

FOR
AGENDA

EBS/84/229

CONFIDENTIAL

November 9, 1984

To: Members of the Executive Board
From: The Secretary
Subject: Zambia - Review of Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for a review of the stand-by arrangement for Zambia. A draft decision appears on page 24.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Woodward (ext. 73816) or Mr. Sharer (ext. (5)8752).

Att: (1)



INTERNATIONAL MONETARY FUND

ZAMBIA

Review of Stand-By Arrangement

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs,
Legal, and Treasurer's Departments)

Approved by A.D. Ouattara and S. Kanesa-Thanan

November 8, 1984

I. Introduction

On July 18, 1984 the Executive Board approved in principle Zambia's request for a 21-month stand-by arrangement (EBS/84/135, and Supplements 1 and 2) in the amount of SDR 225 million (83 percent of quota), equivalent to 47.5 percent of quota at an annual rate. This arrangement became effective on July 26, 1984 following a determination by the Fund that satisfactory arrangements had been made with respect to the financing of Zambia's estimated balance of payments deficit in 1984 (EBS/84/135, Supplement 3). Following the entering into effect of the arrangement Zambia made an initial purchase of SDR 30.0 million under the arrangement. The next purchase of SDR 50 million 1/ is subject to the completion of this review of performance under the program 2/ and to the observance of performance criteria for end-September, 1984.

As of September 30, the Fund's holdings of Zambian kwacha subject to repurchase equalled SDR 686.4 million, equivalent to 253.9 percent of quota, or 183.4 percent excluding holdings under the Compensatory Financing Facility. If the balance available under the stand-by arrangement is fully drawn, this amount would rise to SDR 747.4 million at the end of the arrangement, equivalent to 276.5 percent of quota; excluding

1/ This comprises two purchases of SDR 25 million each, which were linked to the July and September performance criteria. These are to be made together due to delays in completing this review.

2/ A staff team composed of Messrs. Bornemann (head), Sharer, and Greene (all of the African Department), Mr. Schneider (FAD), Mr. Hatayama (ETR), and Ms. Wood (secretary-AFR) visited Lusaka during August 21-September 5, to conduct the discussions that provided the basis for this review. Mr. Woodward (AFR) also participated in the discussions during August 27-September 5. The discussions were continued in Washington during the period of the Annual Meetings.

purchases under the CFF, the corresponding amounts would be SDR 598.2 million or 221.3 percent of quota. The current phasing of the arrangement and the total outstanding use of Fund credit are shown in Table 1.

The attached letter (Appendix III) from the Minister of Finance to the Managing Director, dated October 31, 1984, reviews developments since the beginning of the program period, indicates the areas in which additional adjustment efforts are being made. Zambia has met all the performance criteria for July and September 1984 except for those on external commercial payments arrears. In his letter the Minister has requested a waiver for the nonobservance of the performance criterion on external commercial payments arrears for end-September and also modification of the ceiling on these arrears for end-December.

The background to the current arrangement is summarized in Section II of this paper. The objectives and policies of the current program are summarized in Section III. Developments and prospects at the time of the review are discussed in Section IV, while prospects and policies for the remainder of 1984 and beyond are set forth in Section V. The staff appraisal and proposed decisions appear in Section VI. Summaries of Zambia's relations with the Fund and the World Bank Group are shown in Appendices I and II.

The staff intends to remain in close touch with the Zambian authorities, and a staff team is expected to visit Lusaka at the end of November 1984 with a view to agreeing on policies and prospects for 1985, including the budget proposals for 1985, the prospects for improving the monitoring and control of government expenditure, and the need for changes in Zambia's trade, payments, and exchange systems.

II. Background

Since the mid-1970's Zambia's economic performance has sharply deteriorated, largely because of a declining trend in export prices leading to a sharp fall in its terms of trade. Over the past decade, the real purchasing power of Zambia's exports has fallen nearly 70 percent, and real per capita income has declined markedly, with domestic consumption sustained only by the accumulation of substantial external indebtedness, including external arrears. There have been periodic adjustment efforts, supported by the use of Fund resources, but these efforts were not sustained; the deterioration was particularly marked in 1982, when a period of lax financial management followed cancellation of an extended arrangement with the Fund.

There was a substantial improvement during 1983, however, when Zambia's economic program was supported by a new one-year stand-by arrangement in the amount of SDR 211.5 million, or 100 percent of Zambia's

Table 1. Zambia: Fund Position During Period of Arrangement, 1984-86

	Outstanding at June 30, 1984	1984		1985				1986
		July- Sept.	Oct.- Dec.	Jan.- March	April- June	July- Sept.	Oct.- Dec.	Jan.- March
(In millions of SDRs)								
Transactions under								
tranche policies (net) <u>1/</u>	--	17.5	25.6	22.7	-2.0	29.0	1.1	29.0
Purchases	--	30.0	50.0	29.0	29.0	29.0	29.0	29.0
Ordinary resources	--	(15.0)	(25.0)	(14.5)	(14.5)	(14.5)	(14.5)	(14.5)
Enlarged access resources	--	(15.0)	(25.0)	(14.5)	(14.5)	(14.5)	(14.5)	(14.5)
Repurchases	--	-12.5	-24.4	-6.3	-31.0	--	-27.9	--
Ordinary resources	--	(-12.5)	(-9.4)	(-6.3)	(-3.1)	(--)	(--)	(--)
Enlarged access resources	--	(--)	(-15.0)	(--)	(-27.9)	(--)	(-27.9)	(--)
Transactions under special								
facilities (net) <u>2/</u>	--	--	--	-7.4	-7.4	-7.4	-7.4	-11.7
Purchases	--	--	--	--	--	--	--	--
Repurchases	--	--	--	-7.4	-7.4	-7.4	-7.4	-11.7
Total Fund credit out-								
standing (end of period)	672.0	686.4	708.9	724.2	714.8	736.4	730.1	747.4
Under tranche policies <u>1/</u>	481.5	495.9	518.4	541.1	539.1	568.1	569.2	598.2
Special facilities <u>2/</u>	190.5	190.5	190.5	183.1	175.7	168.3	160.9	149.2
(As percent of quota)								
Total Fund credit outstanding								
(end of period)	248.6	253.9	262.3	268.0	264.4	272.4	270.1	276.5
Under tranche policies <u>1/</u>	178.6	183.4	191.8	200.2	199.4	210.2	210.6	221.3
Special facilities <u>2/</u>	70.5	70.5	70.5	67.8	65.0	62.2	59.5	55.2

Source: IMF, Treasurer's Department.

1/ Ordinary and enlarged access resources.

2/ Compensatory Financing Facility.

then existing quota. ^{1/} Under this arrangement Zambia reduced the overall budget deficit (including official transfers) from 18.9 percent of GDP in 1982 on a cash basis, or 14.6 percent of GDP on a commitment basis, to 6.9 percent of GDP in 1983 and curbed the growth in net domestic assets, net credit to government, and broad money. In the course of the program, all credit ceilings were observed. On the external side, the program included a number of measures to improve the operating efficiency of the mining sector and to strengthen incentives for export diversification; during the year the kwacha was depreciated by 38.5 percent against the U.S. dollar. However, Zambia's external position remained precarious, again in large part because copper prices and export volumes were both considerably less favorable than anticipated at the start of the program. As a result of the shortfall in foreign exchange receipts, Zambia was unable to meet the performance criteria on arrears under debt rescheduling agreements and on external commercial payments arrears. Consequently, Zambia was able to make only three of the four purchases under the 1983 arrangement.

III. The Current Stand-By Arrangement

The economic program of Zambia supported by the present stand-by arrangement has as its main objective the consolidation of progress begun in 1983 toward further reducing domestic and external imbalances to sustainable levels. The program also seeks to promote the diversification of economic activity away from the dominant mining sector and into new areas, particularly agriculture. Economic and financial indicators for recent years and the program's targets for 1984 are summarized in Table 2.

Under the program, the Zambian authorities undertook a number of measures aimed at further strengthening public sector finances and restraining domestic consumption. The overall budget deficit was to be reduced from 6.9 percent in 1983 to 4.5 percent of GDP, through a combination of measures to raise revenue and reduce real expenditures (Table 6). Revenue and grants were programmed to increase by 15.5 percent, reflecting mainly higher excise and import duties, including a new minimum rate of import duty of 10 percent and a shift in the basis for taxing imports from f.o.b. to c.i.f., to be effective August 1, as well as higher nontax revenues from licencing fees and dividends. In addition, the program included a number of administrative actions aimed at improving tax collection. Expenditure growth was to be limited to 7 percent, well below the projected level of price increases, including sharply reduced levels of real outlays for personnel emoluments and subsidies. As a percentage of GDP, total expenditure (excluding interest payments) was to be reduced to about 27 percent, compared with 32 percent for 1983 and an average of 38 percent for the period 1980-82. Furthermore, the authorities undertook to establish a blocked account for government external debt

^{1/} EBS/83/67.

Table 2. Zambia: Selected Economic and Financial Indicators, 1981-84

	1981	1982	1983		1984	
			Prog. 1/	Prel.	Prog.	Revised
(Annual percent changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	4.7	-2.2	--	0.8	--	--
GDP deflator	9.4	5.6	25-30	17.1	25	25
Consumer prices	14.0	12.5	25-30	19.6	25	25
External sector						
Exports, f.o.b. (millions of SDRs)	833	839	963	853	765	728
Imports, c.i.f. (millions of SDRs)	1,050	1,049	841	775	688	680
Non-oil imports, c.i.f. (millions of SDRs)	839	878	660	588	532	553
Export volume	-8.2	7.9	1.8	-4.2	-4.0	-4.0
Import volume	--	-4.0	-17.0	-19.7	-9.5	-9.7
Terms of trade (deterioration, -)	-14.1	-10.5	2.7	3.4	-7.4	-11.9
Nominal effective exchange rate (depreciation, -) 2/	1.6	-2.8	...	-31.8	...	...
Real effective exchange rate (depreciation, -) 2/	7.9	15.7	...	-15.8	...	...
Government budget						
Revenue and grants	5.3	4.2	26.9	19.5	15.5	15.0
Total expenditure 3/	9.4	8.8	-4.3	-3.7	7.3	12.8
Money and credit						
Net domestic assets 4/	41.2	75.3	23.7	22.8	23.9	23.9
Government 4/	18.1	49.9	11.4	8.8	12.0	12.0
Money and quasi-money (M2)	7.9	33.8	12.5	11.1	15.4	15.4
Velocity (GDP relative to M2)	3.5	2.5	2.7	2.9	3.1	3.1
Interest rate (maximum lending rate, percent per annum)	12.0	12.0	13.0	13.0	15.0	17.5
(In percent of GDP)						
Central government budget deficit (cash basis)						
Including official transfers	13.4	18.9	5.6	6.9	4.5	5.2
Excluding official transfers	14.1	19.7	6.3	7.6	5.3	6.8
Domestic bank financing	4.7	13.7	3.7	2.7	3.3	3.3
Foreign financing	7.2	3.1	0.5	1.8	-0.3	0.4
Gross domestic investment	19.5	16.9	...	15.3	15.5	15.5
Current account deficit						
Including official transfers	18.9	17.7	7.4	8.7	10.5	10.7
Excluding official transfers	19.6	18.7	8.8	9.8	11.6	13.0
External debt 5/	89.7	91.5	...	107.9	...	...
Debt service ratio 6/	34.3 7/	50.4 7/	53.3 7/	59.4 8/	42.1 8/	47.8 8/
Interest payments 6/ (including Fund charges)	11.5 7/	19.8 7/	18.1 7/	15.4 8/	28.8 8/	30.2 8/
(In millions of SDRs, unless otherwise specified)						
Overall balance of payments	-327 7/	-561 7/	-295 7/	-98 8/	-27 8/	-93 8/
Gross official reserves (weeks of imports)	4.5	6.3	7.8	7.4	7.5	7.5
External payments arrears 9/	501 10/	947 11/	695 12/	648 12/	597	620

Sources: Data provided by the Zambian authorities; and staff projections.

1/ Data differ from the original program paper to reflect revisions in 1982 data and 1983 GDP estimates.

2/ Year-end data, adjusted for relative consumer prices.

3/ Includes net lending but excludes payment of past arrears.

4/ As a percentage of money and quasi-money at the beginning of the period.

5/ Inclusive of use of Fund credit but excluding all external payments arrears.

6/ In percent of exports of goods and nonfactor services.

7/ Before debt relief.

8/ After debt relief.

9/ Consists of commercial payments arrears, arrears on external debt, and arrears of the mining company.

10/ Excluding unknown amount of arrears on debt service.

11/ Including debt service arrears.

12/ Consists of commercial arrears and SDR 38 million in Paris Club arrears following rescheduling of debt.

service into which monthly payments were to be made in domestic currency, regardless of the availability of foreign exchange. Despite less recourse to domestic nonbank borrowing, banking system credit to government was to be limited to K 175 million, equivalent to 12 percent of the broad money stock at the beginning of the period. Total net domestic assets of the banking system were to increase by the equivalent of 23.9 percent of broad money, of which credit to the nongovernment sector, including parastatals and marketing agencies, was to account for nearly 50 percent, compared with 41 percent in 1983. Broad money was projected to rise by 15 percent, compared with the projected growth in nominal GDP of 25 percent. Interest rates were increased by an average of 2 percentage points, with the maximum lending rate raised to 15 percent.

The program's balance of payments projections assumed a decline in the average copper price from US\$0.72 in 1983 to US\$0.65 per pound in 1984, and an export volume of 530,000 tons, giving total exports of SDR 765 million, a reduction of 10.3 percent from the level attained in 1983 (Table 5). As a result of the shortage of foreign exchange, the program assumed a reduction of 11 percent in nominal imports to SDR 688 million, following the 26 percent nominal reduction experienced in 1983. It was also assumed that Zambia would obtain debt relief from private and non-OECD official creditors comparable to that obtained from the Paris Club ^{1/}. External commercial payments arrears were to be reduced by SDR 20 million (measured at a constant exchange rate and excluding reductions from refinancing and rescheduling) from the end-March 1984 level. The program also provided for continuation of a flexible exchange rate policy that would ensure, as a minimum, no appreciation of the kwacha in real effective terms, maintain the financial viability of the mining company in the face of declining export prices, and continue to provide adequate incentives for export diversification. Incentives for non-traditional exports were further strengthened through the introduction of foreign exchange retention schemes.

On the supply side the program included increases in agricultural producer prices ranging from 12 percent to 42 percent, greater price liberalization and higher retail prices in key areas of the economy (including significant increases for a number of key products such as maize meal, petroleum products, fertilizer, and beer), and additional efforts to reduce costs and increase managerial efficiency in parastatal enterprises. These measures, together with continued wage restraint throughout the economy, were expected to improve the financial position and operating efficiency of the nongovernment sector. The program envisaged no increase in real GDP, reflecting the limited possibilities for increasing mineral exports, which should account for 97 percent of total exports, and the limited prospects for increasing capacity utilization in the domestic manufacturing sector, in view of the acute shortage of foreign exchange resources.

^{1/} The terms of the rescheduling are set forth in EBS/84/135, Supplement 3.

IV. Performance under the Program

Most of the measures envisaged in the 1984 financial program have been implemented, although delays have occurred in some areas (Table 3). However, there has again been a deterioration in external prospects, not only on account of a further decline in the world copper price, but also because of revised estimates of amounts due for debt service payments after relief. Thus, although all credit ceilings for July were observed, the program's July and September performance criteria for a reduction in external commercial payments arrears by cash payments were not met (Table 4), nor will the authorities be able to achieve the reduction in these arrears provided for in the end-December ceilings. The intensification of the shortage of foreign exchange has also adversely affected economic performance and prospects throughout the economy.

Regarding the balance of payments, revised projections for 1984 are shown in Table 5. Export projections have been revised downwards by a further 4.8 percent to SDR 728 million, reflecting lower receipts from copper. The program anticipated an average price of US\$0.65 per pound, which was in line with the actual average attained during the first half of the year. However, there was a subsequent decline to an average of only US\$0.60 per pound for the third quarter of the year. Revised projections are now based on the price remaining at around the present level for the remainder of the year, giving an annual average of US\$0.61 per pound. Copper export volume is still expected to be in line with the program's target of 530,000 tons. Revised projections of debt service debt payments due in 1984, including amounts due but not paid in 1983, and the impact of rescheduling agreements concluded so far this year ^{1/}, show a net deterioration of about SDR 32 million. In addition to some reclassification of amounts due between interest and principal payments, the increase reflects higher interest payments due to non-OECD creditors. At the same time debt relief figures now indicate that total relief is likely to amount to only SDR 482 million, as against the SDR 495 million projected at the time of program implementation, in part because Zambia made unanticipated debt payments of approximately US\$10 million on amounts outstanding from earlier years to two non-OECD countries. Agreement has been reached in principle with the London Club commercial banks, but no agreement has yet been concluded with Zambia's major non-OECD creditor, the U.S.S.R. Consistent with the agreed minute of the Paris Club, in August the Zambian authorities established an external special account at the Federal Reserve Bank of New York into which monthly deposits of at least SDR 5.67 million,

^{1/} Under the Paris Club agreement, bilateral agreements with creditors must be concluded by end-December 1984. No bilateral agreements have been signed so far, but monthly payments are being made into the special account established at the Federal Reserve Bank of New York, in accordance with the agreed Minute of the Paris Club.

Table 3. Zambia: Summary of Financial Program, 1984

	1984	
	Program	Revised
Assumptions		
Real GDP growth (percent)	--	--
Nominal GDP growth (percent)	25	25
Change in terms of trade (percent)	-7.4	-11.9
Exports, f.o.b.: (millions of SDRs)	765	728
Of which: Copper:		
Volume (thousand tonnes)	530	530
Price (US\$/lb.)	0.65	0.61
Targets		
Current account deficit (including grants)(millions of SDRs)	297	303
As percent of GDP	10.5	10.7
External payments arrears (end of period - millions of SDRs)	597	620
Of which: Commercial payments arrears <u>1/</u>	597 <u>2/</u>	620 <u>2/</u>
Arrears under debt rescheduling agreements	--	--
Reduction in arrears through cash payments <u>3/</u>	20	-- <u>4/</u>
Budget deficit (including grants) (percent of GDP)	4.5	5.2
Total expenditure (percent increase)	7.3	12.8
Total revenue and grants (percent increase)	15.5	15.0
Domestic bank financing (K million)	174.4	174.4

Sources: Staff Report for 1984 stand-by arrangement; and staff estimates and projections.

1/ Includes arrears of the mining company but excluding reductions through rescheduling.

2/ Excludes reductions through depreciation of the kwacha in the case of kwacha-denominated arrears. If these reductions were included the corresponding figure would be approximately SDR 59[^] million.

3/ Compared with the end-March 1984 level.

4/ Compared with the end-July 1984 level.

Principal elements
External sector

Status of Implementation

Flexible exchange rate policy with monthly monitoring and adjustments.

Implemented. Currency depreciated through monthly adjustments by 23.8 percent against the U.S. dollar during January 1 through end-September.

Successful rescheduling of external debt with Paris Club and other creditors.

Agreement reached with Paris Club; discussions continuing with other official and commercial creditors.

Improved foreign exchange budgeting system, better coordination with import licensing.

Improved coordination but continued excess of licenses because of overestimates of available foreign exchange.

Increase foreign exchange retention of ZCCM to 35 percent of all proceeds.

Implemented.

Legalization of emerald mining for private sector, marketing by Reserved Minerals Corporation at market prices with 10 percent of foreign exchange to be retained by producer.

Implemented, but with delays in issuing prospecting and mining licenses.

Budget

Budget deficit (cash basis) in 1984 limited to K 239 million, with domestic bank borrowing limited to K 175 million.

Projected budget deficit of K 278.7 million, with domestic bank borrowing limited to K 175 million.

New tax measures equivalent to K 73 million.

New revenue measures limited to K 54 million because of revised yield estimates and delays in implementing proposed increases in import duties.

Expenditure growth limited to 7.3 percent.

Expenditure growth projected to equal 12.8 percent.

Expenditures on personnel limited to K437.4 million, with freeze on net employment outside ministries of health, education, and agriculture.

Expenditure and employment level ceilings observed.

Study of employment levels to be undertaken aimed at freezing and, if possible, reducing total government employment in 1985 budget.

Study not yet undertaken.

Establishment of blocked account for external debt service payments, with monthly payments in domestic currency by the Treasury irrespective of the availability of foreign exchange.

Account established and payments begun during August 1984.

Money and credit

Increase in net domestic assets limited to 11 percent; increase in credit to nongovernment sector limited to 20 percent.

Implemented.

No increase in Bank of Zambia credit to the mining company.

Implemented.

Increase in broad money limited to 15 percent.

Implemented.

Increase in maximum interest rate to 15 percent; other rates increased on average by 2 percentage points.

Implemented.

Pricing and other structural policies

Implementation of additional measures to reduce costs and increase efficiency at ZIMCO subsidiaries, including K 50 million in savings from new measures at ZCCM, and World Bank studies of improved performance for the oil refinery and NCZ.

Underway.

Increase in producer price for maize to K 28.30 per bag for 1984/85, and cooperation with World Bank in formulating medium-term policies for the agricultural sector.

Implemented.

Increase in wholesale prices for petroleum prices averaging 35 percent (effective April 11, 1984).

Implemented.

Increase in beer prices of K 0.08 per bottle.

Implemented.

Rise in retail maize meal price of K 6.5 per 90 kg/bag, or 21.7 percent.

Implemented.

Increase in sale price of fertilizer of K 2.7 per 50 kg/bag, or 11 percent.

Implemented.

Table 4. Zambia: Quantitative Performance Criteria, 1983-84

(End of period)

	1983	1984				
	Dec. Actual	March Actual	July Ceiling	Actual	September 1/ December Ceilings	
(In millions of kwacha)						
Net domestic assets <u>2/</u>	3,132.9	3,147.7	3,346.3	3,233.5	3,402.3 <u>3/</u>	3,480.6 <u>3/</u>
Claims on Government (net)	2,098.5	2,165.0	2,211.0	2,184.6	2,238.5 <u>3/</u>	2,273.5 <u>3/</u>
Bank of Zambia claims on ZCCM	165.5	165.5	165.5	165.5	165.5	165.5
(In millions of SDRs)						
Cumulative net change in commercial payments arrears through cash payments <u>4/</u>	597.0 <u>5/</u>	617.0 <u>5/</u>	-6.0	14.0 <u>6/</u>	14.0 <u>6/</u>	14.0 <u>6/</u>
Arrears under debt rescheduling agreements	38.0	...	--	--	--	--
New nonconcessional external borrowing contracted or guaranteed by Government (cumulative)						
1-12 years' maturity	...	...	50	...	50	50
1-5 years' maturity	...	...	--	--	--	--
1 year and under	...	...	--	--	--	--

1/ According to preliminary data, September performance criteria were met, except for the reduction in commercial payments arrears.

2/ These data have been revised to eliminate revaluation changes that have occurred in respect of external commercial payments arrears that are classified as foreign liabilities of the banking system. The absolute increase in net domestic assets during the program period, as specified in EBS/84/135, has been preserved. Using the previous definition, actual net domestic assets for end-July would have amounted to K 3,399.5 million as against the program limit of K 3,444.5 million.

3/ The ceilings will be reduced to the extent that government payments to the Bank of Zambia for external debt service fall short of the K 20 million to be paid into the blocked account each month, beginning July 1984. For these purposes, external debt service payments will be treated as if they were paid from the blocked account. Balances in the blocked account will be excluded from net credit to Government and from net domestic assets for the purposes of monitoring the program.

4/ The net change applies to the end-March level of commercial payments arrears, which amounted to SDR 617 million, including those of ZCCM.

5/ Absolute level of commercial payments arrears.

6/ Net increase on a cash basis from the end-March level.

Table 5. Zambia: Balance of Payments, 1982-85

(In millions of SDRs)

	1982	1983	1984		Revised	1985 Projected
			Program before debt relief (EBS/84/ 135)	Program after debt relief (ERS/84/ 135, Sup.3)		
Trade balance	-210	78	77	77	48	165
Exports, f.o.b.	839	853	765	765	728	849
Imports, c.i.f.	-1,049	-775	-688	-688	-680	-684
Services and unrequited transfers (net)	-405	-351	-374	-374	-436	-366
Interest payments ^{1/}	-226	-236	-253	-253	-350 ^{2/}	-266
Other services	-155	-98	-100	-100	-100	-100
Private transfers	-60	-51	-50	-50	-50	-50
Government transfers	36	34	29	29	64	50
Current account	-615	-273	-297	-297	-388	-201
Nonmonetary capital (net) ^{1/}	33	-74	44	-225	-187	-10
Government	109	11	22	-247	-195 ^{2/})
Mining Company	96	7	22	22	8	) -10
Other, including errors and omissions	-172	-78	--	--	--)
SDR allocation/gold revaluation	21	-8	--	--	--	--
Debt relief (net)	--	257	-202	495	482	58
Overall balance	-561	-98	-455	-27	-93	-153
<u>Financing</u>						
Use of Fund resources (net)	-52	60	74	74	74	21
Purchases	(34)	(174)	(148)	(148)	(148)	(116)
Repurchases	(-86)	(-114)	(-74)	(-74)	(-74)	(-95)
Incurrence/cash re- duction (-) of arrears	447	-27	-38	-38	20)
Scheduled debt service	(222)	(--)	(--)	(--)	(--))
Commercial payments	(225)	(-65)	(--)	(--)	(58))
Rescheduled debt	(--)	(38)	(-38)	(-38)	(-38)	) 132 ^{8/}
Other foreign assets (net) (increase-)	166	65	419	-9	-1)
<u>Memorandum items:</u>						
Cash payments under rescheduling agreements	--	-41 ^{4/}	-202 ^{5/}	-59 ^{6/}	-76	-234
Market price of copper (US\$/lb)	0.67	0.72	0.65	0.65	0.61	0.67

Sources: Data provided by the Zambian authorities; and staff estimates.

^{1/} Includes payments due on debt as originally scheduled.

^{2/} Includes (1) payments due in 1984 to Paris Club creditors under 1983 consolidation agreement, and (2) payments originally due in 1983 on debt to non-Paris Club creditors, the rescheduling negotiation of which has been under way in 1984.

^{3/} Reflects pipeline and ZCCM arrears and includes gross reduction through a refinancing arrangement.

^{4/} Debt service due on bilateral agreements actually signed (excludes Federal Republic of Germany and Italy).

^{5/} Includes payments due in 1983 if bilateral agreements had been signed by the end of 1983.

^{6/} Downward revision of cash payments from SDR 202 million to SDR 56 million reflects from the fact the 1984 rescheduling has agreed to consolidate arrears outstanding at end-1983 and 1984 maturities on more favorable terms compared with the 1983 rescheduling under the Paris Club.

^{7/} Preliminary projections, excluding effect of further debt relief agreements.

^{8/} Unfinanced gap.

with a minimum of SDR 20 million every three months, are to be paid. The first payment into the account was made in August, although the September payment was not made on schedule due to the shortage of foreign exchange. Estimated capital inflows in the form of transfers have been increased by SDR 35 million as a result of the Consultative Group meeting. However, delays in loan disbursements to the Government and to the mining company have led projected capital inflows to decrease by SDR 40 million over the year.

The above developments have greatly intensified the shortage of foreign exchange. Despite an increase of grant supported commodity imports following the Consultative Group meeting, aggregate imports are expected to be slightly below the level anticipated in the program because of further reductions in the availability of foreign exchange for industrial inputs. The tight foreign exchange position has also led to difficulties in Zambia's remaining current on its payments to the consortium of banks that finance oil shipments, leading to occasional delays in opening letters of credit for shipments. The shortage has also strained the import licensing system, as the issuance of licences during the second quarter of the year was based on the anticipated higher copper price. Mainly on account of the shortage of foreign exchange the authorities were unable to comply with the program's ceiling on reduction of external commercial payments arrears through cash payments. Between end-March and end-July these arrears rose by SDR 14 million compared with the program's target of a reduction of SDR 6 million.

Preliminary balance of payments projections for 1985 are also shown in Table 5. They assume an increase in the average copper price of 10 percent to US\$0.67 per pound, ^{1/} as against the projection of US\$0.75 per pound made at the inception of the present program. Export volume is still projected to increase to 580,000 tons, reflecting mainly the coming on stream of the Tailings Leach project involving the reprocessing of past wastes from which copper could not previously be extracted. Thus total export earnings are projected at SDR 849 million, as against SDR 942 million projected at the inception of the present program. Preliminary projections indicate that capital flows and net services and unrequited transfers will be broadly in line with the previous projections. Consequently, the decrease in projected export earnings will be reflected in lower net imports, which are now expected to be virtually unchanged in nominal terms from the 1984 level, as against an 11 percent increase previously assumed.

In response to the deteriorating external outlook, the authorities have continued to pursue a flexible exchange rate policy; during the ten month period to end-October 1984, the kwacha was depreciated by a further 26.8 percent against the U.S. dollar, a depreciation of about 13 percent

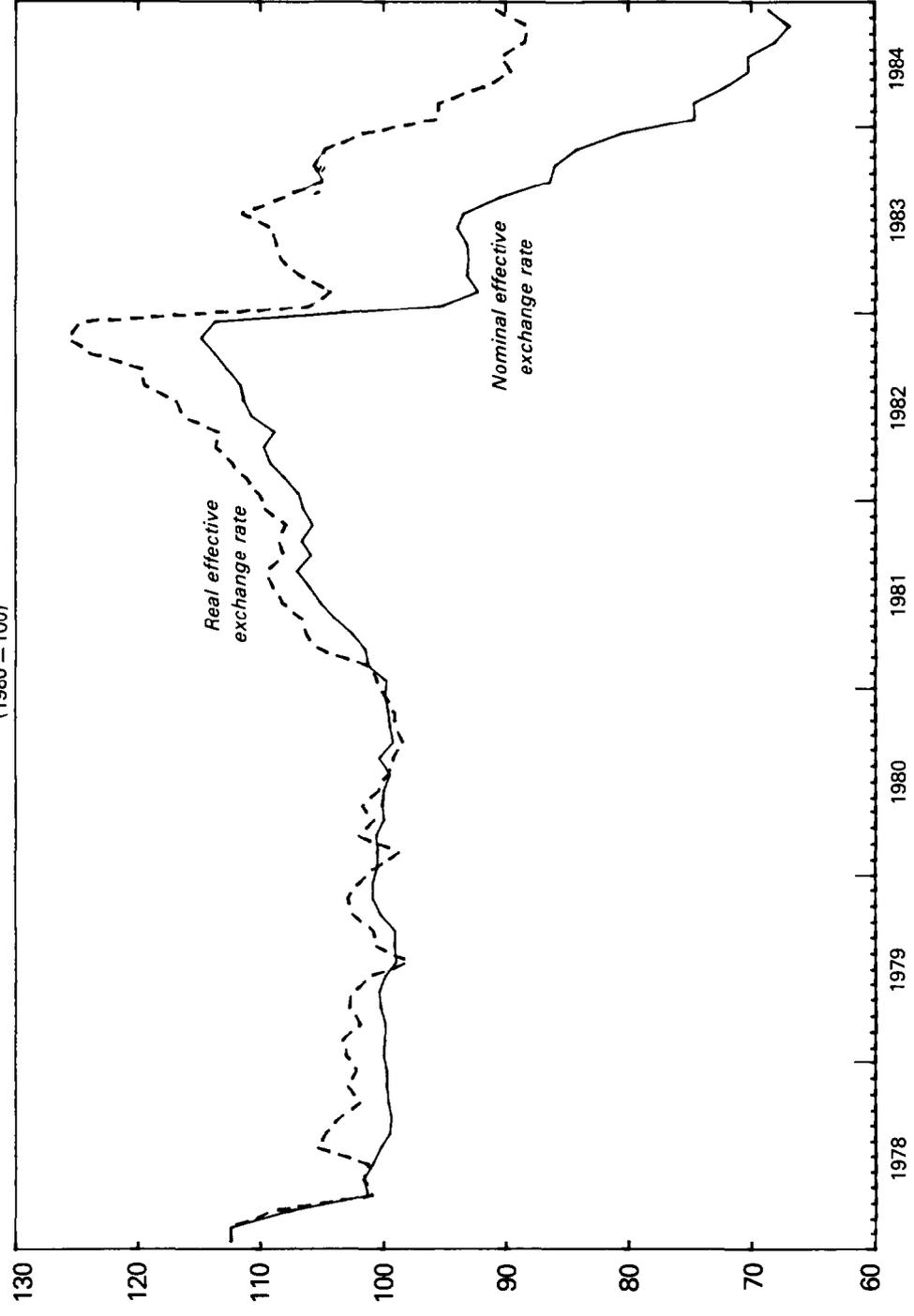
^{1/} This is in line with present forecasts of other international institutions, and represents an increase of about 8 percent from the present price of US\$0.62 per pound.

in real effective terms (Chart 1). In addition to constraining the demand for imports, this reinforced incentives for export diversification and import substitution, and protected the profitability of the mining company despite the fall in export prices. The authorities also introduced foreign exchange retention schemes for nontraditional exports and proceeded with issuance of licences for emerald prospecting. While progress in the latter area has been disappointing, there is encouraging evidence of increased activity in the area of nontraditional exports, mainly agricultural products. However, the amounts remain small in relation to total exports, and rapid growth is somewhat inhibited by the difficulties involved in entering new markets.

In the fiscal area, the authorities succeeded in meeting the ceiling for end-July on net credit to government through strenuous efforts to increase tax collections, particularly on import duties, and to restrain government expenditure. In addition, since August the Government has been making payments of K 20 million per month into the blocked account established with the Bank of Zambia for its external debt service payments. For the year as a whole, total revenue and grants are now expected to amount to K 1,231.7 million, compared with K 1,222.8 million anticipated in the program (Table 6). In part this reflects the impact of higher-than-anticipated exchange rate movements on import duties, the minerals export tax, and grant receipts, and in part the substantial increase in estimated receipts of grants as a result of the Consultative Group meeting held in May 1984. These increases will be offset by shortfalls in excise duties as a result of continuing production difficulties at domestic breweries and in sugar refining and lower-than-anticipated mineral licensing fees. In addition, the new minimum import tax and conversion of the tax basis from f.o.b. to c.i.f. were subject to technical and legal delays and were implemented on October 1, some two months later than planned.

Total expenditure is now projected at K 1,510.4 million, some K 48.6 million, about 3 percent, above the program estimate. Food subsidy payments are estimated to reach K 111.2 million, some K 20 million above the programmed level, partly due to the impact of higher than expected exchange rate movements, which were not accounted for in the original price adjustment, but also reflecting inadequate margins for the crop marketing parastatals following the revised pricing structure introduced on July 1, 1984. Government interest payments are expected to be in line with program estimate, the adverse impact of higher-than-expected exchange rate movements being offset by changes in timing of payments due to the Paris Club. There is also some reclassification between foreign and domestic interest payments on account of a revised agreement between the Bank of Zambia and the Ministry of Finance regarding the treatment of Fund charges. Estimated expenditures include a K 19 million increase in net lending, reflecting the transfer of a U.S. Government commodity grant to the domestic fertilizer company (NCZ). The same amount is, however, included in government grant receipts.

CHART 1
ZAMBIA
REAL AND NOMINAL EFFECTIVE EXCHANGE RATES
USING CURRENCY BASKET, JANUARY 1978-AUGUST 1984
(1980 = 100)



Source: Staff computation.



Table 6. Zambia: Central Government Finance, 1982-84

(In millions of kwacha)

	1982	1983			1984	
		Program	Revised program	Provisional outcome	Program	Revised
Revenue and grants	868.2	1,101.7	1,061.9	1,071.0	1,222.8	1,231.7
Tax revenue	744.3	945.9	903.7	940.9	1,071.2	1,026.4
Nontax revenue	96.1	97.5	99.9	77.2	109.7	125.2
Grants	27.8	58.3	58.3	52.9	41.9	80.1
Total expenditure and net lending	1,389.7 ^{1/}	1,329.7	1,295.9	1,338.6	1,461.8	1,510.4
Current expenditure	1,162.1	1,139.7	1,155.5	1,185.3 ^{2/}	1,311.8	1,338.5
Personal emoluments	356.3	387.8	387.8	393.8	437.4	438.3
Recurrent departmental charges	236.3	203.1	217.1	216.7	228.3	232.1
Subsidies	125.5	82.8	82.8	82.8	91.6	111.2 ^{3/}
Constitutional and statutory	302.6	309.2	322.1	322.3	411.1	413.5
Interest payments	(149.6)	(147.0)	(159.9)	(142.8) ^{2/}	(247.7)	(247.0) ^{4/}
Other ^{5/}	(153.0)	(162.2)	(162.2)	(179.5)	(163.4)	(166.5)
Other payments ^{6/}	141.4	156.8	145.7	169.7	143.4	143.4
Capital expenditure	100.9)	190.0	140.4	153.3	150.0	142.9)
Net lending	126.7)					29.0) ^{7/}
Overall deficit (commitment basis)	-521.5	-228.0	-234.0	-267.6	-239.0	-278.7
Payment of arrears	153.0	--	--	-9.4	--	--
Overall deficit (cash basis)	-674.5	-228.0	-234.0	-258.2	-239.0	-278.7
Financing	674.5	228.0	234.0	258.2	239.0	278.7
External (net)	111.6	19.9	13.6	77.3	-13.3	19.4
Gross borrowing	(193.0)	(80.5)	(62.5)	(94.1)	(57.9)	(71.9)
Amortization	(81.4)	(60.6)	(48.9)	(16.8)	(71.2)	(52.5)
Domestic nonbank (net)	38.9	58.1	105.4	125.2	77.9	84.9
Domestic bank (net)	488.8	150.0	175.0	115.1	174.4	174.4
Other	35.2	--	-60.0	-59.4	--	--
<u>Memorandum item</u>						
Estimated reduction in debt service payments as a result of debt rescheduling ^{8/}	--	161.2	165.0	165.0	376.9	...

Sources: Ministry of Finance, Financial Reports (Annual), 1979-83; Estimates of Revenue and Expenditure, 1984; data provided by the Zambian authorities; and staff estimates.

^{1/} Excludes payment of arrears of K 153 million.

^{2/} Includes incurred arrears on external interest of K 9.4 million.

^{3/} Assumes bank credit to NAMBOARD is limited to K 52.0 million.

^{4/} Assumes that Fund charges, previously to be paid from the budget, will be paid by Bank of Zambia (BOZ), and Government charges on its overdraft will be increased.

^{5/} Mainly defense expenditure on wages and goods and services.

^{6/} Mainly transfers.

^{7/} Includes transfer of US\$10 million U.S. government commodity program grant for fertilizer aid.

^{8/} Effects of current year's rescheduling only. Includes relief on principal and interest payments for current maturities, rescheduled payments falling due in 1984, and arrears.

The overall budget deficit is now projected to be K 278.7 million, some K 39.7 million more than the program amount. Estimated net external financing for the budget has increased by K 32.7 million, however, reflecting a K 18.7 million decrease in projected amortization payments due under debt rescheduling agreements, and a K 14 million increase in gross borrowing, mainly on account of larger U.S. Government commodity loans. Domestic nonbank borrowing is projected to be K 84.9 million. Thus, taking account of the measures listed in Section V below, government credit from the banking system will be kept within the programmed level of K 175 million.

Regarding monetary developments, as noted above the end-July ceiling on banking system credit to government was observed 1/, as was the ceiling on Bank of Zambia credit to the mining company. Net domestic assets of the banking system amounted to K 3,233.5 million at end-July, compared with the ceiling of K 3,346.3 million (Table 7) 2/. However, despite this margin, there are indications that pressures are likely to emerge in the area of nongovernment credit, particularly during the fourth quarter. Seasonal credit demand for agriculture is expected to continue to rise toward the end of the year and the two agricultural marketing agencies, NAMBOARD and the Cooperative Unions, are likely to show substantial increases in their credit needs. In part this reflects inadequate margins provided at the time of the revision to the price structure for maize and maize meal, introduced on July 1, 1984, but it also reflects higher-than-anticipated cost increases, particularly for imported inputs and transportation, mainly due to the impact of the depreciation of the kwacha. On the other hand, the credit demands of the nongovernment sector have been constrained by the lack of foreign exchange, by diminished economic activity, and by the authorities' continued pursuit of the liberal pricing policies provided for in the program, which have improved company liquidity, particularly for parastatals. However, there have been administrative delays for price changes in some areas, particularly for bread prices, which is one of the three remaining items subject to price control and for which Cabinet approval of any price increase is needed, and also for petroleum prices. The net result of these developments, together with other assets (net) of the banking system being below the expected level, has been that money supply (broadly defined) has stagnated, rising by only 2 percent in the seven-month period to end-July 1984.

As a consequence of the above developments, particularly the severe shortage of foreign exchange, real GNP is unlikely to show any increase, implying a continuation of the decline in real per capita incomes. Output of the mining sector is in line with the program estimates, as the retention scheme whereby the company retains 35 percent of its export earnings

1/ According to preliminary data, these ceilings were also observed for end-September.

2/ See Footnote 1 to Table 7.

Table 7. Zambia: Monetary Survey, 1982-84

(In millions of kwacha; end of period)

	1982	1983	1984				
			March (Actual)	July (Actual)	July (Prog.)	Sept. (Prog.)	Dec. (Prog.)
<u>Net foreign assets</u> 1/	-1,442.5	-1,777.7	-1,872.2	-1,968.2	...	-2,006.8	-2,082.6
<u>Net domestic assets</u> 1/	2,890.9	3,132.9	3,147.7	3,233.5	3,346.3	3,402.3	3,480.6
Credit to Government	1,983.4	2,098.5	2,165.0	2,184.6	2,211.0	2,238.5	2,273.3
Bank of Zambia credit to mining company	160.5	165.5	165.5	165.5	165.5	165.5	165.5
Credit to nongovernment sector	744.9	867.0	874.9	952.5	967.9	996.4	1,039.9
Other assets (net) 1/	2.1	1.9	-57.7	-69.1	1.9	1.9	1.9
<u>Money and quasi-money</u>	1,309.2	1,454.1	1,393.7	1,481.6	...	1,630.5	1,678.0
<u>Other liabilities</u> 2/	139.2	-98.9	-118.2	-216.3	...	-235.0	-280.0

Sources: Data provided by the Zambian authorities; and staff projections.

1/ These data have been revised to eliminate revaluation changes that have occurred in respect of external commercial payments arrears which are classified as foreign liabilities of the banking system. The absolute increase in net domestic assets during the program period, as specified in EBS/84/135 has been preserved. Using the previous definition, actual net domestic assets for end-July would have amounted to K 3,399.5 million as against the program limit of K 3,444.5 million.

2/ SDR allocation, revaluation of official gold holdings, and revaluation losses of the Bank of Zambia.

has protected its operating efficiency, and the depreciation of the kwacha has preserved the company's profitability despite the decline in export prices. The effect of the foreign exchange constraint has to a small extent been offset by increased domestic value added. Agricultural output may be somewhat higher than anticipated, but prospects for the industrial sector have deteriorated, with a number of factories now threatened with closure by the continued lack of essential imported inputs. The parastatal holding company, ZIMCO, has shown a slight increase in profitability compared with the 1982/83 fiscal year, largely in response to the program's price and wage policies. The increase in consumer prices is expected to be in line with the program's estimate of 25 percent, and the Government has continued to pursue the cautious wage policies envisaged in the program.

V. Near-Term Prospects and Policies

The staff will shortly be conducting a further review of Zambia's economic situation, including discussion of the policies and targets to be included in the 1985 adjustment program. In the meantime, the authorities have given firm assurances of their intention to continue pursuing policies of fiscal restraint and external adjustment, and to take additional actions to ensure that the program's end-December performance criteria are observed. They will also be taking further measures in the context of the 1985 program to mitigate the impact of the additional deterioration in short- and medium-term external prospects, consequent to the further deterioration in world copper prices. In the fiscal sector, in addition to the implementation of the import tax measures discussed earlier, further efforts are now being made to improve tax collection, including an acceleration in the processing of applications for emerald mining licenses. The increased level of grants that resulted from the Consultative Group Meeting will be promptly collected and transferred to the government budget, and close attention is being given to implementing methods of improved expenditure monitoring and control. In addition, careful attention is being given to measures that can be taken to reduce the budget deficit still further in 1985, including opportunities to increase tax revenues and to reduce subsidy expenditures.

The authorities are continuing to implement the principle of economic pricing, as indicated by the substantial increase in prices of a number of key commodities enacted earlier this year. In pursuit of this objective, and in view of the need to further strengthen parastatal finances, the prices of bread and wheat flour have been decontrolled effective November 1, 1984. It is expected that this will lead to an immediate and substantial increase in prices, sufficient to restore the margins of the milling companies to adequate levels. In addition, in view of the recent emergence of losses in petroleum operations in early November the authorities implemented increases in the price of petroleum products ranging from 4 percent for kerosene to 100 percent for heavy fuel oil, to restore the

company at least to the level of profitability as of April 1984, the time of the last significant price increase. Prices will continue to be adjusted promptly in line with cost increases, including the impact of exchange rate movements. In addition, the authorities will implement early in 1985, probably at the time that the government budget is submitted to Parliament, a further increase in the price of maize meal sufficient to provide significantly improved margins for NAMBOARD and the Co-operative Unions. To further reinforce the program's monetary policy, the Bank of Zambia is introducing a revised structure of interest rates, involving an increase in maximum deposit and lending rates of 2.5 percentage points. The Bank is also cooperating closely with the commercial banks to ensure that the targets for credit to the nongovernment sector and the net domestic assets of the banking system are respected. The Bank has also concluded an agreement with the Treasury concerning interest payments by the Government that will ensure that the Bank's operations remain profitable.

Regarding the external sector, the authorities are aware of the need to improve the allocation of scarce foreign exchange resources. For this reason they are continuing to pursue a flexible exchange rate policy, with monthly monitoring and adjustment of the rate. The objective will be to achieve a further reduction in the real effective exchange rate in view of the intensification of the foreign exchange shortage. The authorities are continuing to maintain close cooperation with the Fund staff in the area of exchange rate management. They intend to effect fundamental changes in this area as part of the 1985 program. They are also aware of the limitations of the present system of import licensing and the adverse impact of the pipeline of commercial payments arrears. The inadequacy of existing arrangements in these and other areas has been clearly recognized in a recent speech made by President Kaunda to the Third National Convention. The authorities are therefore giving urgent consideration to methods of improving existing arrangements so as to channel resources to the most productive and essential uses, to facilitate a return to more normal relations with suppliers, and to reduce the present disincentives to foreign companies and nonresidents in Zambia. In the interim, they intend to prevent any increase on a cash basis in the level of commercial payments arrears (measured at a constant exchange rate and excluding any reductions from refinancing or rescheduling) during the period of end-July to end-December 1984. 1/

In the area of external debt the authorities are continuing discussions with non-OECD creditors, with whom agreements have not yet been concluded. They intend to comply strictly with the terms of the agreed Minute of the Paris Club meeting, and with the agreements with commercial creditors, and accordingly will not agree to more favorable terms with any

1/ Provisional data show that this target was observed for the period to end-September.

non-Paris Club creditors. They also intend to resume making the scheduled payments into the external special account established in accordance with the agreed Paris Club minute.

Through continued appropriate domestic and external policies within the framework of the 1984 adjustment program, particularly with respect to pricing policies and other actions to sustain and improve the structure of incentives, the authorities are endeavoring to mitigate the adverse effect of the real resource constraint on domestic production. To enhance this effort they are also continuing to cooperate closely with the World Bank and other multilateral and bilateral donors in formulating and implementing appropriate sectoral policies. A US\$300 million export rehabilitation and diversification project, cofinanced by the World Bank, is already underway for the mining sector. Discussions are also well advanced on an agriculture sector rehabilitation credit, for which the policy package has been largely agreed and most of the necessary measures are already in place. The authorities are also cooperating closely with the Bank in efforts to improve the efficiency and profitability of ZIMCO, and the Bank has undertaken an industrial sector project that may later be supported by a credit.

Despite these efforts, prospects for 1985 and beyond do not appear favorable. In the absence of a substantial recovery in the copper price, and even assuming continued very generous debt relief from official and commercial creditors, there will be little scope for any significant recovery in import volumes from the present very low levels. Therefore the pressures on the productive capacity of all sectors of the economy will continue. Furthermore, economic prospects are increasingly vulnerable to any further deterioration in external prospects. The authorities are fully aware of the extremely difficult short- and medium-term economic prospects facing Zambia. In these circumstances, the authorities intend to redouble their efforts in 1985 to further reduce domestic and external financial imbalances and to spur the pace of diversification of the economy away from the dominant mining sector. Efforts will be strengthened to restrain domestic consumption and boost savings through a further reduction in the overall budget deficit, appropriate prices and incomes policies, and tight monetary policies. In the external sector the authorities will need to continue to pursue an active exchange rate policy and take such other actions as are necessary to promote export diversification and restrain demand for imports. The authorities have stated their firm intention to make important changes in their trade, payments, and exchange systems, to continue their flexible approach to pricing policies, and to find a way to address more adequately the problems associated with the pipeline of commercial payments arrears, as part of the 1985 program.

VI. Staff Appraisal and Proposed Decisions

Under the present stand-by arrangement, the Zambian authorities have continued their efforts to reduce domestic and external imbalances in the face of declining real incomes resulting from continuously declining terms of trade. In the course of the program they have implemented a number of important adjustment measures. These include the continued depreciation of the kwacha, increases in interest rates, a number of additional tax increases and other efforts to improve tax collections, curtailment of budgetary expenditures (including further significant reductions in real outlays for personnel), significant increases both in the retail prices of maize and fertilizer and in agricultural producer prices, and further increases in wholesale and retail prices for petroleum and other key commodities consistent with the principles of full economic pricing. Efforts to reduce costs and improve financial performance and efficiency throughout the parastatal sector, including the critical mining sector, have also continued, and a new consolidation and rescheduling of external debt service payments and accumulated arrears has been reached with the Paris Club. In addition, the authorities have reached agreement in principle on rescheduling terms with the commercial banks, and are near agreement on rescheduling with non-OECD official creditors.

Despite these measures, the balance of payments outlook for 1984 and beyond now appears even more serious than envisaged at the outset of the program. Further significant decreases in the price of copper since mid-year have led once again to a downward revision in projected export earnings, and the latest estimates of Zambia's debt service obligations and likely debt relief for 1984 show a significantly greater increase than earlier anticipated in debt service payments. This has imposed further constraints on imports, which in turn is affecting the present and potential performance of all sectors of the economy, and has made it impossible for Zambia to observe the performance criteria relating to the reduction in external arrears through cash payments. Furthermore, the additional deterioration in short- and medium-term balance of payments prospects consequent to the further weakening of world copper prices indicates that even stronger medium-term structural adjustment efforts are needed.

Regarding the budgetary situation, shortfalls in tax revenues, resulting largely from shortfalls in excise duties and licensing fees and a delay of two months in implementing the new import duty measures, are likely to be offset by higher estimated receipts from grants. Outlays on subsidies are expected to be higher-than-anticipated, mainly due to the greater-than-anticipated depreciation of the currency, which was not accounted for in the original price adjustment, and net lending to parastatals will rise as counterpart to the increased grants included in revenue. As a result, the budget deficit for 1984 is likely to be slightly higher than that projected at the start of the program, but this will be offset by additional external net financing and domestic nonbank borrowing.

The prospects are that the target on net banking system credit to government will be maintained. However, this requires a timely transfer to the Government of the increased level of grants resulting from the Consultative Group meeting. Moreover, additional attention must be given to improving the monitoring and control of expenditure in line with the recent fiscal technical assistance report of the Fund's Fiscal Affairs Department.

With regard to banking system credit to entities other than the central Government, difficulties may be encountered during the remainder of the year in view of the seasonal demand for agricultural credit and credit demands of the parastatal agencies. The authorities have pledged to maintain a tight monetary policy and restrict lending by the commercial banks so that the program's ceilings on net domestic assets are observed. To facilitate this, the structure of interest rates has been revised upward by two-and-a-half percentage points, which will improve the allocation of scarce financial resources and substantially increase incentives for domestic savings. Nevertheless, interest rates remain negative in real terms at the present rate of inflation. Furthermore, the upward adjustment in the price of bread and wheat flour following the decontrol of bread and flour prices and the substantial increase in the price of petroleum products should limit the demand for credit on a net basis. It is important that the authorities recognize the necessity of maintaining adequate margins for the distribution and processing of agricultural products, especially maize meal. The authorities have stated their commitment to appropriate action in this area early in 1985.

In order to sustain the profitability of exports in the face of deteriorating external terms of trade, the authorities are pursuing a flexible exchange rate policy. Since January 1983 the rate has been depreciated by more than 50 percent against the U.S. dollar, or more than 100 percent measured in local currency terms. Furthermore, in response to the most recent further deterioration in the external position, the rate of depreciation has been increased. This will reduce the imbalance between the demand for foreign exchange and its availability, further reinforce incentives for export diversification, and ensure the profitability of the mining sector despite the decline in export prices. The staff welcomes the authorities' intention to continue to pursue a flexible exchange rate policy, and to take further substantial actions in this area early in 1985 to facilitate essential structural changes in the Zambian economy.

While the improvement in incentives is beginning to have a visible effect on export diversification, particularly of agricultural products, progress is slow and the increased shortage of foreign exchange is adversely affecting all sectors of the economy. There is, indeed, a danger of a rapid downward spiral of falling production and falling external and domestic budgetary receipts that would certainly exacerbate economic difficulties. In addition, the import licensing system is clearly overburdened, as was recognized in a recent speech by President Kaunda at the

Third National Convention. The problems associated with administrative attempts to allocate increasingly scarce foreign exchange resources to their most productive and essential end-use are enormous. Failure to anticipate a decline in receipts from exports results in the value of licenses issued continuing to exceed resources, causing continued disruption, and uncertainty in import activities. The foreign exchange shortage also prevents the authorities from reducing external commercial payments arrears in line with the program's targets. In addition, the failure to deal effectively with the pipeline of arrears has a serious adverse effect on the Zambian economy. It leads to difficulties with Zambia's external suppliers, who customarily charge higher prices in anticipation of payments delays. It also leads to reluctance on the part of foreign firms and expatriate workers to do business in Zambia. The staff welcomes the intention of the authorities to change early in 1985 the present arrangements for import licensing, to improve allocation of scarce resources, and to deal with the pipeline so as to facilitate a return to more normal relations with suppliers and reduce the disincentive to foreign companies and nonresidents in Zambia.

The staff believes that the requested waiver and modification of the performance criterion on external payments arrears are justified. The measures taken thus far, and the further policy initiatives described in this paper, are consistent with strengthening Zambia's balance of payments and domestic financial position, and in promoting structural change in the economy as envisaged under the current program, and should ensure that the revised end-December performance criteria are attained. Nonetheless, since the external outlook remains extremely precarious, Zambia will need in the near future to reinforce its adjustment policies, especially in the areas of foreign exchange, subsidies, and social policy in general. On the basis of present expectations for export receipts in 1985 and beyond, Zambia's balance of payments position will remain extremely difficult. Creditors both within and outside the Paris Club will also need to continue to be understanding of Zambia's difficulties, and concessional aid on a substantial scale will also be needed for a considerable time to come in support of Zambia's intensified adjustment efforts. In this respect the staff welcomes the more active role of the World Bank in assisting Zambia, in particular its sponsorship of the Consultative Group meeting in May 1984 and its role in organizing the export rehabilitation and diversification project approved in March 1984 and in initiating plans for new projects in agriculture and the industrial sector.

Proposed Decision

In view of the foregoing, the following draft decision is proposed for adoption by the Executive Board:

1. Zambia has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Zambia (EBS/84/135, Supplement 2, 7/20/84), which entered into effect on July 26, 1984, and in accordance with the letter from the Minister of Finance dated June 1, 1984 attached thereto.

2. The letter of the Minister of Finance of Zambia dated October 31, 1984, shall be annexed to the stand-by arrangement for Zambia and the letter dated June 1, 1984 shall be read as supplemented and modified by the letter of October 31, 1984.

3. The Fund decides that, notwithstanding the fact that external commercial payments arrears have not been limited as contemplated in paragraph 4(a)(1) of the stand-by arrangement for Zambia, Zambia may proceed to make purchases under the stand-by arrangement.

4. The understandings referred to in paragraph 4(a)(1) of the stand-by arrangement for Zambia, relating to external commercial payments arrears, shall be those for end-December 1984, as described in paragraph 5 of the letter of the Minister of Finance of Zambia dated October 31, 1984.

5. The Fund and Zambia have concluded the review pursuant to paragraph 4(c) of the stand-by arrangement for Zambia and paragraph 6 of the letter of June 1, 1984 attached thereto. The Fund finds that no understandings in other respects are necessary.

ZAMBIA - Relations with the Fund
(As of September 30, 1984)

I. Membership Status

- (a) Date of membership: September 23, 1965
- (b) Status: Article XIV

II. General Department (General Resources Account)

- (a) Quota: SDR 270.3 million (previously SDR 211.5 million)
- (b) Total Fund holdings of currency:
SDR 956.7 million (353.9 percent of quota)
- (c) Fund credit: SDR 686.4 million (253.9 percent of quota)
 - Credit tranche--SDR 104.7 million (38.7 percent)
 - EFF--SDR 77.0 million (28.5 percent)
 - Enlarged access--SDR 314.2 million (116.2 percent)
 - CFF--SDR 190.5 million (70.5 percent)
- (d) Reserve tranche position: None
- (e) Current operational budget: Not included
- (f) Lending to the Fund: None

III. Current Stand-by or Extended Arrangement and Special Facilities

(a) Current stand-by

- (i) Duration: July 16, 1984-April 30, 1986
- (ii) Amount: SDR 225.0 million
- (iii) Utilization: SDR 30.0 million
- (iv) Undrawn balance: SDR 195.0 million

(b) Stand-by and extended arrangements during last 10 years:

- (i) First credit tranche purchase - one-year stand-by for 25 percent of quota, approved in May 1973;
- (ii) One-year stand-by for 82 percent of quota, approved in July 1976;
- (iii) Two-year stand-by for 177 percent of quota, approved in April 1978;
- (iv) Three-year extended arrangement for 378 percent of quota, approved in May 1981 and canceled in July 1982;
- (v) One-year stand-by for 100 percent of quota, approved in April 1983;

ZAMBIA - Relations with the Fund (contd)
(As of September 30, 1984)

(c) Special facilities in the past two years:

(i) Compensatory financing facility purchase for 16 percent of quota (SDR 34 million), approved in December 1982.

(ii) Compensatory financing facility purchase for 46 percent of quota (SDR 97.2 million), approved in principle April 18, 1983 and authorized May 18, 1983.

IV. SDR Department

(a) Net cumulative allocation: SDR 68.3 million

(b) Holdings: SDR 0.45 million (0.7 percent of net cumulative allocation)

(c) Current Designation Plan: Not included

V. Administered Accounts

(a) Trust Fund Loans

(i) Disbursed SDR 42.77 million

(ii) Outstanding SDR 41.80 million

(b) SFF Subsidy Account: SDR 3.52 million

VI. Overdue Obligations to the Fund: None.

B. Nonfinancial Relations

VII. Exchange rate arrangement

The Zambian kwacha is pegged to an unannounced basket of currencies. The U.S. dollar is the intervention currency, and the Bank of Zambia's rates for the U.S. dollar are based on the U.S. dollar/SDR rate calculated by the Fund for the preceding day. As of September 28, 1984, the rate was K1 = US\$0.50458

VIII. Last Article IV consultation and stand-by review

The last Article IV consultation discussions were held in Lusaka during February 7-22, 1984 with Board discussion on July 16, 1984. The last review under the previous arrangement was held concurrently with the Article IV consultation. A staff visit to conclude negotiations for the present arrangement took place in Lusaka May 22-June 2, and discussions for the first review under this arrangement were held in Lusaka August 21-September 5.

ZAMBIA - Relations with the Fund (concluded)
(As of September 30, 1984)

IX. Technical Assistance

The Central Banking Department has furnished the Bank of Zambia with a Research Adviser (February 1983-February 1984), an economic adviser to the Governor (appointed October 1983), and an external debt adviser (appointed November 1983 for one year).

A technical assistance mission from the Fiscal Affairs Department visited Zambia March 25-April 9, 1984.

X. Resident Representative:

A Fund resident representative has been stationed in Lusaka since November 1983.

ZAMBIA: Financial Relations with the World Bank Group

A. IBRD/IDA operations (as of July 31, 1984)

(In millions of U.S. dollars)

	<u>Disbursed</u>		<u>Undisbursed</u>	
	<u>IBRD</u>	<u>IDA</u>	<u>IBRD</u>	<u>IDA</u>
Agriculture (incl. industrial forestry)	37.84	6.49	9.32	22.48
Education	63.56	3.86	--	18.80
Export sector rehabilitation	0.19	--	74.81	--
Industrial and development finance	110.43	0.79	6.34	3.28
Power, energy, and water supply	154.77	1.47	--	13.56
Program lending	42.50	--	--	--
Technical assistance (incl. petroleum exploration)	2.27	2.16	4.33	2.84
Telecommunications	31.55	--	0.45	--
Transportation	60.53	13.78	22.92	12.47
Urban	<u>20.00</u>	<u>--</u>	<u>--</u>	<u>--</u>
Total	523.65	28.55	118.17	73.42
Of which has been repaid	182.78	--		
Total now outstanding	340.87	28.55		

B. IFC investments
(as of September 30, 1984)

<u>Disbursed</u>	<u>Undisbursed</u>
55.2	17.9

Sources: IBRD and IFC.

Office of the Minister
Ministry of Finance
P.O. Box 50062
Lusaka, Zambia

October 31, 1984

Dear Mr. de Larosiere,

1. Under the provisions of the stand-by arrangement approved by the Fund's Executive Board on July 18, 1984 and activated on July 26, 1984, following the results of the Paris Club meeting on Zambia held July 20, the Government is to review with the Fund progress under the program prior to the program's second purchase. In pursuance of this, extensive discussions have recently been held with the Fund staff covering the most recent developments and prospects of the Zambian economy and the need for adjustments in policy, in order to achieve the objectives of the program in the light of the substantial changes that are continuing taking place in the external environment.
2. Despite the pursuit of an extremely tight fiscal policy and a flexible exchange rate policy, the shortage of foreign exchange has intensified the immediate balance of payments situation and, in the absence of policy modifications, medium-term prospects appear again to have deteriorated. While copper export volumes are expected to be in line with the program target for 1984, copper prices have again declined. Our price projections for 1984 have been revised downward to US\$0.61 compared with US\$0.65 per pound envisaged in the program. As a result, export receipts have fallen below those envisaged in the program. In addition, drawings on new loans were less favorable than had been assumed. This had led inter-alia to increased difficulties in allocating scarce foreign exchange with increasingly serious economic repercussions both for domestic production and in our ability to meet our external obligations. In particular, it led to a situation in which we were unable to comply with our undertaking to bring about a net reduction in cash terms of SDR 6 million in commercial payments arrears in the period March-July 1984; there was instead a net increase of SDR 14 million.
3. We have had to implement budgetary and credit policies under difficult circumstances. With regard to the Government budget there have been continued production problems at the brewery and difficulties at the sugar refinery leading to a significant shortfall in sales and excise taxes. In addition for administrative reasons there was a delay in implementing the new minimum rate of import duty of 10 percent and the change in the basis of import taxation from f.o.b. to c.i.f. Nevertheless, we were able to observe the end-July and end-September ceilings on net banking system credit to the Government specified in my letter of June 1, 1984. Prospects

for the remainder of the year appear to be more favorable because receipts of grants following the Consultative Group Meeting held in May 1984 are expected to be in excess of the budgetary estimate. The ceilings on net domestic asset were met with substantial margins despite increased demand for credit from our parastatal enterprises and a worsening financial position of NAMBOARD and the Cooperative Unions which resulted in inadequate margins having been allowed at a time when other costs have risen sharply, due to the depreciation of the kwacha.

4. In view of the above difficulties and to ensure that credit limits mentioned in my letter of June 1, 1984 are observed, we have taken the following additional actions:

- (i) The new tax measures involving higher import duties have been implemented effective October 1 and we do not intend to authorize any discretionary tax rebates.
- (ii) The prices of bread and wheat flour will no longer be subject to price control effective November 1 and it is to be expected that significant increases in prices will take place sufficient to restore the margins of the milling companies to adequate levels.
- (iii) On November 5 the prices of gasoline, diesel, and kerosene were raised on average by some K0.04 per liter, or some 6 percent. At the same time the prices of all other petroleum products were raised by amounts ranging from 8 percent to 100 percent. In addition to improving the position of Zambia National Energy Limited, the latter increases represent significant progress in eliminating cross-subsidization between products. These price changes are judged to be sufficient to restore the levels of profitability of Zambia National Energy Limited to that prevailing in April 1984, the date of the last substantial price increase. Oil prices have been liberalized and we expect them to continue to be adjusted in line with developments in a flexible manner and without undue delay.
- (iv) Interest rates will be raised effective by 2.5 percentage points, bringing the maximum deposit rate to 15.5 percent and the maximum lending rate to 17.5 percent.
- (v) The rate of depreciation of the kwacha has been increased. During the first 10 months of 1984 there has been a depreciation against the dollar of 27 percent in foreign currency terms, a depreciation of about 13 percent in real effective terms. It is our intention to continue to pursue a flexible exchange rate policy designed to facilitate the structural changes in the Zambian economy.

(vi) We will also take all actions necessary to ensure that existing budgetary policies are strictly implemented and in particular that the increased level of grants anticipated as a result of the Consultative Group Meeting are promptly collected and transferred to the Government. We will also continue to make the monthly payments of K 20 million into the blocked account for Government external debt service and remain current in meeting all other obligations.

(vii) Finally agreement has been reached between the Ministry of Finance and the Bank of Zambia which ensures that the Bank of Zambia does not make losses on its day-to-day operations.

5. The above actions will inter alia improve the Government's budgetary position and the financial position of the parastatal sector. On the basis of these actions we expect to be able to observe the program's targets for the remainder of the year for net banking credit to the Government, the net domestic assets of the banking system and Bank of Zambia credit to the mining sector. We will also not incur any arrears under debt rescheduling agreements and will comply with the program's ceilings on new non-concessional external borrowing. However, as noted above, we have been unable to achieve the programmed reduction in external commercial arrears during the period end-March to end-July and we do not expect to comply with the target reduction for the remainder of the year. We therefore wish to request that the September ceiling in respect of external commercial payments arrears be waived and the ceiling for December be modified to reflect that there will be no increase on a cash basis on commercial payments arrears during the period end-July to end-December 1984. The revised performance criteria are as set forth in Attachment I.

6. With regard to the outlook for 1985 and beyond, we do not envisage any major improvement in the copper price and we are moreover aware that our reserves of copper and other minerals are depleting. We intend therefore to continue the strong adjustment efforts of 1983 and 1984, to further reduce domestic and external imbalance and to enhance the pace of diversification of the economy. We are therefore giving urgent consideration to the need to improve the existing import licensing and foreign exchange allocation system and to find a way to address more adequately the problems associated with the pipeline of commercial payments arrears. At the same time we intend to continue to pursue tight budgetary and monetary policies as well as appropriate prices and incomes policies. We are aware that urgent consideration needs to be given to implementing methods of improved expenditure monitoring and control along the lines of the recommendations made in the report by the Fund's Fiscal Affairs Department, to become effective in early 1985. These matters, as well as steps taken to improve the financial position of NAMBOARD and the Cooperatives and additional means of taxation would be important in the

context of the next review discussion of the stand-by arrangement to take place in late 1984. In all these regards we will remain in close contact with the Fund staff during the period prior to the next review of the stand-by arrangement with the Fund which we intend to carry out before end-March 1985, on which occasion understandings will be reached on policies to be pursued and performance criteria to be observed for the remaining period of the arrangement.

Yours sincerely,

L.J. Mwananshiku, M.P.
Minister of Finance
(signed)

Zambia: Quantitative Performance Criteria, 1983-84

(End of period)

	1983	1984					
	Dec. Actual	March Actual	July Ceiling	Actual	September	1/December Ceilings	
	(In millions of kwacha)						
Net domestic assets <u>2/</u>	3,132.9	3,147.7	3,346.3	3,233.5	3,402.3 <u>3/</u>	3,480.6 <u>3/</u>	
Claims on Government (net)	2,098.5	2,165.0	2,211.0	2,184.6	2,238.5 <u>3/</u>	2,273.5 <u>3/</u>	
Bank of Zambia claims on ZCCM	165.5	165.5	165.5	165.5	165.5	165.5	
	(In millions of SDRs)						
Cumulative net change commercial payments arrears through cash payments <u>4/</u>	597.0 <u>5/</u>	617.0 <u>5/</u>	6.0	-14.0 <u>6/</u>	-14.0 <u>6/</u>	-14.0 <u>6/</u>	
Arrears under debt rescheduling agreements	38.0	...	--	--	--	--	
New nonconcessional external borrowing contracted or guaranteed by Government (cumulative)							
1-12 years' maturity	...	...	50	...	50	50
1-5 years' maturity	...	...	--	--	--	--
1 year and under	...	...	--	--	--	--

1/ According to preliminary data, September performance criteria were met, except for the reduction in commercial payments arrears.

2/ These data have been revised to eliminate revaluation changes that have occurred in respect of external commercial payments arrears which are classified as foreign liabilities of the banking system. The absolute increase in net domestic assets during the program period, as specified in EBS/84/135 has been preserved. Using the previous definition, actual net domestic assets for end-July would have amounted to K 3,399.5 million as against the program limit of K 3,444.5 million.

3/ The ceilings will be reduced to the extent that government payments to the Bank of Zambia for external debt service fall short of the K 20 million to be paid into the blocked account each month, beginning July 1984. For these purposes, external debt service payments will be treated as if they were paid from the blocked account. Balances in the blocked account will be excluded from net credit to Government and from net domestic assets for the purposes of monitoring the program.

4/ The reduction applies to the end-March level of commercial payments arrears, which amounted to SDR 617 million, including those of ZCCM.

5/ Absolute level of commercial payments arrears.

6/ Net increase on a cash basis from the end-March level.

