

MASTER FILES

EBS/83/274

CONFIDENTIAL

December 23, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Zambia - Review of Exchange Rate Policy Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a review of the exchange rate policy under the stand-by arrangement for Zambia. A draft decision appears on page 6. 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. Bornemann, ext. 78181 or Mr. Sharer, ext. (5)8752.

Att: (1)

INTERNATIONAL MONETARY FUND

ZAMBIA

Review of Exchange Rate Policy Under the
Stand-By Arrangement

Prepared by the African Department

(In consultation with the Exchange and Trade Relations,
Legal and Treasurer's Departments)

Approved by O.B. Makalou and S. Kanesa-Thanan

December 23, 1983

I. Introduction

On April 18, 1983, the Executive Board approved Zambia's request for a one-year stand-by arrangement in the amount of SDR 211.5 million, or 100 percent of quota (EBS/83/67, Supplement 3, 4/19/83). At the time of the mid-term review of the arrangement on September 16, 1983 (EBS/83/176), the Executive Board decided that, in addition to the observance of the end-October performance criteria, purchases after November 30, 1983 would be subject to a review of Zambia's exchange rate policy. 1/ (See Paragraph 4(b) of Executive Board Decision No.7531-(83/142), adopted September 16, 1983). An early review of the exchange rate policy was provided in order to ensure that the exchange rate would be adjusted by a sufficient margin to support the continued financial viability of the mining sector.

II. Performance Under the Program

The authorities have implemented all the measures included in the mid-term review, as set forth in the letter from the Prime Minister and Minister of Finance to the Managing Director, dated August 16, 1983. 2/ Furthermore, all the program's performance criteria for end-October were observed, as shown in Table 1.

1/ The staff team which carried out the discussions in Lusaka during November 22-December 7, 1983 that provided the basis for the review was composed of Messrs. Bornemann, Sharer, and Greene, all of the African Department, Mr. Schneider (FAD), Mr. Hatayama (ETR), and Miss Simpson (secretary-AFR). Mr. Paljarvi, IMF Representative in Zambia, assisted the mission in these discussions. Mr. Mtei, Alternate Executive Director, also participated in some of the policy discussions.

2/ Appendix III of EBS/83/176.

Table 1. Zambia: Quantitative Performance Criteria, 1982-83

	<u>1982</u> <u>Dec.</u> Actuals	<u>April</u> Ceiling Actual		<u>1983</u> <u>July</u> Ceiling Actual		<u>Oct.</u> Ceiling Actual		<u>Dec.</u> Ceiling		
(In millions of kwacha)										
Net domestic assets	2,933.0	3,063.9	2,972.8	3,117.8	2,996.9	3,221.2	2,989.7	3,243.0		
Claims on Government	1,983.4	2,058.4	2,110.1	2,158.4	2,127.0	2,158.4	2,055.0	2,158.4		
Bank of Zambia claims on ZCCM	160.5	170.5	170.5	170.5	170.5	170.5	165.5	170.5		
(In millions of SDRs)										
Commercial payments arrears <u>2/</u>	669.3	669.3 <u>1/</u>	686.5 <u>1/</u>	669.3	659.7	654.3	638.4	639.3		
Arrears under debt resched- ulings agreements	--	--	--	--	--		
New external borrowing contracted or guaranteed by Government cumulative										
1-10 years maturity	...	100.0	--	100.0	--	100.0	--	100.0		
1-5 years maturity	...	--	--	--	--	--	--	--		
Memorandum item:										
<u>Exchange rate</u> (end of period)	<u>Dec.</u>	<u>Jan.</u>	<u>June</u>	<u>July</u>	<u>August</u>	<u>Sept.</u>	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.-Nov.</u>	<u>June-Nov.</u>
									(Change in percent)	
SDRs per kwacha	0.9763	0.7810	0.7810	0.7531	0.7031	0.6949	0.6983	0.6657	31.8	14.8
U.S. dollars per kwacha	1.0756	0.8458	0.8309	0.8045	0.7345	0.7345	0.7397	0.6939	35.5	16.5

1/ End-May.2/ Reflects reductions through cash payments. In addition, there was a reduction of SDR 21 million due to rescheduling in October.

The banking system's net claims on Government actually declined between July and October 1983. Budgetary expenditures for 1983 appear to be in line with the projections made at the time of the mid-term review following implementation of the program's expenditure constraint measures (Table 2). Revenues and grants are expected to be slightly lower than earlier estimates, due to lower import licensing fees, but the shortfall should be financed by slightly higher net external borrowing, due to delays in the conclusion of bilateral debt rescheduling agreements. Thus government borrowing from the banking system is expected to remain within the program limit of K 175 million.

There was virtually no change in the net domestic assets of the banking system during July-October, reflecting mainly the reduction in net claims on Government. Credit to the private sector has increased slightly more than anticipated during the mid-term review due to buoyant demand for agricultural credit, particularly from the commercial farmers' sector.

Since the time of the mid-term review, Zambia's external prospects have deteriorated somewhat, mainly due to a drop in world market prices for copper. Export receipts are now expected to be SDR 877 million, or 7 percent below earlier estimates, reflecting a 3 percent decline in volume, and an average annual price of US\$0.72 per lb., versus US\$0.76 previously forecast. The value of imports is now estimated to be slightly lower, but movements on services and unrequited transfers appear to be in line with the earlier projections. Thus the current account deficit is now expected to reach SDR 263 million, as against SDR 207 million anticipated at the time of the mid-term review (Table 3).

The capital account of the balance of payments is now estimated to be somewhat better than previously forecast. This reflects higher gross inflows in government capital mainly related to refinancing arrangements for commercial payments arrears. In addition, it appears likely that some of the debt rescheduling agreements involving initial cash payments will only be signed in early 1984, which would alleviate the external position in 1983 by means of a larger effective debt relief. As a result an overall balance of payments deficit amounting to SDR 83 million is projected, SDR 23 million higher than the previous estimate. Moreover, it should be noted that purchases from the Fund in 1983 would be SDR 67.5 million lower, as the purchase linked to the October performance criteria is now expected to be made only in January 1984. On the other hand, projected cash payments of SDR 38 million in respect of debt related arrears will not be paid during 1983 due to delays in the signing of the related agreements. Consequently, an unfilled financing gap of SDR 53 million is expected to remain in 1983, which will be met by the corresponding increase in external liabilities reflecting in part some short-term bridging loans until the next Fund purchase; such loans would also be essential for the authorities to comply with the end-December performance

Table 2. Zambia: Central Government Finance, 1981-83

(In millions of kwacha)

	1981	1982	1983	
			Revised program	Estimate
Revenue and grants	834.1	868.2	1,061.9	1,036.6
Tax revenue	732.9	744.3	921.3	923.9
Nontax revenue and grants	101.2	113.9	140.6	112.7
Total expenditure and net lending	1,277.7	1,543.0	1,295.9	1,295.9
Current expenditure	1,148.6	1,233.5	1,155.5	1,155.5
Personal emoluments	273.0	292.2	304.5	...
Recurrent departmental charges	230.6	328.2	300.4	...
Subsidies	110.4	154.1	82.8	...
Constitutional and statutory	444.2	317.6	322.1	...
Interest payments	(117.7)	(149.6)	(159.9)	...
Other <u>1/</u>	(326.5)	(167.9)	(162.2)	...
Other payments <u>2/</u>	90.4	141.4	145.7	...
Capital expenditure	119.3)	182.9)	140.4	...
Net lending	9.8)	126.7)		
Payment of past arrears <u>3/</u>	19.0	--	--	--
Overall deficit (-)	-462.8	-674.8	-234.0	-259.3
Financing	462.8	674.8	234.0	259.3
External (net)	247.4	111.8	13.6	38.9
Gross borrowing	(278.6)	(193.2)	(62.5)	(87.8)
Amortization	(31.2)	(81.3)	(48.9)	(48.9)
Domestic nonbank (net)	52.0	38.9	105.4	105.4
Domestic bank (net)	163.8	488.9	175.0	175.0
Other	-0.4	35.2	-60.0	-60.0

Sources: Ministry of Finance, Financial Reports (Annual), 1979-81; Estimates of Revenue and Expenditure, 1983; data provided by the Zambian authorities; and staff estimates.

1/ Primarily defense expenditure on wages and goods and services.

2/ Mainly transfers.

3/ Current expenditure in 1982 includes repayment of K 153 million of arrears.

Table 3. Zambia: Balance of Payments, 1981-1983

(In millions of SDRs)

	1981	1982	1983	
			Mid-term Review	Rev.
Exports, f.o.b.	833	839	943	877
Imports, c.i.f.	-1,050	-1,049	-786	-776
Trade balance	-217	-210	157	101
Services and unrequited transfers (net) <u>1/</u>				
Investment income	-178	-226	-221	-221
Other services	-148	-131	-111	-111
Private transfers	-100	-104	-75	-75
Government transfers	23	36	43	43
Total	-403	-425	-364	-364
Current account	-620	-635	-207	-263
Nonmonetary capital (net) <u>1/</u>				
Government	242	126	-19	-15
Inflow	(272)	(188)	(78)	(102)
Outflow	(-30)	(-62)	(-97)	(-117)
Mining Company	85	96	36	37
Inflow	(209)	(163)	(133)	(134)
Outflow	(-124)	(-67)	(-97)	(-97)
Other (net) <u>2/</u>	-96	-169	-80	-70
Total	231	53	-63	-48
SDR allocation	15	--	--	--
Valuation adjustments <u>3/</u>	47	21	--	--
Debt relief on principal and interest during the year	--	--	210	228 <u>4/</u>
Overall balance	-327	-561	-60	-83
Financing:				
Use of Fund resources (net)	312	-52	128	60
Purchases	(359)	(34)	(242)	(174)
Repurchases	(-47)	(-86)	(-114)	(-114)
Payments arrears (decrease-)	39	447	-270	-223 <u>4/</u>
of which: cash payments of commercial arrears	(--)	(--)	(-30)	(-30)
cash payments of debt service	(--)	(--)	(-38)	(--)
Rescheduling of arrears	--	--	202	193
Other foreign assets, net (increase-)	-24	166	--	53

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

1/ Debt service represents original maturities before rescheduling.

2/ Includes errors and omissions.

3/ Revaluation of Bank of Zambia holdings of gold.

4/ Assumes that some of the bilateral agreements will be signed only in early 1984.

criteria on external payments arrears, including the avoidance of arrears on debt rescheduling agreements.

The financial position of the mining company, ZCCM, has been adversely affected by the recent decline in world copper prices. Nevertheless, because of successful implementation of the cost-cutting measures included in the program, the company is expected to approximately break even during 1983, after payment of the minerals export tax provided for in the program. However, at the present production level, the company would incur substantial operating losses in 1984 should the world market price for copper remain at its current level of around US\$0.65 per lb. The company is endeavoring to introduce additional measures to cut costs and improve efficiency during 1984. More importantly, it will benefit from the Government's continued implementation of a flexible exchange rate policy.

By end-November the kwacha had been depreciated by a further 5.3 percent against the SDR as compared with the rate at end-August; the cumulative depreciation against the SDR during the period January-November 1983 amounted to 31.8 percent. The authorities are committed to continuing the policy of managing the exchange rate in a flexible manner, and will continue the gradual downward movement of the exchange rate. In pursuance of this policy the kwacha has been depreciated by a further 3 percent during December.

The staff is satisfied that the authorities are implementing their exchange rate policy flexibly, as envisaged in the program. Accordingly, the following draft decision is proposed for adoption by the Executive Board:

Zambia has consulted with the Fund in accordance with paragraph 4(b) of Executive Board Decision No.7531-(83/142), adopted September 16, 1983, and paragraph 8 of the letter of the Prime Minister and Minister of Finance dated August 16, 1983, in order to review with the Fund the appropriateness of exchange rate policy. The Fund finds that no further understandings are necessary.

Zambia: Relations with the Fund
(As of November 30, 1983)

Date of membership	September 23, 1965	
Quota:	SDR 211.5 million (Zambia has consented to its new quota of SDR 270.3 million)	
Status:	Article XIV	
Exchange system:	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 November 30, 1983 the rate was K 1 = U.S. dollar 0.6939.	
Fund holdings of Zambian kwacha:	<u>Millions of SDRs</u>	<u>Percent of quota</u>
Total	853.5	403.5
Under credit tranches	114.6	54.1
Under enlarged access	259.9	122.9
Under extended fund facility	77.0	36.4
Under compensatory financing facilities (exports)	190.5	90.1
Total Fund credit	641.9	303.5
SDR position:	Holdings are SDR 24,438 or 0.04 percent of net cumulative allocation (SDR 68.3 million).	
Gold distribution (four distributions):	65,042.532 fine ounces	
Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980):	US\$12.07 million	
Trust Fund Loan outstanding:	SDR 42.77 million	

Technical assistance:

The Central Banking Department is currently providing an advisor to the Governor of the Bank of Zambia, a foreign debt advisor, and an economic advisor.

Staff contacts:

The last Article IV consultation discussions were held in Lusaka in November 1982 and January-February 1983. Use of Fund resources missions visited Zambia in February and June 1983. Zambian delegations held discussions at the Fund in July and August 1983. The review mission visited Zambia during November 22-December 7, 1983.