



## CTPD'S MONDAY OPINION

This is a weekly column aimed at sharing CTPD's perspective and steering public debate on various issues pertaining to Trade & Investments Law, Public Finance Management, Extractives and Human Development.

TODAYS TOPIC

**A GLANCE AT THE FIRST TWO MONTHS OF THE NEW DAWN NATIONAL BUDGET IMPLEMENTATION: PROJECTING THE END FROM THE BEGINNING (PART 2).**



In last week's Monday Opinion, we relied on the fiscal performance for the first two months of the New Dawn Government's maiden National Budget to situate what has been done so far within the broad context of Government's 2022 National Budget aspirations. We concluded our opinion piece by arguing that "the reliance on Special Drawing Rights (SDRs) for deficit financing has potential to present inflationary pressures and undo gains so far made in containing rising prices through Balance of Payment imbalances which may exacerbate the weakening of the Zambian Kwacha against major currencies and feed into higher domestic aggregate prices." This week, we motivate this argument by delving deeper into the potential implications of SDRs deficit financing for an economy like ours.

Like in many other countries, the SDR allocation provided Zambia with a scope for a sizable increase in spending. The National Budget for 2022 increased by over 44 percent to K173 billion, up from K119.6 billion in 2021. As has become clear, a portion of this planned expenditure will be financed with Special Drawing Rights from the International Monetary Fund (IMF) (SDRs). However, given the institutional and policy framework that underpin our economy, we argued last week, and we motivate this argument below that special care must be exercised when relying on SDRs for deficit financing.

Firstly, the large spending envisaged in the 2022 National Budget needs to be carefully rolled out to ensure that it is well targeted and executed, but more importantly, it should be part of our medium-term spending plan to avoid unwittingly setting up future problems by overspending now. For example, a large increase in ongoing government spending may not be sustainable in coming years if government revenues do not increase to fill the hole the SDRs are plugging now. Our fall-back plan in this regard is the anticipated IMF Extended Credit Facility program but again, it has become even more apparent that we cannot and should not completely rely on external financing to achieve key aspirations as the prospects of such are entirely out of our control.

Secondly, we must pay particular attention to the interlinkages between deficit financing and inflationary pressures in an inflation targeting regime such as ours. In recent past years, efforts by the Bank of Zambia to contain inflation within the target range were often hindered by consistent but negating fiscal pressures. In an Inflation Targeting regime where the central bank commits to specific numerical target (point or range) for inflation, there are standard and empirically tested preconditions that must be met for such efforts to bear fruit. An inflation targeting regime involves an explicit central bank mandate to pursue price stability as the primary objective of monetary policy, as well as explicit quantitative targets for inflation (i.e. 6-8% in the case of Zambia); policy actions based on a forward-looking assessment of inflation pressures, taking into account a wide array of information; a high degree of transparency of monetary policy strategy and implementation; a high degree of accountability for performance in achieving the objective.

For such a regime to succeed consistently, there is need to ensure central bank independence (CBI) and freedom from fiscal dominance. The central bank should not be obliged to fund budget deficits. This requires deficits to be strictly limited or there should be a wide and deep market within which government can borrow from the non-bank private sector. Unfortunately, Zambia does not adequately meet any of these two conditions currently. The strategy is to avoid creation of new money which may be at variance with the Central Bank's monetary target consistent with the desired inflation target.

When we survey the literature on how different countries have used their SDRs post the August 2021 allocation, results are mixed. The SDR allocation has provided a financial lifeline to many countries, but usage has been dependent on each country's situation and reserve management strategy. Notable uses include paying eligible debt directly with SDRs, exchanging SDRs for useable currency to pay for outstanding debt, current imports, or advance commitments to purchase goods such as vaccines through multilateral agreements, holding on to SDRs to rebuild depleted reserves, and indeed relaxing budgetary constraints to meet urgent needs or to finance medium-term investments.



However, spending all or part of the SDR allocation through an increase in credit from the central bank needs to coordinate with central bank sales of foreign exchange to avoid inflationary pressures or hikes in interest rates resulting from overheated domestic demand. A case in point on this is Zimbabwe who withdrew US\$311 million from their SDR allocation, with most of the funds (US\$144 million) going to the rehabilitation of the Harare-Beitbridge Highway and the remainder being allocated to Covid-19 vaccination programmes (US\$77 million) and agriculture social protection (US\$80 million) while the remaining amount, US\$280 million was set aside for foreign exchange reserves. Consequent to this, annual inflation rose to around 58% by end of 2021 from the initial projections of 10% at the beginning of the year. This was largely attributed to the growth in money supply and further depreciation of the local currency.


In conclusion, we argue that reliance on SDRs for deficit financing can be a faulty policy crutch for Zambia in view of our economic structure if care is not taken to abate potential implications for the effectiveness of monetary policy to control inflation.

About the author

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