure (Kadhani, 1986). However, from the point of view of government, the expenditure was justified as necessary. For example, defense expenditure (in view of the destabilization by

South Africa, the problems of integrating armies, demobilization and post-war re-orientation), education and health.

This is the reason why during the brief stabilization, IMF funding was targeted at the restoration of financial balances on the budget and external account. Regarding the former, the Fund would normally require a reduction of the total government expenditure and net lending levels while for performance measurement purposes, the size of the deficit would supply the benchmark. The essential feature of this condition took the form of curtailment of development programs unless these were externally funded, reduction of subsidies and curtailment of growth in social spending (IMF, 1986)

The IMF recommended short-term demand management, which included the following measures:

- Removal of subsidies on maize, bread and milk
- Reduction of civil service employment programs by 1990
- Devaluation of the Zimbabwe dollar.

In the external sector, emphasis was placed on downward currency re-alignments to strengthen financial incentives to produce for export and general domestic demand compression, on the argument, first, that resources can be diverted to exports, and second, that reduced domestic inflation and production costs enhanced export sector performance.

Economists have argued that the short-term stabilization measures did not work to reverse the economic slump of the TNDP years (1982-84). As Kadhani (1986) points out, this virtually meant that the TNDP had been abandoned as the framework for guiding national economic policy and management.

Kadhani (1986) observes that in the absence of planning, the annual budget became not only the central and independent instrument for resource mobilization but also the major mechanism for the structuring of financial and economic policy.

Economic management thus took an essentially short-term fiscal and external balance stabilization orientation and outlook. The budget, unlike the TNDP, programmed purely public sector activities (social and public administration) and the funding of the government sector. This precipitated the crowding-out of the private sector. By 1988, signs of significant internal and external economic imbalances had begun to show, threatening to escalate pressure for the tightening of import controls and also to generate rapid deficit induced inflation.

According to Stoneman and Cliff (1989), on the domestic front, rapid increases had taken place in government expenditures, especially on recurrent items, without corresponding increases in revenue, so that the overall budget moved from 7.7% of GDP in 1981/82 to 10.7% in 1982/83. By 1988, the budget deficit stood at 12% of GDP. As regards the external sector, the growth that was permitted in imports in the period 1980-1981 without a matching improvement in export earnings, led to an increase in the current account deficit from 6.5% of GDP in 1980 to 15.0 % by the end of 1988. Net foreign assets declined from Z\$178m at the end of 1980 to negative levels by 1988. The debt service ratio stood at an estimated 60% by 1988, a six fold increase in three years from the 1980 levels.

Employment growth was poor with significant job losses suffered (except in the social sectors where total spending in education nearly tripled from Z\$227.6million in 1980 to Z\$628million in 1988 as did expenditure on healthcare which

increased from Z\$66.4million in 1980 to Z\$188.6 million by 1988, thanks to the donor community). The land resettlement and redistribution program, which was one of the corner stones of the TNDP, only managed to resettle one fifth of the original target of 162 000 families

First 5 Year National Development Plan.

Finally, the 5 Year National Development Plan (FYDP), which was put into place in 1985, aimed to achieve an average annual growth rate of 5.1% and the creation of 28 000 jobs a year. From the onset, the success of the FYDP critically depended on the restructuring of expenditure away from recurrent items and the realization of sustainable positive growth in the productive sectors. At the end, the FYDP failed dismally as GDP grew by an average of 1.5% and foreign exchange bottlenecks emerged.

It is however, difficult to evaluate the effectiveness of 3 successive government programs (Growth with Equity, Transitional Development, Stabilization Plan and First Five Year Plan) which were crafted in a row for the period 1980-1985. The formulation of plan after plan demonstrates policy inconsistency on the part of the new government and casts serious doubt on the extent of the implementation of these rolling plans.

5.4.4 Macroeconomic Implications

The net effect of expansionary fiscal policies pursued during the dirigisme period was cumulative budgetary imbalances which sowed seeds of macroeconomic instability. In the next table, we summarize the budgetary picture that obtained as a result of the expansionist and populist public spending by the Zimbabwe government between 1980 and 1988. The table shows the effect of a loose fiscal policy and the fact that government lived beyond its

means. This is evident from the consecutive negative budget balances registered since 1980.

The table below depicts the budgetary picture between 1980 and 1990.

Table 18: Zimbabwe: Central government budget account (Z\$ thousand, 1980 –1988)

Period (Year ended 30 June)	Revenue and Grants	Expenditure and net lending	Deficit (-) /Surplus (+)	Non-bank	Bank	Net Foreign Borrowing	Total Financing
1980	674.8	1 049.80	-375.0	+164.8	+137.5	-72.7	+375.0
1981	949.1	1283.9	-334.8	+108.9	+159.7	+66.2	+334.8
1982	1364.5	1681.1	-316.6	+109.9	-12.9	+219.6	+316.6
1983	1780.7	2247.1	-466.4	+310.3	+106.2	+49.9	+466.4
1984	1997.1	2627.2	-630.0	+373.6	+205.7	+50.7	+630.0
1985	2212.3	2923.0	-710.7	+495.8	-274.3	+489.2	+710.7
1986	2616.2	3307.8	-691.6	+703.4	-222.7	+210.9	+691.6
1987	3056.4	4053.2	-996.9	+620.2	+166.0	+210.8	+996.9
1988	3784.9	4680.7	-895.8	+601.5	+146.7	+147.6	+895.8

Source: Reserve Bank of Zimbabwe Quarterly Economic & Statistical review (various issues).

The central government budgeted expenditure was generally higher than revenue during the dirigisme period leading to cumulative budget deficits. The deficits increased rapidly between 1980 and 1988 as a result of excess demand. High deficit levels are attributed to the rapid social sector expansion, which started at independence as already discussed. During the ensuing years, government made efforts to reduce the deficit and it dropped to Z\$316.6 million in 1982 before rising again the following year, reaching Z\$710.7 million in 1985 due to increased recurrent expenditure. It remained at more or less the same level in 1986 but continued the upward trend again.

The fiscal deficit was largely financed by borrowing from the domestic bank and non-bank sources. This saw a progressive increase in the stock of domestic debt.

Table 19: Zimbabwe: Escalation of Domestic Debt (Z\$ million) (1980-1988)

Year	Debt
1980	1843.3
1981	2098.6
1982	2481.3
1983	2853.0
1984	3746.7
1985	4641.3
1986	5452.8
1987	6551.1

Source: Reserve Bank of Zimbabwe (1990)

The gross public domestic debt of central government increased from Z\$1843.3 in 1980 to Z\$6551.1 in 1987. Domestic borrowing constituted about 60% of the gross public debt. The main debt instrument was the domestic stock issue (short term treasury bills). During the period under review, there was a marked increase in external borrowings, particularly in registered bonds and other loans, especially from 1982 to 1987.

Government debt and the budget deficit were worsened by government subsidies to loss making parastatals in the late 1980s. Parastatal performance was riddled by managerial incompetence, sub-economic pricing of goods and services and general lack of capitalization.

Table 20: Zimbabwe: Deficit (nominal increase) and % increase of macro-economic indicators (1980-1990)

Years	Inflation %	Interest rate %	Exchange rate Z\$: US\$	Deficit Z\$m
1980	8.5	7.5	1.6	375
1981	9.8	13	1.4	334.8
1982	11.1	13	1.1	316.6
1983	13.3	13	0.9	466.4
1984	15.5	13	0.7	630
1985	16.9	13	0.6	710.7
1986	19.3	13	0.6	691.6
1987	21.6	13	0.6	996.9
1988	23.3	13	0.5	895.8
1989	23.8	13	0.4	1119.3
1990	29.8	12	0.4	1137.7

Source: Central Statistical Office, GoZ

Deficit Escalation

In 1980, the deficit was Z\$375 and inflation stood at 8.5%. With the increase in the budget deficit to Z\$334.8 in 1981, inflation rose to 9.8%. The Budget deficit slightly declined to Z\$316.6 in 1982 but inflation remained on an upward trend. The Budget deficit rose from Z\$466.4 in 1983 to Z\$1137.7 in 1980, while inflation jumped from 13.3% in 1983 to 29.8% in 1990. However, inflation was moderate during the dirigisme period despite the rising fiscal deficit because government borrowed externally to finance its budget. Moreover, the central bank did not monetize the debt. It must be borne in mind that the period 1980-1988 was characterized by relative adherence to strict financial rules and economic orthodoxy in the financing of the deficit as opposed to later years.

There is debate however, regarding the connection of the deficit and inflation in Zimbabwe during the dirigisme period. While the anecdotal evidence above links movements in the inflation to deficit changes, this cannot be conclusive as it would amount to "casual empiricism". In analyzing inflationary changes during this

period, it is important to note that changes in the food price index for both low and high income groups tended to drive prices upwards. Other inflationary pressures came from public utilities that charged monopolistic prices. The point is that, during the dirigisme period, there is little or no evidence that deficit changes directly caused higher inflation. Moreover, we also have to bear in mind the possible impact of lags in the deficit-inflation relationship.

Deficit and Exchange Rate

During the period 1980 – 1988, the exchange rate remained strong against other major currencies. The inflow of foreign currency following the opening up of the economy further strengthened the domestic currency. By then, Zimbabwe pursued a managed float.

According to estimations done by Morande (1991), the deficit was found to be weakly responsive to the real exchange rate, “a 1% real depreciation would reduce the deficit by 0.06% of GDP, i.e. the strong effect on the deficit via higher interest payments on foreign debt was almost neutralized by higher tax revenue, as both direct and indirect tax payments are boosted by a depreciation” (1991:29)

Deficit and Interest Rates

The relationship between the deficit and interest rates was indirect. We argue that because government had to finance the growing deficit, there was a deliberate attempt to resort to financial repression. But despite financial repression, there was still a direct relationship between the deficit and the nominal interest rate. On the other hand, real interest rates actually fell in the face of inflation. This discouraged savings and deprived the money market of the much needed investible surplus.

Declining private investment until 1987 implied lower aggregate capital formation and probably, lower efficiency of domestic investment. The effect of the 1987 fiscal adjustment on private investment was encouraging as it allowed a recovery of 2.4% of the gross domestic investment rate (Kanyenze, 1990). In this regard, there was some crowding-out relationship between the budget deficit and private investment. However, this relationship is complicated by the mechanism that operated in Zimbabwe, which was the requirement by government that insurance companies hold prescribed proportion of their assets in government bonds, which created a further channel of crowding out investment.

The Twin Deficits

The rising deficit interacted with a fixed exchange rate to cause foreign currency bottlenecks. This led to foreign exchange rationing and the introduction of import licensing. The removal of sanctions precipitated high import demand as the private sector began to increase its capacity utilization. Exports could not match imports hence the current account deficit. High budget deficits caused the overvaluation of the Zimbabwe dollar, so much so that in 1982, the first devaluation took place in order to enhance the competitiveness of exports. What sustained the capital account in the first five years after independence were the improvements in portfolio investment, external grants and foreign direct investment (FDI).

Summary

The period shortly after Zimbabwe's independence is sometimes referred to as the "successful eighties", Davies (2005:8). The government successfully improved social welfare in the 1980s. Davies argues that, "the rapid expansion of the education system and improved access to both preventive and curative health

services were the most notable successes. The rise in the marketed output of maize and cotton from communal farmers is often cited although it not clear, how widespread this success was. Minimum wage legislation probably raised wages in the early period at least. Although the resettlement program was small, there were also some successes there. No rewriting of history can negate these achievements and their significant outcomes" (Davies, 2005:14).

However, notwithstanding the redistributive gains acknowledged above, the impact on the budget became unsustainable. Clearly government could not financially cope with the public expenditure. Moreover, protection sustained high cost companies but discouraged exports by raising the cost of inputs leading to a shortage of foreign currency needed to import new technology. Public spending skyrocketed, particularly in the realm of civil service employment, spending on social services, drought relief and subsidies. This in turn generated a chronic budget deficit, a high tax regime and a rapid increase in public debt, all of which created a drag on the economy, Sichone (2003)

The major conclusion of this section is therefore that between 1980 and 1988, post independence public expenditure, that was targeted at redressing colonial socio-economic imbalances, laid foundations for unsustainable fiscal deficits which were to later have far reaching effects on macro-economic stability in Zimbabwe. Government expenditure exceeded revenue and deficits were funded from domestic and foreign sources. However, the macro-economic impact was diminished because between 1980 and 1988, government had good access to foreign finance, so the exchange rate remained relatively stable and deficit monetization was avoided. However, the most disturbing thing is that Parliament failed to censure government over its incurrence of successive deficits, even though they were not as yet harmful.

However, despite the criticism more often directed at the disastrous consequences of budget deficits in developing countries, the case of Zimbabwe during the dirigisme period proves that the impact of deficits can be minimized by avoiding inflationary financing. We can also argue that in the case of Zimbabwe, deficits incurred on social infrastructure were more justified than if they were spent on consumption per se. One important lesson derived in this instance is that for as long as the economy is growing, the impact of budget deficit is absorbed. The period between 1980-1988 saw steady growth rates being registered, despite, as earlier on pointed, the fact that the country's potential high growth rates could not be realized due to the distortions imposed by economic controls and declining investment in the real sectors of the economy.

The next section looks at the further deterioration of the fiscal deficit and the macroeconomic consequences thereof during the period of **market based reforms (1989-1996)**.

5.5 Fiscal deficits and macroeconomic consequences during the period of market based reforms (1989-1996)

5.5.1 Introduction

The second Five Year National Development Plan was supposed to be launched at the end of 1989. It was however, not the case. By 1990, the economy had reached crisis proportions as many years of command economic policies and overspending precipitated economic stagnation, a budget deficit of 10% of GDP, declining exports, sluggish growth, rising unemployment, resurgent inflation and shortages of basic goods. In short, macroeconomic fundamentals were deteriorating. The Table below summarizes the economic scenario before the launch of the economic structural adjustment program.

Table 21: Zimbabwe: Economic indicators (1980-1987)

	1980	1981	1982	1983	1984	1985	1986	1987
GDP %	10.6	12.5	2.6	1.6	-1.0	6.8	2.6	-1.5
Inflation	10.3	14.6	14.2	19.4	3.5	2.0	15.2	9.2
Budget Deficit (% of GDP)	9.1	13.5	13.1	14.4	12.7	14.3	14.4	10.9
Real Exchange Rate 1980=100	100	115.1	132.0	134.2	123.3	108.7	119.7	108.2
Nominal Interest On Deposit	3.5	7.8	8.0	8.0	8.0	8.1	8.0	8.2
Current Account (Z\$m)	-301	-739	-762	-527	-177	-166	-511	-300

Source: Jenkins (1997)

By 1989, it had become apparent that the dirigistic measures used to manage the economy had failed. The economy started to show signs of weak growth rates with increasing unemployment and public spending. The over-regulation of the economy had started to cause shortages of commodities and investment had started declining to insignificant levels.

As a pre-condition for Structural Adjustment Programmes (SAPs), the government had adopted new investment guidelines in April in 1989. The Zimbabwe Investment Centre had been established in July 1989 as a move to create a one-stop investment window. Government signed the World Bank's Multi-lateral Investment Guarantee Agency Convention (MIGA) in September 1989. In June 1990, government signed the USA's Overseas Private Investment Corporation Agreement (OPIC). As a way of providing incentives, a number of goods were put on the open general import license (OGIL) scheme until 1994 when the scheme was abolished. In addition, government introduced the export retention scheme whereby exporters could retain a portion of their earnings. Export processing zones were also established later in 1996 in order to boost investment and exports.

An Export Support Facility was put in place to finance exports. In addition, import quotas were replaced by tariffs. The foreign currency market was deregulated and exchange control regulations were relaxed and foreign exchange bureaus established together with individual and corporate foreign currency denominated accounts.

These were transitional measures that eventually allowed Zimbabwe to migrate from dirigisme to market based reforms. Moreover, the introduction of ESAP in 1990 was not a sudden change of policy but the culmination of a trend noticeable throughout the 1980s. "there were always strong undercurrents of neo-liberalism beneath ZANU PF's socialist rhetoric from the outset of independence. The erosion of many of the control measures that the government had operated since independence in effect moved policy towards structural adjustment. With the end of the cold war, neo-liberalism had become the only game in town: it would have been more startling if, at that time, government had adopted more dirigisme or socialist policies. ESAP was therefore not a surprise", Davies (2005: 19). In Sub-Saharan Africa, market reforms were embraced as the panacea to the economic stagnation, unsustainable deficits and balance of payments problems. This view was encouraged by the Washington Consensus. In Africa, Ghana was cited as the star economy of Africa as a result of structural adjustment.

Faced with a balance of payment crisis, Zimbabwe finally succumbed to the IMF and embarked on a classical structural adjustment program in 1991 at the behest of the IMF and World Bank. This marked the beginning of market based reforms whose hallmark was the liberalization of the economy. However, liberalization worsened rather than abate the budget deficit. The

IMF failed to put in place a budget monitoring and tracking mechanism.

Hence, the period under structural adjustment, still saw the pursuit of a loose fiscal policy by central government, underpinned by budgetary overruns and lack of accountability. This exacerbated the fiscal deficit, led to the severance of relations with the IMF, and the suspension of balance of payments support due to general lack of fiscal discipline. This had serious macro-economic repercussions for the country.

5.5.2 Economic Structural Adjustment Program (ESAP), 1990-1995

The new policy regime designed by the government (ESAP) with the support of the IMF and World Bank, set out to encourage job creation, improving access to foreign currency, reducing administrative controls over investment and employment decisions and most importantly, reducing the budget deficit. A 40% devaluation of the Zimbabwe dollar was allowed to occur and wage and price controls were removed. Thus, like other classical structural adjustment programs implemented in Sub-Saharan Africa, Zimbabwe's economic structural adjustment program aimed to achieve the following objectives:

- Average growth rate of 5%
- Investment level of 25% of GDP
- Export growth rate of 9% per year, which would raise the share of exports to GDP to 44% while allowing imports to rise.
- The liberalization of the trade and exchange rate regimes (Devaluation)
- Reduction of the budget deficit from 10.4% in 1990 to 5% of GDP in 1995 and reform of public enterprises.
- Reduction of inflation from 17.7% in 1990 to 10% in 1995.

- Reduction of the civil service by 25% and deregulation of the labor market
- Cutting of direct subsidies from Z\$629m in 1990/91 to Z\$40 million by 1995
- Establishment of a Social Dimensions Fund to deal with the social impact of ESAP
- The liberalization of the financial sector (GoZ, 1991; World Bank, 1992)

The above objectives were outlined in a government document entitled: Zimbabwe Framework for Economic Reform (1991-1995) and World Bank Policy Framework Paper (1992). During the first phase, lasting five years, progress was made in many of these objectives (Jenkins, 1997). However, urban poverty worsened due to the policy of labour market flexibility which saw incomes lagging behind the cost of living. Moreover, cost recovery policies compounded the plight of urban workers.

However, the reform program was hamstrung by the failure to make progress in the management of the budget deficit.

As already previously stated, the objective had been to reduce the deficit by 2% annually from 10.4% of GDP to a target of 5% of GDP by 1994/95. The deficit was to be reduced by a combination of additional revenue measures such as cost recovery and improved allocative efficiency, the postponement of capital spending, wage restraint, retrenchment and cuts in subsidies to parastatals (Jenkins, 1997). It is, however, strange that the IMF would advise the Zimbabwean government to cut capital spending, knowing very well that capital spending is a key enabler of growth. Moreover, it is doubtful whether cost recovery alone could improve revenue in the absence of sound revenue generating measures and improvement in revenue collection.

In order to cushion the vulnerable groups from the effects of adjustment, a Social Dimensions Fund was established and spending on education, health, social services and infrastructure was protected from expenditure rationalization.

Tax rates were lowered rather than raised because it was believed that the tax ratio of 34% of GDP was already too high. Progressive tariff reduction also reduced tax revenues. It was not clear where additional resources would come from, except from foreign borrowing (Jenkins, 1997).

Non-compliance with fiscal conditions stalled the implementation of the Second Economic Structural Adjustment Program (ESAP 11) because donors were not happy with the progress made on fiscal adjustment and parastatal reforms.

In effect, aid (IMF Stand-by Facility) provided under the first phase of ESAP simply allowed high public spending to continue while simultaneously increasing foreign debt and interest obligations. Zimbabwe's foreign debt rose from 45% of GDP in 1990 to 75% in 1994, before falling to 67% at the end of 1995 (Mabugu and Kowero, 2000).

Apart from Salaries and Wages and Subsidies to parastatals, government resources were absorbed in interest payments. Interest payments grew consistently. The average real annual growth of government spending on interest was 8.21% during the 1980s. At independence it was 7% of total expenditure. By 1990, interest payments were absorbing 16% of total expenditure (the equivalent of 6% of GDP), exceeding all departmental votes with the exception of education and defense (Jenkins, 1997).

In our view, government invariably abused and misused donor aid that was supposed to go towards ESAP programs. Rather, funds were diverted to fund discretionary expenditure. This reinforced the budget deficit, no wonder why the IMF had to discontinue the adjustment program. As the table below shows, the debt burden increased between 1990 and 1999. Government was caught in debt trap.

Table 22: Zimbabwe: Deficit financing (Z\$m)

Year	Bank	Non-Bank	Total Domestic	Net Foreign Borrowing	Total Financing
1990	58.9	877.3	936.2	201.5	1137.7
1991	140.3	1362.1	1502.4	94.3	1596.7
1992	208.1	1112.8	1320.9	388.4	1709.3
1993	416.7	862	1287.7	1365.8	2644.5
1994	1985.4	-209.1	1776.3	358.5	2134.8
1995	5153.3	360.5	4792.8	989.5	5791.6
1996	4111.6	139.1	3972.5	1174.9	5147.4
1997	5006	161.8	5167.8	-91	5076.8
1998	13553.6	-18.1	13535.5	-2908.2	10627.3
1999	24457.8	-631.9	23825.9	-4895	18930.9

Source: Reserve Bank of Zimbabwe, Monthly Review, Vol.8. No.8, August 2000

Note: Figures are in nominal terms.

According to the World Bank Development Report (1994), Zimbabwe dropped from a low middle income country into the low-income category during SAPS, suggesting an increase in poverty and a declining per capita income. Furthermore public spending continued to grow and this was largely on recurrent expenditure as opposed to productive investment.

In an evaluation of ESAP in Zimbabwe the IMF (1996) pointed out that government had lacked the commitment that was critical to the success of SAPS especially in regard to trade liberalisation, parastatal reform, exchange rate depreciation and most importantly fiscal consolidation. The evaluation concluded that the whole

program had failed because of lack of political commitment. Lack of political commitment was a term used to describe government unwillingness to reduce excess demand and the unsustainable fiscal deficit, which had far-reaching implications on economic performance.

The austerity plan was followed by enormous difficulties. Growth, employment, wages and social welfare contracted sharply, inflation was not reduced, the deficit remained well above target, and many industrial firms notably in textiles and footwear closed in response to increased competition and high real interest rates. The incidence of poverty in the country increased. ESAP was undermined by extremely unfavourable weather conditions. Drought reduced agricultural output, exports, public revenue and domestic demand for local manufactures. Growth during the drought affected years (1992, 1993, 1995) averaged 2.6% compared to the good years (1991, 1994 and 1996) when growth averaged 6.5%.

According to Davies (2005:20), "the government's failure to bring the fiscal deficit under control, undermined the effectiveness of those elements in the program that were followed through. This led to growth in public borrowing, sharp increase in interest rates and upward pressure on the exchange rate. The government's austerity plan coupled with a relatively weak and highly protected economy came far too quickly".

5.5.3 Implications for Macroeconomic Stability

The annual rate of inflation shot up from 15.5% in 1990 to 42% in 1992. The budget deficit grew from 8.4% in 1991 to 12.1% in 1995. According to the Reserve Bank of Zimbabwe (1996) the high budget deficit was due to rising government expenditure. Furthermore, extensive borrowing coupled with high interest rates in the 1990s resulted in serious debt problems. Outstanding debt

rose from 42% of GDP in 1990 to 70% in 1995. The debt service ratio which had been targeted to fall to 20% during SAPs instead averaged 28% of GDP (Ncube 1998). Between 1990 and 1998 government resorted to foreign and domestic borrowing to finance its fiscal expenditure. The following table shows the deteriorating debt position.

Table 23: Zimbabwe: Increase in public debt from 1991 to December 31 1998

Financial Year	Nominal Public Debt Z\$	Nominal increase in Public Debt Z\$	% Increase of Public Debt on 1989/90 Debt
1990/91	12 636 265 252	2 189 506 491	
1991/ 92	17 063 584 125	6 617 095 364	63.3
1992/93	21 824 135 687	11 377 376 926	108.9
1993/94	27 860 380 877	17 413 622 116	166.7
1994/95	37 137 925 573	26 691 166 812	255.5
1995/96	51 597 501 738	41 150 742 977	393.9
1996/97	57 545 478 726	47 098 719 965	451
1997/98	116 861 740 848	106 414 982 087	1019

Sources: 1. Comptroller and Auditor General reports (various)
2. Central Statistical Office (CSO) (various issues)

Government borrowing from the central bank rose from Z\$2 billion in 1990/91 to Z\$106 billion in 1997/98. This increased financial seigniorage and money supply growth thereby increasing inflationary pressures in the economy. Compared to a 3.9% average growth rate in the pre SAP era (1985-90), GDP grew by only 0.9% between 1991-95. By the end of 1995, the budget deficit remained high at 7.1 % of GDP.

During ESAP, social conditions had deteriorated rapidly. Employment grew by an average of 1.6 % per annum compared to 2.4% in 1985-99 while real wages declined by 9.9% compared to 1.2% in the period 1985-1990 (Ncube 1988). The removal of price controls and lifting of subsidies led to the escalation of prices of basic commodities. The Social Dimensions of Adjustment Fund

(SDF) failed because it was too small and moreover it became very difficult to target the vulnerable groups.

According to Jenkins (1997) the burden of adjustment was pushed to the monetary authorities. Moreover, the uncertainty caused by the growing public sector debt reduced private investment. The result was a further reduction in the growth rate.

Summary

Market based reforms failed to rein in the budget deficit. Economic structural adjustment dismally failed to achieve macro-economic and fiscal adjustment. In the absence of fiscal adjustment, it was clear that Zimbabwe was now treading on a dangerous economic path that was to graduate the economic crisis from a mild problem to a severe phenomenon in the coming years. The abdication of the IMF was the most regrettable development in Zimbabwe as it gave way to unbridled state bungling in the affairs of the economy. We therefore maintain that during the period of market based reforms, the lack of fiscal adjustment contributed to the macro-economic instability that followed. Our view is however, contradicted by Davies (2004: 10) who thinks that although ESAP had many faults, "the early 1990s saw some growth and by 1996 there appeared to be a possibility that by its own criteria –the program was bearing fruit"

5.6 Fiscal deficit and implications on macroeconomic performance during the period of failed controls (1997-2003)

In 1997, government abandoned the IMF-backed ESAP program and reverted back to a regime of controls. As Davies (2005: 13) points out, 1997 saw a reversal of some of the positive trends registered during and "marked the start of the current economic and political crisis. Many would date this from the collapse

of the Zimbabwe dollar on 14 November 1997. Numerous factors contributed to this, including the cumulative effects of the government's failure to tackle the budget deficit since the beginning of ESAP and the unbudgeted payments to war veterans. The latter indicated once and for all, government's unwillingness to exercise control over its expenditure in the face of demands and signaled the likely unraveling of ESAP" However, in our opinion, the success of ESAP should be looked at from the vantage point of the ESAP benchmarks. It is our humble view that ESAP failed to meet its set macro-economic targets. But in terms of structural changes we tend to agree with Davies that indeed the liberalization of the economy helped it to face competition.

After ESAP, Government launched the Zimbabwe Program for Economic and Social Transformation (ZIMPREST) which was dubbed a homegrown program to replace ESAP. However the program failed to achieve a 6% annual growth rate and the economy grew by an average of 3% while the budget deficit exceeded 5%. In the year 2000, government launched the Millennium Economic Recovery Programme (MERP) which also dismally failed because it was based on an inflationary assumption of 35%, when inflation turned out to be 60% for the year 2000 while growth plummeted to -4,5% as opposed to the projected 3.5%. The millennium budget which was supposed to buttress the MERP was also revised from an expenditure of Z\$98.7 billion (October 1999) to Z\$164.6 billion in August 2000 – an increase of 66.8 %. Revenue estimates were revised from \$87.2 billion in October 1999 to Z\$89.3 billion in August 2000 – an increase of 2.5%. This led to a huge increase in the budget deficit from Z\$11.5billion in October 1999 to Z\$75.3 billion in August 2000 (an increase of 55.4%)

The revised budget was necessitated by:

- A Z\$22 billion rise in wages and salaries following the 69% to 90% public service wage increases awarded in February 2000.
- A Z\$27.3 billion increase in domestic debt-service charges taking the total debt service bill to Z\$55.5 billion from Z\$28.2 billion in the original budget.
- The cost of the war in the DRC, estimated at Z\$412 billion as at December 2000.

By the late 1990s, it was apparent that the government was losing the war on the deficit. Deficit levels were becoming unsustainable. As table 5.14 shows, the deficit as a percentage of GDP grew from 8.0% in 1986 to 12.7% in 1995 and reached 24.1% in 2000.

Table 24: Zimbabwe: Deficit (1986-2000) as % of GDP

Year	Deficit as % of GDP
1986	8.0
1987	10.2
1988	8.0
1989	7.6
1990	6.4
1991	7.0
1992	6.7
1993	8.9
1994	6.1
1995	12.7
1996	10.4
1997	5.9
1998	6.0
1999	9.9
2000	24.1

Source: Budget Statements (GOZ)

Political Expediency

Besides the lack of fiscal discipline and poor policies, other ad hoc policy decisions and actions by government worsened macro-

economic performance in Zimbabwe. *For Example* – the rewarding of unbudgeted gratuities to war veterans in 1997.

After waging running battles with the veterans of the 1970s war of independence, government finally succumbed to the demands of the former freedom fighters for monetary and material recognition for their war effort. By then war, veterans under the leadership of Chenjerai Hunzvi (Ex-Zipra cadre) staged nationwide demonstrations to press for recognition. At one stage in 1997, the war veterans embarrassed President Mugabe when they booed him while officiating at the Heroes Day Celebrations at the Heroes Acre in Harare. After that, war veterans marched to State House to demand gratuities.

Government responded by awarding Z\$50 000 gratuity to each former freedom fighter. In addition, government unveiled a package that included pension, medical and housing facilities for the war veterans and their families. Inflation rose from 15% to 40%. Government paid the gratuities which were not budgeted in the first place. This put severe pressure on the budget, thereby worsening the budget deficit.

Worsening Central Government Accounts

The deficit in both monetary and percentage terms was just unsustainable and as already pointed out this was caused by expansionary fiscal policies and loose monetary policies which were designed to cope with the government's insatiable appetite to spend.

In the year 2000, government continued with its failed controls. The Zimbabwean economy entered a phase of unprecedented economic meltdown, which was sparked by the land reform program. In fact, the extent of economic meltdown after 2000 even exceeded the decline usually experienced by war economies. To make matters worse, the parliamentary elections of 2000 and the presidential elections of 2002, further worsened the economic situation as the international community lost confidence in Zimbabwe due to the lack of credibility of the two elections. Zimbabwe withdrew from the Commonwealth. Donors withdrew funding and lines of credit. Government digged-in and introduced price controls and foreign exchange controls. The economy registered successive negative growth rates from 2000, 2001, 2002, 2003 and beyond.

The fiscal deficit grew from Z\$74billion in 2000 to Z\$2.4 trillion in 2003. Government had to rely on supplementary budgets and borrowing to sustain its high appetite to spend. In fact, due to hyperinflation, Zimbabwean computers failed to capture the many zeros as budgets were denominated in trillions. As a result on 1st August 2006, the Central Bank introduced newly re-denominated currencies by removing three (3) zeros.

Fiscal policy was characterized by increased financing requirements for government. Given the slow pace of privatization, and reduced foreign inflows, government financing was wholly met from bank sources (Reserve Bank, 2000). This contributed to sharp money supply growth (which increased from under 30% in 1999 to 500% in 2003) and high inflation. High money supply growth was largely unrelated to economic activity and therefore had adverse effects on inflation, and on cost of borrowing, incomes and overall production. Money supply growth during this period was underpinned by domestic credit expansion of 61.5%, against the

background of high public sector borrowing requirements (Reserve Bank of Zimbabwe, Annual Report 2005). According to the Reserve Bank, these very large public sector borrowings exerted upward pressure on interest rates and starved the rest of the economy of needed finance. This is consistent with the crowding out effect of budget deficits enunciated by economic theory.

External debt stood at US\$4.5 billion (public and publicly guaranteed external debt). The external debt to GDP ratio in 2000 reached 68%, well above the critical benchmark of 50%, thereby precipitating a serious debt trap. Social expenditures were also increased beyond sustainable levels.

Government expenditure ballooned after 2000. There was a huge jump (80% annual increase) in Health, Education, Defense and Home Affairs Expenditures between 2000 and 2003. This allocation of the budget towards recurrent expenditure worsened the deficit. In order to cover the funding gap, government heavily borrowed from the domestic market and printed money to meet its obligations.

Summary

During the period of failed controls (or revisionism), the budget deficit increased due to the interest burden. The early impact of hyperinflation was already felt as shown by the high nominal budget revenue and expenditure figures typical of a hyperinflationary economy. It became evident that due to failed control policies, the economy's capacity to grow was limited. In the absence of a new economic trajectory, the economy started to go on a free fall, especially after 2000. The drying up of external loans, meant that government over-dependended on the domestic budget which became incrementally characterized by a growing funding gap. The non-performance of the "vote of credit" in the budget did not help the situation. Controls harmed the economy and reinforced structural rigidities and further distortions, making it very difficult for the economy to grow. Moreover, the land reform program of 2000 also contributed to the ensuing economic meltdown as it decimated the viability of the agricultural sector, the main backbone of the economy. In summary, the period of failed controls was marked by a " broad contour of events: the engagements in the DRC that started in 1998, the further deterioration of the economy, the rejected constitution in 2000, the immediately subsequent land invasions and their evolution into the fast track land reform program and the rise of the MDC as a serious opposition", Davies (2005:14). On the back of high and unsustainable deficits, the macro-economic situation deteriorated fast before the economic entered into the phase of chaos, which is the subject of the next discussion.

5.7 Fiscal deficit and implications on macro-economic performance during the period of political chaos (2004-2008)

The period 2004 and beyond was underpinned by political turmoil, corruption, capital flight, economic mismanagement, and economic plunder that was triggered by the Reserve Bank's Quasi Fiscal Operations, which were introduced in December 2003. This became the major cause of macro-economic and fiscal instability (Hanke, 2008). The period, 2004-2008, was the most chaotic period in the history of Zimbabwe. Everything that happened during this period, defied all logic, whether economic or political. The application of economics was redefined and was replaced by voodoo economics or for lack of a better word – bush economics. Zimbabwe became a fragile state and indeed, a banana republic. The state as a functional institution virtually collapsed and became insolvent. Therefore, the reserve bank morphed into an executive decision - making institution and thereby abandoned its core functions in monetary policy. Of course, this happened with the tacit approval of President Mugabe and his powerless cabinet. During this chaotic and shambolic period, the reserve bank usurped the mandate and fiduciary functions of Cabinet and arrogated unto itself all the powers of the executive. In this regard, Zimbabwe became a state without cabinet. This was the de facto position. To call it a fragile state is to underestimate the extent of collapse. In our view, Zimbabwe became a failed state. Other countries which have been described by the IMF and World Bank as failed states include Somalia, Afghanistan, Iraq, Ivory Coast and others. But the distinction here is that these states were fighting raging wars. But for Zimbabwe, whose conflict was a political one, to join the category of failed states, was an indictment on the governance of the country. A country with potential wealth in the form of its agricultural base, mineral deposits, including diamond and platinum

reserves, became a basket case. Therefore, the policies and events that occurred during the period of chaos, transcends technical analysis as it requires political economy analysis in order to fully comprehend it. This approach answers the call for the qualitative approach set out in the methodology section of this study. The economic analysis of the budget deficit as happened in previous chapters, cannot explain the total collapse of the economy during the period of chaos. We have to look at other political economy issues that were at play beyond the budget deficit. In fact during the period of political chaos, the effect of governance on the economy overshadowed the economic impact of the deficit itself. In many ways it became a chicken and egg situation. Notwithstanding this, however, we hereby start with budgetary developments during the period of political chaos.

As confirmed by the IMF in their Article IV Consultation Report, published in December 2003, the IMF Executive Board acknowledged the centrality of the large fiscal deficit in "the growing internal and external disequilibria in Zimbabwe" (page 1).

Furthermore, since 2004, the IMF noted that the economic crisis had deepened due to the continued deterioration in the political situation. Negative growth rates were exacerbated by the decimation of the agricultural sector whose output declined by 60% between 2004 and 2005). This meant a reduction in the revenue base, in real terms. The manufacturing sector declined by over 15% due to the poor macro-economic environment, especially the dearth of international credit lines. According to the Reserve Bank (2005), poor performance was due to cumulative effects of high inflation and rising production costs, as well as increased competition from finished imported products. Shortages of foreign exchange also exacerbated the situation. Major declines were experienced in other sectors: transport (-31.2%), wood and furniture (-19.4%), clothing

(-19.2%), non-metallic products (-16.4%). mining declined overall by 14% (Reserve Bank of Zimbabwe, 2005).

Hyperinflation

After 2004, Zimbabwe entered an unprecedented phase of hyperinflation. Hyperinflation is defined as a rate of inflation above 50% per month (Hanke 2008:1). In the history of hyperinflation (excluding Latin America) most of the countries that experienced hyperinflation had earlier on went through wars, for example Germany, Yugoslavia and Italy, after the first World War. But even then, their inflation never went as far as the hyperinflation experienced in Zimbabwe, a country not at war.

The causes are arguably various – ranging from the printing of money and increase in money supply and high food prices. In addition, the macroeconomic distortions caused by poor policies, economic meltdown and international isolation triggered the collapse of the Zimbabwe dollar. In 2005, Zimbabwe removed three zeros from the currency but that even fuelled more inflation. In early 2008, Zimbabwe again introduced further currency reforms that saw the decapitation of six zeros from the currency in order to move away from trillions and quad trillions.

For someone who has not lived under a hyperinflationary economy, it is beyond imagination to talk of quad trillions, quintillions, sextillions and all that. For most economies, a double digit inflation figure is bad enough. For that reason, We thought of giving a graphical insight to demonstrate what we are discussing in a manner that gives a vivid picture. The Zimbabwean dollar reached quintillion levels before the Reserve Bank introduced multiple currencies in November 2008 when the dollarization of the economy started in earnest. In fact because of the recurrence of the zeros soon after decapitation, statistical agencies abandoned the

publication of Central Statistical Office data in September 2007. Such was the impact of hyperinflation in Zimbabwe.

Table 25: Illustration of Hyperinflation

Name	Number of Zeros
Million	6 (000 000)
Billion	9 (000 000 000)
Trillion	12 (000 000 000 000)
Quadrillion	15 (000 000 000 000 000)
Quintillion	18 (000 000 000 000 000 000)
Sextillion	21 (000 000 000 000 000 000 000)
Septillion	24 (000 000 000 000 000 000 000 000)
Octillion	27 (000 000 000 000 000 000 000 000 000)
Nonillion	30 (000 000 000 000 000 000 000 000 000 000)
Decillion	33 (000 000 000 000 000 000 000 000 000 000 000)

Source: Zimbabwe Herald, Thursday, 13 November, 2008)

Zimbabwe's inflation sharply accelerated after 2004 with the appointment of a new Reserve Bank governor who resorted to the printing of money in order to finance credit to government and the private sector. The Reserve Bank played a more significant role because the state was broke and the economy had collapsed by normal standards. Quasi fiscal activities fuelled hyperinflation. Moreover, the controlled fixed exchange rate regime created a thriving black market for foreign currency (Hanke, 2008). Fuel shortages and shortage of the Zimbabwe dollar further triggered hyperinflation (Robinson, 2008). The result was that prices in shops started increasing monthly, weekly, daily and then hourly (Confederation of Zimbabwe Industries, 2008).

The national payments system also fuelled inflation, especially the Real Time Gross Settlement System (RTGS) which enabled the electronic transfer of funds between accounts. Dealers sold US\$ on the black market and using the RTGS, transferred Zimbabwe dollars into their clients' accounts at highly inflated parallel market rates. This created high aggregate demand at a time when the economy's capacity to produce goods was limited.

Table 26: Hyperinflation in Zimbabwe (% change in CPI, 2000 – 2008)

Month	2000	2001	2002	2003	2004	2005	2006	2007	2008
January	55.90	57.00	116.70	208.10	622.80	133.60	613.20	1593.60	100580.20
February	48.90	57.70	116.30	220.90	602.50	127.20	782.00	1729.90	165000.00
March	50.80	55.80	113.30	228.00	583.00	123.70	913.00	2200.20	406000.00
April	53.70	56.90	114.00	269.20	505.00	129.10	1092.00	3713.90	500300.00
May	58.70	55.50	122.50	300.10	448.80	144.40	1193.50	4530.00	2200000.00
June	59.30	64.40	114.00	364.50	394.60	164.30	1184.60	7251.10	11200000.00
July	53.40	70.10	123.50	399.50	399.50	254.80	993.60	7634.80	251000000.00
August	53.60	76.10	135.10	426.60	426.60	265.10	1204.60	6592.80	n.a
September	62.00	86.30	139.90	455.60	455.60	359.80	1023.30	7892.10	n.a
October	60.80	97.90	144.20	525.80	525.80	411.00	1070.00	14840.00	n.a
November	56.00	103.80	175.50	619.50	619.50	502.40	1098.80	26470.80	n.a
December	55.20	112.10	198.90	598.70	598.70	585.70	1281.10	66212.30	n.a

Source: Reserve Bank Quarterly Statistical Bulletins (various issues)

Notes: n.a (not available)

5.7.1 Acceleration of the budget deficit: quasi-fiscal operations during the era of political chaos (2004 – 2006)

The period saw Zimbabwe adopting the so-called “Look East Policy” arguing that “The Chinese economy, which is now the envy of many today, growing at 9% per annum, has progressed through various stages of growth and development, overcoming challenges and setbacks of one form or another, using homegrown programs...” (RBZ Monetary Policy Statement 2003: 121).

In his maiden Monetary Statement of December 2003, Dr Gono vowed that “failure was not an option”. He pointed out that, “my five year of term office as Governor, begins at a time when Zimbabwe is facing a host of challenges without precedent in its short history” (RBZ Monetary Policy Statement, December 2003, p. 1). *These challenges mainly related to the growing budget deficit in the wake of hyperinflation, growing international isolation and lack of foreign capital inflows which was slowly bringing the economy to its knees.*

On Inflation, the new Governor said, “inflation remains our number one enemy.” When Dr Gideon Gono took over the governorship of the Reserve Bank of Zimbabwe in 2003, inflation

rose from 55.6% in 2000 to 365% in 2003. Money supply growth on the other hand stood at 500% in 2003. A dual interest rate system was introduced for productive sectors and non-productive sectors in order to stimulate the supply response. The Reserve Bank introduced the so-called productive sector support concessionary finance at very low interest rates of 50% per annum when commercial lending rates were over 800%. The result was disastrous. Companies accessed cheap funds and invested on speculative activities, not production. This had a major impact on interest rates, money supply and inflation despite the fear that Dr Gono had at the onset expressed thus , "monetary authorities recognize the negative inflationary impact that could arise from utilization of concessionary resources priced at below inflation levels" (RBZ Monetary Policy Statement 2003: 10).

At this stage, the Reserve Bank tried to exonerate government: "government has had its own part to play in our inflation misery, but it is not entirely to blame" (RBZ Monetary Policy Statement, 2003:14)

On the fiscal front, the Reserve Bank, observed that: "the rate of inflation is a function of government deficit and how that deficit is to be financed." On the intention of government to borrow Z\$1.9 trillion in its 2004 budget, Dr Gono had this to say, " monetary authorities recognize the inflationary impact this is likely to have unless government sticks to its commitments to reduce expenditure by line ministries through improved cash management and enforcement of discipline" (RBZ Monetary Policy Statement 2003:13).

The Bank said that it would work closely with government to ensure that most of the borrowing requirements are funded from non-bank sources adding that, "this will reduce pressure on money

supply (M3) growth" (p14). The Bank also promised to comply with the Finance Minister's directive to dishonour parastatal cheques, if they were outside approved limits. However, fiscal policy remained expansionary. The budget deficit rose to 130.4% of GDP in the first half of 2004. The current account deficit rose to 6% of GDP.

On the exchange rate, the Reserve Bank, following the Zambian model, introduced a foreign currency auction system of bids. Under this system, foreign exchange was auctioned through a currency exchange – an independent body that operated under the supervision of the Reserve Bank. The foreign exchange auction system failed dismally and had to be abandoned after it proved unworkable. The Reserve Bank would reject 90% of the bids and in the end, companies failed to secure the foreign exchange they so much needed for imports.

Between 2004 and 2007, the Reserve Bank played a central role in the economic policy direction of the country. The battery of measures and policies put in place during this period hastened rather than slow down the economic meltdown as inflation became endemic and the economy registered negative growth rates on the back of high government expenditure. As the UNDP (2008:12) noted, "the resultant high inflation has reduced aggregate domestic demand, crowded out the private sector and brought the disarticulation of the economy and the collapse of real productive investment"

In 2004, money supply growth was reduced to 490.9% on the back of government's maintenance of a positive cash balance on the Reserve Bank account, which "played a significant role in reducing monetary expansion" (p34). Hyperinflation also fell from its peak of 622.8% in January 2004 to 251.5% in September 2004. In this regard, the Reserve Bank was quick to point out that "it is critical

that the fiscal side remains vigilant to consolidate the disinflation gains made so far. This should be bolstered through containment of expenditure levels; avoidance of supplementary budgets; avoiding of unplanned benevolent or gratuity payments that are unrelated to current production activities or real economic growth.” (Monetary Policy Statement, October 2004: 44)

Despite these measures, GDP declined by -5% in 2004. Agriculture, the backbone of the economy contributing about 16.5% of total output and a third of total foreign exchange earnings, declined by -3.3%. The Manufacturing sector which accounts for around 18% of GDP and about 33% of foreign exchange earnings, declined by -8.5% in 2004.

Table 27: Sectoral allocation of productive sector facility (Z\$billion) by the Reserve Bank (quasi-fiscal operations)

Sector	Loan Amount	Percentage of Total
Agriculture	893.1	43.4
Manufacturing	831.7	40.4
Mining	143.8	7.0
Transport	74.7	3.6
Tourism	68.5	3.3
Construction	15.3	0.8
Distribution	15.0	0.7
Communication	12.0	0.6
Health	3.4	0.2
Total	2 057.5	100.0

Source: RBZ Monetary Policy Statement, October 2004, p95.

Concessionary lending was also extended to loss making parastatals, without carrying out due diligence analysis. These quasi-fiscal operations proved to be dangerous to fiscal consolidation.

In 2005, the Reserve Bank identified, among others, the following “inflation drivers” – “corruption in its various forms and outlooks, lack of accountability in both public, parastatals, local

authorities and private sectors" (Monetary Policy Statement, May 2005, p.5). After a downward trend in 2004, inflation resurged from 123% in March 2005 to 129% in April. Money supply had declined to 177.6% by January 2005. In December 2005, inflation closed the year at 585.8% which the Reserve Bank attributed to, "quasi-fiscal operations of the central bank which fuelled money supply growth, the fiscal side of the inflation coin arising from the drought considerations in particular, international oil prices, parallel market activities as well as the general indiscipline in the economy" (p18) However, the year 2005 was marred by the increase in public spending in the Parliamentary elections which took place as well as the prevalence of parallel market rates and perennial shortage of fuel. As a result the economy continued to melt down.

In 2006 it was clear that Dr Gono's turnaround programmes were failing. Dr Gono said, "in order to burst the inflation bubble, that is threatening to reverse the gains made over the past 24 months, there is need for a comprehensive, holistic framework that significantly reduces money supply, align fiscal expenditures to budgeted levels..." (Monetary Policy Statement, January 2006: 21). Broad money supply (M3) had been on an upward trend from 177.6% in January 2005 to 411.5% in November 2005. The Reserve Bank tried to shift the blame by arguing that, "while agreeing that high money supply growth arising from both ASPEF and other quasi-fiscal operations of the central bank contributed greatly to the inflation out-turn, it has to be appreciated by all stakeholders that Zimbabwe is not an economy operating under normal conditions. The country has been under international siege now for over 5 years arising from a multiplicity of factors, principal of which is the land reform program. Accordingly, with no balance of payments support for almost 9 years, no or little capital stock formation, maintenance and replacement, some of the critical

infrastructure, especially in parastatals and local authorities, needed and still require revitalization if the same parastatals are to play an effective role in the turnaround of the economy. To this end, as has been demonstrated with agricultural financing which had collapsed, the central bank could not fold its hands and allow these critical assets to go to waste, hence the expenditure outlay. In turnarounds, extraordinary situations demand extra ordinary responses, sometimes unorthodox in their character in order to survive. We chose simply to survive in 2005 and in 2006 we will begin to correct the side-effects of preserving our survival kit. Theory does not apply in survival situations but practical approaches do" (pp24-25).

Clearly this was an excuse by the central bank to continue its quasi-fiscal operations, which however, pushed up money supply growth and triggered unprecedented hyperinflation in the ensuing years.

In fact in 2006, the Reserve Bank went on to print Z\$21trillion to encash on the parallel market to get foreign currency to service IMF arrears. President Mugabe publicly defended the printing of money arguing that "you don't eat textbook economics", (Herald, Sunday 20/08/2006).

In 2006, Dr Gono warned that inflation control had to move from being a walk over the edge of the cliff by the "collective avoidance of precipitous acts of exuberance on the fiscal side" (p.25). This shows the extent to which public expenditure was feared to negatively impact on macro-economic stability in Zimbabwe especially after 2003. Parastatals continued to be heavily subsidized by Reserve Bank funds with no turnaround strategy. This prompted the Governor to aptly describe parastatals "as the missing link in the turnaround efforts" of the Reserve Bank.

In April 2006, inflation increased from 1042.9% to 1193% in May due to high money supply growth and benchmarking of prices on the parallel market exchange rate. M3 growth increased from 528.2% in February 2006 to 669.9% in May 2006. These high levels of monetary expansion “reflected the inevitable interventions that the central bank is having to do in the economy to prevent further deterioration of infrastructure...” (p25).

Thus, for example, the increase in broad money supply in May 2006 was underpinned by expansion in domestic credit of 629.3%, driven by:

- Credit to government, which grew by 927.5% (mainly through treasury bills to finance inescapable government expenditure).
- Credit to the private sector, 455%
- Claims on public enterprises, 635.5%.

In his First Half Year 2006 Monetary Policy Review Statement (July 2006), Dr Gono surprised his audience when he announced that, “from Monday 21 August 2006, all current bearer cheques and other forms of old currency will become obsolete and valueless” (p31), Thus the Zimbabwe currency was redenominated by the removal of three zeros in an exercise code named “Operation Sunrise – From Zero to Hero”. Only 21 days of changeover were given. The Reserve Bank mobilized state machinery to enforce compliance. Redenomination meant that the Reserve Bank had finally capitulated to the number one enemy – inflation – and nobody ever talked of “failure is not an option”. It appears failure had become the only option.

Government domestic debt rose from Z\$11.7 trillion in June 2005 to Z\$50 trillion in July 2006 (327% increase) while external debt stood at US\$6 billion, of which US\$2 billion were external arrears.

The Reserve Bank called upon government to exercise fiscal restraint, “fiscal expenditures have to be streamlined to be in line with the economy’s revenue generative capacity. Monetary financing of the fiscal budget directly or indirectly through quasi fiscal outlays at the Reserve Bank is a boon for high inflation. We implore all ministries to stick to the resource allocation votes. It is imperative that we work to entrench a strong culture of fiscal discipline. Such a reflective mode allows us to clear our lenses so as to elevate the national budget and its implementation as a powerful tool to direct and influence the country’s economic growth and developmental programs” (Reserve Bank of Zimbabwe Monetary Policy Statement, 2005:47).

With the deficit standing at 4.6% of GDP (Z\$13.9 trillion) in 2006, the Central Bank went further to recommend the following fiscal consolidation measures:

- Measures that ramp up revenue collection efficiencies and closure of evasion loop holes
- Notable greater weight on capital formation, supported by belt tightening on recurrent outlays.
- A steadfast commitment at ensuring that real expenditure levels in key social sectors such as health and education are defended and grown over time.
- Realistic revenue expenditure targets are set in a manner that recognizes the extraordinary circumstances confronting the nation. Through this realism, scope will be created to allow the fiscal side to take on board some of the inflationary quasi fiscal outlay being inevitably discharged through the Reserve Bank as a second best survival intervention (Reserve Bank of Zimbabwe Monetary Policy Statement, 2005:47).

On public enterprises, the Minister of Finance commented that, "the debt stock of major parastatals as at June 2006, stood at Z\$76.43 trillion. As a result parastatals are failing to service their debts, often calling on government to assume their obligations" (Mid Term Fiscal policy Review, July 2006, p 14). At the same time interest payments on debt amounted to Z\$8.8 Trillion by July 2006.

By the end of 2006, Quasi fiscal operations outlays stood as follows:

- Agricultural Sector Productivity and Enhancement Facility (Z\$19.54 trillion)
- Parastatals Reorientation Programme (Z\$6 trillion)
- Distressed Companies Fund (Z\$200 billion)
- Local Authority Re-Orientation Programme (Z\$300 billion)
- Productive Sector Facility (Z\$6.3 trillion)
- Loans to Government Departments (Z\$7.7 billion)
- Troubled Banks (Z\$3.2 Billion)

In his National Budget Statement presented to the Parliament Of Zimbabwe on Thursday, 30 November, 2006, the Minister of Finance fired a broadside at the Reserve Bank and attacked the Governor's Quasi Fiscal Operations, "Mr Speaker Sir, Inflation remains one of the major challenges facing our economy. Year-on-year inflation rose from 613.2% in January 2006, to reach a peak of 1204.6% in August. Some of the major drivers of inflation remain – the impact of public sector borrowing requirements for budgetary financing; Quasi Fiscal activities funded through the Reserve Bank..." (p19).

The Finance Minister announced that, "In this regard, combating inflation will require the phasing out of all quasi fiscal operations and adequately providing resources for prioritized expenditures within the budget. Hence consistent with our

Constitution and the Audit and Exchequer Act, beginning 2007, all such and any other additional public expenditures will be strictly and adequately reflected through the budgetary process” (p 19).

The Minister announced that Quasi fiscal expenditures included, the budget deficit would stand at 43% of GDP, excluding interest, “such a high budget deficit underpins the very high money supply growth rates of over 1000% and the hyperinflation this nation continues to experience” (p33). In this regard the Minister set aside Z\$100 billion towards the phased amortization of quasi fiscal operations.

This was an open admission that all quasi fiscal operations were being done outside the authority of parliament, which was clearly unconstitutional.

In the absence of external funding, arrears continued to accumulate to reach US\$2.1billion in 2004 or 44% of external debt. Arrears to the fund totaled SDR 197 million as at end of April 2004. Zimbabwe has been in continuous arrears to the Fund since February 2001 and following a decision by the Executive Board on 3 December 2003, the Managing Director issued a complaint on February 6, 2004 that initiated the procedure on Zimbabwe’s compulsory withdrawal from the Fund.

5.7.2 Impact of bad governance and political blunders on Zimbabwe’s economy

In the previous section, this paper discussed the interventions made by the Reserve Bank of Zimbabwe to bridge the budgetary gap. We also saw how quasi-fiscal operations worsened the budget deficit and spurred hyperinflation as well as causing macroeconomic instability. However, economic reasons alone cannot explain the unprecedented economic collapse in Zimbabwe, during the third post independence decade which began in 2000.

The inclusion of governance issues, brings a new dimension in the understanding of the inter-relation between politics and economics and how this greatly affected economic growth and stability in Zimbabwe.

The following section examines the extent to which other factors besides fiscal expenditures contributed to the worsening of the Zimbabwean economy. These factors include the land reform program, the Democratic Republic of Congo War, Corruption and of course the overall governance of the country.

The Land Reform

In their 2004/2005 Article IV Consultations, the IMF pointed out that “the disorderly implementation of the land reform program has contributed to a sharp reduction in agricultural production. Concerns about governance, the rule of law and human rights, and the continued lack of clarity about property rights have severely damaged confidence, discouraged investment, and promoted capital flight and emigration, thus contributing to the economic decline” (p.4).

Despite criticisms directed at the land reform, other scholars like Moyo et al, (2002) argue that the land reform was necessary to correct the historical imbalances which were created by the colonial administration. During the colonial era and until 2000, about 4500 white farmers occupied 85% of arable land with rich soils leaving the blacks who constituted 95% of the population to settle in semi-arid and barren tribal trust lands.

Moreover, in terms of the policy of black economic empowerment, land reform was seen as a vital tool to enable blacks to enter into mainstream economic activities (GoZ, 2000). Furthermore, government justified its land reform program on the

basis that the British had reneged on their promise to advance funds to the new Zimbabwe government to enable it to acquire land on a willing buyer, willing seller subject to compensation. Government also considered land reform as a key plank in the fight against poverty, hence the thrust of farm mechanization program and the heavy deployment of resources and inputs to new farmers.

Corruption

Corruption in any society is a serious scourge. Corruption leads to the sub-optimal and inefficient use of resources because of rent-seeking activities, overpricing and misallocation of resources. In macro-economic terms, corruption bleeds the economy. Unfortunately, most cases of corruption are never brought to book because they assume the white-collar form which is difficult to prove. In the late 1990s, corruption in Zimbabwe began to rear its ugly head. In 1989, government lost billions of Zimbabwe dollars in tax revenue in the infamous Willowgate Scandal. Willowvale Industry is the major manufacturer and assembler of MAZDA motor-vehicle kits in Zimbabwe. In 1989, the Chronicle newspaper unearthed a corruption scandal involving government ministers and public officials, whereby Toyota Cressida models were bought for a song and resold at high black market prices. President Mugabe set up a Commission of Enquiry chaired by High Court Judge, Justice Sandura. The findings of the Sandura Commission were horrendous – massive corruption. As a result, Enos Nkala, the then Home Affairs Minister was forced to resign and Maurice Nyagumbo, the then Senior Minister for Political affairs, committed suicide. The Willowgate scandal involved millions of Zimbabwe dollars. Later on, another Sandura 2 Commission on Willowvale was set up but this time, results were never made public.

Other cases of corruption which hit the headlines in the Zimbabwe press included, the export and re-importation of grain by the Grain Marketing Board, a government parastatal. This case led to the arrest of Kumbirai Kangai, who was a senior cabinet minister in charge of agriculture. The case of Wiridzai Nguruve and Augustine Chihuri – both Commissioners of Police – also demonstrated the pervasiveness of corruption in Zimbabwe. In the early 1990s, high profile cases of corruption involving senior public officials were suppressed. This had to do with the self allocation of government built villas, houses and apartments.

In 2003, Parliament passed the Anti-Corruption Act. In 2005 President Mugabe established a fully fledged Ministry called Anti-Corruption and Anti-Monopolies Ministry headed by Paul Mangwana, a lawyer. Critics have however, chided the anti-corruption drive arguing that the swoop was selective and politically motivated. For example, the arrest of the Minister of Finance, Dr Chris Kuruneru, in 2005 for alleged externalization of US\$40million when he built a villa in Cape Town's Constantia suburb was thought to be politically motivated as he was eventually not found guilty by the courts.

Similar controversial cases of arrests took place after 2003, when the Reserve Bank Governor went on a crusade to punish the so-called offenders in the banking and financial sectors. A number of Chief Executive Officers of major banks fled the country, for instance National Merchant Bank, Barbican and Metropolitan Bank. Others who fled the country include business mogul, James Makamba, who had a majority shareholding in Telecel Zimbabwe. He was being charged for externalization. A number of companies were arrested for externalization and were prosecuted. But most of these people fled from the absence of due process rather than from the crimes allegedly committed. Government passed legislation

which allowed the state to re-arrest and re-detain a person even after courts would have granted bail.

However, government argued that it was trying to get rid of corruption and was fighting corruption without fear or favour. The enactment of the Anti-Corruption Act was thought to be enough testimony to government's seriousness.

The point is that public resources were misused and furthermore, government committed further expenditures to try and investigate corruption cases but all these efforts did not yield any notable success.

Military Intervention in the Congo

Foreign currency reserves are the backbone of a robust economy. The general international practice on currency reserves is to aim to have at least three months of import cover. Adequate reserves act as a buffer against currency depreciation and strengthen the balance of payments position (Levacic, 1991). Zimbabwe's involvement in the Congo war led to the running down of its foreign currency reserves (Melber, 2002).

Zimbabwe's military intrusion into the fighting in the Congo-Kinshasa began in August 1998, but was pre-figured in 1996 when President Mugabe allegedly "donated" US\$5million to Laurent Kabila to finance his rebellion against Mobutu (Melber, 2002).

It is on record that the Zimbabwe Defense Industries (ZDI), a state owned firm, run by retired officers, arranged to supply Kabila's forces with food, uniforms and weaponry, in a deal estimated worth US\$53 million. The war was very costly for the Zimbabwean people and deeply unpopular as it failed to be self financing. All payments had to be done in foreign currency.

According to Melber (2002) initially 6000 troops supported by Hawk and MiG 21 fighter planes and armed helicopters were dispatched in August 1998. By October, 2000 more soldiers were sent. This decision was made by President Mugabe and his Joint Operation Command (JOC), without parliamentary or cabinet approval.

Many lives were lost. By the end of 1998, it was revealed that 164 soldiers had been killed and 434 seriously injured in Congo. Considerable equipment had been lost, including an Allouette 3 helicopter gunship, a MiG fighter, and Brazilian-made Cascavek tanks and armoured personnel carriers. The budget for the defense ministry had been set at US\$9 million for the next year. The Zimbabwean government repeatedly denied that the Zimbabwean military was in Congo for profit: "You don't go where people lose lives just because you want to make a few dollars. But as a result of our presence, a number of Zimbabwe businessmen are taking advantage of the goodwill there. If they don't, others will", argued the Minister of Defense (Melber, 2002: 18).

Authorities grossly understated the cost of the Congo operations, assuring the IMF that their spending was around US\$3 million a month, when the actual expenditure through 1999 —on an internal Finance Ministry memorandum — was US\$27.7 million monthly (Melber, 2002)

The DRC war strained public finances, leading to the further increase of the twin deficits – the budget deficit and the external deficit.

Despite the negative economic implications of the war, the Government justified the intervention in terms of a mandate of the SADC organ on Politics, Defense and Security. Most SADC countries for financial and economic reasons reneged on the SADC resolution

of 2007. In the end, only three SADC countries ended up participating. These were Zimbabwe, Angola and Namibia. These countries raised strong justifications for going into the DRC. Chief among those reasons was the defense of the sovereignty and legitimacy of the DRC government which had been invaded by Rwanda and Uganda.

The Congo war was unbudgeted and it led to the severe bleeding of the Zimbabwean economy. However, government justified its intervention allegedly on the basis of a SADC resolution made in 2007 that urged SADC to send troops to the DRC. Government argued that other SADC countries had chickened out and left Namibia, Angola to sent troops.

The Securitization of the State

In many African countries, budgets are overrun due to heavy defense and security expenditures. In Southern Africa, Zimbabwe and Angola are examples of countries which have maintained high defense and security budgets. In the case of Zimbabwe, since independence in 1980, it faced security threats from the then Apartheid South Africa as well as economic threats on the Beira Oil Pipeline from Renamo in Mozambique.

But even well after the security threats had gone, President Mugabe continued to increase the defense and security forces budget.

President Mugabe created a team of securocrats who ran the country using repressive pieces of legislation such as Public Order and Security Act (POSA) and the Access to Information and Public Protection Act (AIPPA). Most public enterprises are run by retired military officers. The economy eventually was run by a National Security Council and the Reserve Bank, while cabinet had been

sidelined. Commercial farming was now done by the army under Operation Maguta. In fact, the country, since 2002, has been run through Operations.

Linked to the securitization of the state, a system of patronage was introduced. Traditional Chiefs were put under full monthly payments plus a motor vehicle and an electrified rural home. These arrangements based on patronage proved costly to the fiscus and actually worsened the budget.

However government justified the securitization on the basis of threats to the security of the state especially from the Movement of Democratic Change (MDC) and the Western powers, Britain in particular.

Operation Murambatsvina (Clean-UP)

In May 2005, President Mugabe destroyed all informal structures in urban areas, leaving more than 2 million people either destitute or homeless. The program was abruptly put to an end when it was roundly condemned by the United Nations envoy, Anna, Kajumolo-Tbaijuka. In fact the UN called for those who had orchestrated the program to be brought to book and tried of crimes against humanity.

This exercise was unbudgeted and proved costly too. Government justified the operation and argued that it was necessary to combat urban illicit activities and improve town planning.

The above sums up the fiscal and political crisis that engulfed Zimbabwe. What started as a simmering deficit in the 1980s later developed into a monster which paralyzed the delivery of service by the government, across all sectors of the economy.

All these were signs or symptoms of economic collapse whose roots had started in the 1980s, worsened in the 1990s and led to economic meltdown in the 2000s.

Future Prospects

After nearly 10 years of political conflict, the three major parties, namely ZANU PF, Movement for Democratic Change led by Morgan Tsvangirai and a breakaway faction led by Professor Arthur Mutambara signed a SADC brokered Global Political Agreement (GPA) on the 15th September 2008. The Agreement led to the formation of an inclusive government on the 13th February 2009.

Since the formation of the inclusive government in February 2009, the economy is slowly stabilizing. The Inclusive government demonetized the Zimbabwe dollar and adopted the multi-currency system (use of the United States dollar and South African Rand) as the major currencies of legal tender in Zimbabwe. This move has tamed inflation. The inclusive government has adopted a Cash Budget in order to avoid budget overruns.

Food is now available in the shops due to the liberalization of food imports mainly from South Africa. However, the social sector which was the major casualty of the economic freefall of nearly three decades, has not yet fully recovered as recovery is based on heavy funding which is not available.

The country is still under EU and USA sanctions and it appears sanctions might take a little longer to be uplifted because progress in their removal has already been linked to the pace of political reforms in Zimbabwe.

Foreign direct investment and official development assistance so far has not been forthcoming. Balance of payments support is still being withheld due to payment arrears and the economic

embargo which is still in force. Zimbabwe's total debt stands at US\$11 billion (GoZ, 2011).

In view of Zimbabwe's large debt stock and its inability to repay the creditors, there is a raging debate in Zimbabwe around the HIPC route.

The inclusive government is only a transitional authority charged with the responsibility to restore economic stability and a road map to free and fair elections. To its credit, the inclusive government has managed to stabilize the economy. The economy was dollarized; average annual inflation is 3.5 (2011). The economy's GDP has grown by an average of 8% since 2009 and government operated a cash budget which in theory, translated into a cash budget. However, in real terms, a budget deficit still exists in different forms: payment arrears and under budgeting.

5.8 Summary

This chapter has discussed the complex link between economic and political factors in the analysis of Zimbabwe's economic performance. The fiscal deficit in Zimbabwe started to accumulate during the period of economic dirigisme (1980-1988) but did not yet upset economic performance because the economy was registering impressive growth rates on the back of high foreign direct investments and access to foreign resources to finance the deficit following the lifting of sanctions.

As a result, inflation though high, was still in the single digit zone for the greater part of the first decade. The impact of the deficit on the exchange rate, trade deficit and interest rate was neutral due to government's interventionist policies. At that time, the exchange rate was fixed and interest rates were not market determined due to financial repression.

The current account balance was affected not so much by the macroeconomics of the deficit than the rise in the import demand.

We saw in the period of market based reforms, Zimbabwe embracing IMF/World Bank economic reforms but failing to achieve the agreed targets as a result of lack of fiscal consolidation. The fiscal quarrel prompted the IMF to suspend balance of payments support in 1998. This triggered a foreign exchange crisis in Zimbabwe. The macro-economics of the deficit started in earnest to have a direct and indirect bearing on hyperinflation and the exchange rate.

During the ensuing periods of failed controls and political chaos, respectively, we saw the fiscal crisis reaching tipping point and we explored the reasons why the Reserve Bank took over all the key financial and economic decisions and policies of the state. Quasi-fiscal operations compounded the deficit and led to macroeconomic problems. Eventually the economic challenges became insurmountable and the economy entered the economic meltdown phase, which was marked by a hyperinflation of 231 million percent in July 2008, the highest in the world. Zimbabwe joined the list of failed states during the period of chaos.

We also discussed the point that economic reasons per se would not explain the economic meltdown that happened in Zimbabwe. Non-economic factors such as the disorderly land reform, corruption, the DRC war, the securitization of the state, the collapse of the judiciary and the political conflict all combined to cause macroeconomic instability and ultimately the economic collapse in Zimbabwe as we know it before February 2009.

We analyzed the macroeconomic impact of the deficit in Zimbabwe since 1981, where we saw the consistent failure to reduce the deficit ratio. As Jenkins (1997) observed, deficit reached

14% of GDP in 1994/95 while total government spending grew from 31% of GDP immediately before independence to around 40% of GDP by end of the 1980s. Capital expenditure accounted for 10% of total expenditure or 3.5% of GDP. Revenue, excluding grants also grew strongly from 25% to 32% of GDP but was insufficient to cover recurrent expenditure which averaged 34% of GDP from 1980 to 1990 before it accelerated to 800% above GDP in 2008 as the economy plunged into the highest hyperinflation ever experienced in the world in peace times. In this regard, the public sector deficit remained one of the primary causes of economic imbalance in Zimbabwe.

Finally, we conclude that, politics and fiscal deficits created a fertile ground for macroeconomic instability in Zimbabwe between 1980 and 2008. As the UNDP (2008:24) points out, "the lack of fiscal discipline throughout the recent post independence period has consistently had an adverse impact on growth. Having begun with the unbudgeted expenditures of 1997, the situation is now characterized by quasi-fiscal expenditures that weigh budgeted expenditures".

This chapter sought to review the economic history of Zimbabwe, track the budget deficit and its occurrence, and examine the cumulative effects of the budget deficit on the Zimbabwean economy between 1980-2008. The budget deficit alone does not sufficiently explain Zimbabwe's economic collapse. Political economy issues equally contributed to the economic meltdown of the country. In this regard, we conclude that, apart from the budget deficit, there is also a close connection between politics and poor macro-economic performance in failed states. Zimbabwe perfectly fits into this category.

Our concern was the impact of the fiscal deficit and politics on macroeconomic performance in Zimbabwe. This bias means that, we may not have covered the full narrative of Zimbabwe's economic history, for it is was never the intention of this study to open that debate.

As Stiglitzⁱ (2002:xv) said, " many of the people I criticize will say that I have gotten it wrong: they may even produce evidence that contradicts my views of what happened. I can only offer my interpretation of what I saw."

ⁱ My apologies to Rob Davies for misappropriating the above quotation from his article, "Memories of Underdevelopment: a personal account of Zimbabwe's economic decline" Institute of Justice and Reconciliation, Cape Town

CHAPTER 6

CONCLUSIONS

6.1 Introduction

This study sought to explore the macroeconomic impact of fiscal deficits and the catalytic effect of governance in Zimbabwe. The study's hypothesis was that, firstly, depending on their composition and financing, fiscal deficits are generally known to trigger macroeconomic disequilibria. Secondly, deficits alone, cannot fully explain the macroeconomic stability that Zimbabwe experienced in the period 1980-2008. The catalytic effect of governance was clearly evident.

The motivation for this study was that fiscal deficits have been at the centre of macroeconomic adjustment since the debt crisis of 1982 and to date, the global financial crisis has made the deficit and fiscal policy a big issue in macroeconomic management. And indeed Zimbabwe has experienced chronic fiscal deficits since independence resulting in negative implications on the economy. Therefore, central to this study, was the question: How did the cumulative fiscal deficits, caused by political and economic factors, affect macroeconomic stability in Zimbabwe since the attainment of independence in 1980?

In Chapter one, we laid out the objectives, hypothesis, relevance and the methodology of the study. The main objective of the study was to investigate the impact of fiscal deficits on macroeconomic performance and in this regard, the role played by governance in Zimbabwe. This was seen as very relevant to policy making, both for Zimbabwe today and as a lesson to policymakers in other countries. It was recognized that public finance management is vital for economic development hence the need to come up with recommendations which could influence policy making

in Zimbabwe, and cause a paradigm shift in fiscal policy in order to enhance macroeconomic stability.

On the methodology of the study, we chose a QUALITATIVE AND COMPARATIVE methodology by looking at the experiences of other African countries with regard to the political economy of fiscal deficits and implications on macroeconomic performance. Our justification of this methodology was that econometric modeling under hyperinflationary conditions would be futile in view of the softness of data and the impact of hyper-inflation. Moreover, we wanted to incorporate political economy issues in the discussion in view of the fact that econometric analysis per se, does not fully explain or capture the intricacies of policy intervention, especially the influence of other factors outside the economic domain – like governance issues and corruption. The impact of these political factors is not so easy to measure. Yet another possible factor that econometrics neglect is ideology, which has been important in setting the policy agenda in African countries in the 1970s and 1980s in general and Zimbabwe in particular, after 2000. These political economy issues include land and factory invasions, price controls, indigenization and economic empowerment in Zimbabwe, the nationalization of mines, the transformation of the state from civilian to quasi-military and the impunity that this transformation bred. Such structural and institutional issues caused serious economic decline, especially in Zimbabwe, but cannot be measured or quantified.

As the World Bank (1994: 16) rightly points out, all these structural factors play some role in Africa's poor performance, "but we can only speculate about their relevance, because they are difficult to quantify and test rigorously".

Chapter two reviewed the theoretical literature on the budget deficit and its relationship with selected economic variables. Chapter two also shed more light on the various deficit concepts that are used in the discourse. These deficit concepts include the conventional deficit, primary deficit, cyclical deficit, operational deficit, quasi-fiscal deficits and structural deficit. A proper specification of the deficit is very important in fiscal policy. It avoids the common problem of understating the deficit. We then discussed theoretical propositions on the budget deficit, namely the Ricardian equivalence, Neo-classical school, and the Keynesian school.

The Ricardian Equivalence argued that budget deficits were neutral because the future taxes implied by government debt, cancel any wealth effects of the debt, thereby preventing all the effects predicted by the traditional view (Barro, 1974).

The Keynesians view was that public expenditure crowds-in private investment, citing the expansionary effects of the budget deficit. Keynesians argue that budget deficits usually result in an increase in domestic demand, which makes private investors more optimistic about the future course of the economy resulting in them investing more. This is known as the “crowding-in effect”. Hence, deficits may stimulate aggregate demand, aggregate savings and investment despite the fact that they raise interest rates and may stimulate inflation.

Neoclassicals opined that deficits crowded out the private sector. The Neoclassical paradigm asserted that the economy was always at, or moving rapidly towards, full resource utilization. Deficits thus affected growth only through their effects on the rate of capital accumulation. Deficits that substitute for tax financing increase lifetime incomes if they do not imply certain future tax increases. Consumption increases and, in the neoclassical model

where all resources are employed, savings decrease. The demand for loanable funds exceeds the supply at the current interest rate, and in a closed economy where government does not resort to money financing of the deficit, interest rates rise, investment falls and savings increase, until savings and investment are brought into balance. The increased interest rates are thus said to crowd out private investment.

In chapter two, theory concluded that the impact of the deficit depends on two things: namely its composition and how it is financed. The findings of chapter two can be summarized as follows: deficit fuel inflation if they are monetized; interest rates positively respond to deficits; there is a connection between the budget deficit and trade deficit; the relationship between deficit and exchange rate is ambiguous; and lastly, deficits crowd out private investment depending on the interest elasticity of investment.

Chapter three looked at the empirical studies which tested the causal link between the deficit and macro-economic variables such as inflation, interest rate, exchange rate, growth, and trade deficit. Empirical studies suggested that: the relationship between the deficit and inflation is statistically significant and positive; there is a causal link between the budget deficit and trade deficit (the so-called twin deficits); the relationship between the deficit and exchange rate is ambiguous; and the relationship between the deficit and growth is non-linear, implying that budgets do not always have to balance – a deficit up to a threshold of about 1.5% enhances growth but a larger deficit inhibits growth.

In chapter four we first did a survey of the general economic performance of Sub-Saharan Africa before undertaking a comparative study on the economic impact of fiscal deficits in Ghana, Botswana, Morocco and Zambia. In general, we found that

fiscal deficits do have an impact on macroeconomic performance. In this regard, the experiences of Ghana and Zambia showed that high public expenditures were detrimental to their economies while good fiscal policy (a low, non-monetized deficit) contributed to macroeconomic stability in Botswana and Morocco.

Finally, in chapter five we then carried out a case study on the impact of fiscal deficits and the catalytic effects of governance in Zimbabwe during the post independence decade (1980-2008). We saw how between 1980 and 1990, the new government pursued populist policies that were based on growth with equity principles and how these resulted in high fiscal expenditures and high budget deficits. Between 1990 and 1995, Zimbabwe embarked on a structural adjustment program but abandoned policy reforms in 1995 after sharp differences with the IMF over the lack of fiscal consolidation and the absence of political will in the implementation of the program. After 2000, we saw how government employed desperate measures such as quasi-fiscal operations to bridge the deficit. Quasi-fiscal operations triggered hyperinflation as they were financed by seigniorage. Between 2000 and 2008, the Zimbabwe government became technically insolvent. The deficit took its toll on the economy and the situation was worsened by poor governance, which was characterized by political instability and poor macroeconomic policies. We concluded that high fiscal expenditures (coupled with lack of fiscal discipline) contributed to economic meltdown in Zimbabwe. We also found that deficits were worsened by bad governance and corruption.

This chapter draws down the curtain on the study and discusses the major findings, implications, recommendations and conclusions.

6.2 Findings

The major findings are that in Zimbabwe fiscal deficits, *coupled with other political economy factors*, had a major impact on macroeconomic performance. We also found that the fiscal deficit is an important economic indicator affecting macro-economic performance, provided it is correctly measured. The study also finds that in Zimbabwe political and institutional factors had a bearing on fiscal policy, hence fiscal adjustment is more likely to yield positive results when it is underpinned by good governance (in all its dimensions), because it is critical for fiscal consolidation.

The study has revealed that the impact of the budget deficit on macroeconomic performance depends first on whether the deficit is incurred on recurrent or capital projects. Theory and evidence has shown that capital expenditure-based deficits tend to crowd-in private investment, whereas recurrent deficits crowd out private investment. Secondly, how the budget deficit is financed has a bearing on the macroeconomic impact of the deficit. Zimbabwe's fiscal expenditure was largely recurrent and its financing was inflationary.

The specific findings are captioned in detail below:

Deficit and Interest rates

Between 1980 and 1988, the impact of the budget deficit on interest rates in Zimbabwe was minimized because the government practiced financial repression *in a bid to cheaply finance its deficit*. After 1988, *the period of market based reforms*, however, deficit-induced borrowing triggered a huge interest burden and for the first time in its history, Zimbabwe was plunged into a debt trap where over three quarters of revenue went towards interest payments. Therefore, although the primary deficit remained relatively subdued, after 1988, the conventional deficit worsened because of interest.

During the period of failed controls, the total deficit (including quasi fiscal deficits) was financed by printing money. The transmission mechanism of deficit to interest rate was blunted by the maintenance of a dual interest rate regime alongside a concessionary credit policy. Therefore in summary, the evidence suggests that deficits had a major bearing on interest rates in Zimbabwe mainly during the market based and failed controls periods. At the end of the failed controls period, and beyond, a dual interest rate policy was adopted to disguise the impact of the budget deficit on interest rates in Zimbabwe. In order to manipulate interest rates, government rolled over Treasury Bills upon their maturity, thereby avoiding interest payments.

Deficit and Inflation

Regarding the impact of the budget deficit on inflation, our conclusion is that in Zimbabwe, after 1988, deficits were monetized and this stoked inflation. The impact of the deficit on inflation was distressing during the period of *chaos as a result of* quasi-fiscal operations run by the Reserve Bank and which were largely financed by seigniorage revenues. Deficits precipitated an unprecedented hyperinflation in Zimbabwe which led to the collapse of the domestic currency (Zimbabwe dollar in 2008) and its replacement by a multiple-currency system in January 2009.

Deficit and Exchange Rate

To the extent that deficits stoked inflation, which in turn led to the overvaluation of the Zimbabwe dollar against major trading currencies, we conclude that the deficit indirectly affected the exchange rate. Since the Zimbabwe dollar remained fixed and overvalued, a thriving black market emerged, especially after 2000. Foreign currency disappeared from the formal market and was now available on the black market. This pushed up commodity prices as

producers sought to recoup the costs of the black market premiums. Therefore, in the absence of official devaluation, the deficit indirectly distorted the exchange rate and contributed to macroeconomic instability.

Deficit and Crowding Out

Did fiscal expenditure cause the crowding out of private investment in Zimbabwe? The results are mixed. On the one hand, it would appear that due to financial repression, and a cocktail of concessionary finance packages offered to the private sector by the central bank, especially after 2000, the impact of interest rates was diminished. More so, real interest rates have been negative for nearly a decade due to inflation and the deliberate restructuring of government debt and the rejection of high bids on treasury bills. Since 2000 the Zimbabwean government has been trying to mop up excess liquidity on the market by issuing long term borrowing instruments. This has led to a significant decline in interest payments. All these measures blunted the transmission effects of government borrowing on interest rates. However, on the other hand Easterly and Schmidt-Hebbel (1991) argue that deficits crowd out private investment in Zimbabwe as government borrowing through money market instruments left the private sector to access short term loans at high interest rates whilst competing with government. This later view confirms our earlier observation that deficits triggered interest rate increases.

Deficit and Trade balance

The Zimbabwean case study also looked at the impact of the deficit on the current account. The budget deficit affected the trade deficit mainly through its impact on domestic absorption and higher parallel exchange rate market premiums. However, the relationship between the deficit and the current account is still mired in

controversy due to other factors that were at play in Zimbabwe, such as the suspension of balance of payments support by multilateral agencies, suspension of development cooperation agreements, and targeted sanctions by the European Union and the USA government. We conclude that the evidence regarding the effect of budget deficits on the current account (trade deficit) in Zimbabwe remains ambiguous.

Deficit and Growth

Zimbabwe's fiscal experience suggests that deficits were partly to blame for the sluggish growth rates registered between 1980 and 1988. And indeed after 2000, negative growth rates could be attributed to high deficit growth. However, there are other more important reasons for Zimbabwe's consecutive negative growth rates other than the deficit. These factors include low capacity utilization, input costs, reduced lines of credit, poor export performance, the exchange rate and inflation, among others. In this regard, the relationship between the deficit and growth in Zimbabwe was non-linear.

The Role of Governance

Indeed, we also looked at the contribution of other factors (other than the budget deficit) to Zimbabwe's economic problems.

Our major findings are that bad governance yielded politically expedient and self-serving policies such as price controls, *the land reform program*, quasi-fiscal operations and subsidies which caused structural distortions. We saw, for example, how the Congo war negatively impacted on the Zimbabwean economy and how unorthodox the government became as shown by the printing of money and other policy aberrations. The issue of political stability and how it affected economic confidence is critical in understanding the current economic meltdown in Zimbabwe. Even the

transformation of the state from a cabinet-based to one where decisions were made by the National Security Council had a bearing on economic policy formulation and implementation. Under such political circumstances, the rule of law was suspended and the functioning of public institutions corrupted. Moreover, the prevalence of high corruption levels also contributed to the economic problems which dogged the country. Hence, fiscal deficits alone may not be sufficient to explain Zimbabwe's economic decline.

6.3 Implications

The implication of the above findings is that the performance of developing countries is hamstrung by poor revenue performances, fiscal indiscipline and bad governance. The problem is worsened by the fact that governments, regardless of resource constraints, continue to live beyond their means by incurring huge deficits as a result of political expediency. This is indeed the tragedy in which Zimbabwe found itself after independence. We argue that, because of low domestic revenue bases, developing countries would have to provide more incentives to attract foreign investment as opposed to external borrowing which would increase their public debt. Poverty and the population needs of developing countries, particularly in health, education, food security and housing, make fiscal discipline particularly difficult.

The recent global financial crisis has put fiscal policy at the centre of macroeconomic adjustment. This might mean the resurgence of a new thinking on the role of fiscal policy in stimulating economic activity.

6.4 Recommendations

The objective of the study was to make a contribution to the understanding of the macro-economic impact of the budget deficit

in Zimbabwe so as to inform policy decision making. In view of our findings on the impact of fiscal deficits and bad governance on macroeconomic performance in Zimbabwe, we draw the following specific policy recommendations.

Policy Formulation

Lack of technical capacity in government departments often leads to half-baked policy measures. In order for public policies to be cost effective and sustainable, there is need for more technical support at the Ministry of Finance and other economic ministries. Policies must be underpinned by thorough analysis of the various economic implications. Moreover, in a developing country like Zimbabwe, policy formulation requires civic participation in order to get the buy-in of key stakeholders. Moreover, Zimbabwe must strengthen its statistical agencies so they can be equipped to compile and maintain up to date and reliable statistical data. In addition, policies should capture the role played by politics. Good governance breeds good economic and structural policies. Political stability boosts market confidence.

In addition, policies must be made with the informal sector in mind because that is where most jobs are created. Government could also create a fiscal policy think tank to assist the Ministry of Finance to develop sound fiscal policies. In one of the federal states in the USA, the Fiscal Policy Institute plays a crucial role in policy formulation.

Budget Reforms

In order to reduce fiscal deficits and improve fiscal space -

- (a) The Zimbabwean government must introduce cash budgeting in order to avoid expenditure overruns.

- (b) The Budget should be formulated with stakeholder participation.
- (c) Realistic macroeconomic assumptions should underpin the budget.
- (d) Public Audits should be brought up to date and in this regard more resources should be allocated to the Comptroller and Auditor General.
- (e) Accounting Officers must be sanctioned for all unauthorized and irregular expenditures.
- (f) Supplementary budgets must be stopped
- (g) The Parliamentary Portfolio Committees, especially the Public Accounts and Budget Committees, must continue to be strengthened so they can effectively play their oversight roles.
- (h) The Budget must be restructured in a manner which sharply increases capital expenditure (capex) in comparison to recurrent expenditure.
- (i) All withdrawals from the Consolidated Revenue Fund (CRF) should be authorized by Parliament and Government should stick to the prescribed borrowing limits.
- (j) Health and Education should continue to be well resourced within the limit of the budget. Social safety nets should be funded in a sustainable manner.
- (k) The Budget must be used as a tool for executing macro-economic stability and not as a substitute for a comprehensive economic development program as has happened in Zimbabwe since 1980.
- (l) Relations with the international community must be restored to allow the resumption of balance of payments support. This will remove pressure on the domestic sources of revenue, which are narrow.

- (m) Public transparency, honesty, integrity and accountability are key to stability in public finance.
- (n) A Public Finance Management Act should be enacted in order to regulate public spending and promote accountability.

All the above propositions are premised on the assumptions of a stable and growing economy. Economic growth is a necessary condition for macro-economic stability and improved revenue performance.

Fiscal Adjustment

- (a) Civil service reforms must be undertaken in order to reduce the wage and salary bill which drives recurrent expenditure.
- (b) Cabinet should be right-sized. (For a small country like Zimbabwe, 38 Ministers, including deputies is a large figure considering the perks that go with their offices.)
- (c) Revenue Collection reforms must be implemented to promote tax efficiency and tax compliance.
- (d) Parastatals should be privatized or commercialized so that they do not depend on loans and transfers from central government.
- (e) Local Authorities should not be subsidized. They must be run autonomously using revenue from licences and ratepayers
- (f) Government must work out a public expenditure reduction program which is specific, measurable, achievable, realistic and time bound (SMART).

Governance

The state must be a catalyst of development. There is a strong case for a developmental state where government creates an enabling regulatory environment in order to facilitate economic development. Corruption in government and the private sector must be tackled seriously. These measures will help boost market confidence and stimulate the economy. But most importantly, the oversight role of Parliament must be strengthened. This is important to ensure that the Executive is always held accountable.

Macroeconomic Policy and Structural Reforms

Price distortions lead to the misallocation of resources. It is therefore important for all structural bottlenecks in the economy to be dealt with, especially in the pricing of public goods and public utilities. It is further recommended that policy reversals be avoided as they undermine market confidence.

Government Borrowing

Zimbabwe has experienced fiscal deficits over a prolonged period. Government has developed an insatiable desire to spend and live beyond its means. Government borrowing must be confined to capital projects only and such borrowing must be long term in order to avoid the interest burden.

Deficit Finance

Deficit finance must be approved by parliament. This will ensure that government becomes accountable to parliament. Moreover, this will stop unauthorized expenditure.

6.5 Limitations of this Study

This study could, by the very nature of the Zimbabwean situation of hyperinflation, not involve an econometric analysis of the relationship between the deficit and other macroeconomic

magnitudes. The author was thus compelled to undertake a qualitative study, also learning from the experience of other African countries. It would in principle have been possible to further broaden the comparative scope, for example by looking at the experiences of more African countries and even Latin American countries which suffered from chronic budget deficits and other economic ills such as the debt crisis, high inflation, low growth, balance of payments crisis and low investment. This may perhaps have provided even more insight on the subject.

Another limitation is that most data in Zimbabwe are not up to date due to funding problems that affected the Central Statistics Office. Moreover, statistical data in a hyperinflation economy such as that of Zimbabwe tend to be soft and hence should be treated with a great degree of caution. The use of nominal aggregate figures may not mean anything in a hyperinflationary economy. Similarly, deflating the figures using hyperinflationary Consumer Price Indices still won't solve this data quagmire. Be this as it may, we hold that these limitations do not materially change the findings and conclusions of this study.

The Zimbabwe case study presented serious challenges emanating from political economy and made it impossible to attribute our explanation of the economic meltdown exclusively to the budget deficit. The budget deficit alone would not sufficiently explain Zimbabwe's economic circumstance – that of a failed state. The failed state status complicated the fiscal analysis.

6.6 Conclusion

We conclude that fiscal deficits and bad governance *contributed to the deterioration of* macroeconomic performance in Zimbabwe since 1980. Political economy *factors such as bad governance, corruption, and the land reform program* in Zimbabwe

contributed to *deteriorating* macroeconomic instability (especially during the period of political chaos). During the period of political chaos (2004-2008), money financing of deficits triggered inflationary pressures which had pervasive effects on other economic variables, especially the parallel market exchange rate, which became the de facto exchange rate of the country.

Furthermore, we acknowledge the need for further macroeconomic, fiscal adjustment and political reforms to restore the economy to its pre-1980 levels. But most importantly, Zimbabwe needs to re-engage the international community with a view to getting access to financial and budgetary support whilst measures are taken to improve revenue performance and other structural impediments related to revenue performance and expenditure control. A clear understanding of the effects of governance on the economy will equip policy makers with the requisite capacity to handle macro-economic policy challenges in Zimbabwe today and in future.

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