0404

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/91

3:00 p.m., July 17, 1992

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	L. E. N. Fernando
	Duan J., Temporary
	J. Jamnik, Temporary
	Q. M. Krosby
	V. Kural, Temporary
E. A. Evans	
	B. Bossone, Temporary
	M. B. Chatah, Temporary
	J. A. Solheim
	S. Shimizu, Temporary
B. Goos	
	C. D. Cuong, Temporary
	G. Bindley-Taylor, Temporary
	I. Martel
	S. Rouai, Temporary
	L. J. Mwananshiku
D. Peretz	
	R. Meron
	D. Saha, Temporary
	M. Da Costa, Temporary
	L. F. Ochoa, Temporary

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

IBRD: J. Todd, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; K. B. Dillon, J. A. Clement, J. P. Gordon, J. R. Hill, M. Katz, M. Nowak, M. A. Tareen, R. C. Williams. Fiscal Affairs Department: W. J. McCarten. Legal Department: J. K. Oh. Policy Development and Review Department: T. Leddy, Deputy Director; S. B. Brown, N. L. Happe, G. R. Kincaid, N. Kirmani. Treasurer's Department: L. Aylward, W. J. Byrne, J. C. Corr. Advisors to Executive Directors: S. von Stenglin. Assistants to Executive Directors: M. E. Hansen, K. M. Heinonen, M. Mrakovcic, J. A. K. Munthali, E. H. Pedersen, D. Sparkes.

1. ZAMBIA - 1992 ARTICLE IV CONSULTATION; ACCUMULATION OF RIGHTS; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors resumed from the previous meeting their consideration of the staff report for the 1992 Article IV consultation with Zambia, and the request of Zambia for a rights accumulation program (EBS/92/114, 7/1/92), together with a staff paper on the further review of Zambia's overdue financial obligations to the Fund following the declaration of its ineligibility to use the Fund's general resources effective September 30, 1987 (EBS/92/117, 7/10/92, and Cor. 1, 7/15/92). They also had before them a statistical appendix (SM/92/137, 7/9/92).

Mr. Solheim made the following statement:

A new Government assumed office in Zambia less than a year ago and took over a country in an extremely difficult economic situation, and which now is hit by the worst drought in the region for decades. On the economic scene, the new Government has demonstrated commitment toward strong economic reforms. I welcome, inter alia, the reform of the personal income tax, the steps toward a liberal exchange system, and the initiative to phase out subsidies.

However, the recent excessive increase in salaries of civil servants is regrettable. Although a public wage structure that makes it possible to attract and keep skilled personnel in the civil service is necessary, this must be done with due regard to the overall budgetary consequences, and not precede a planned civil service reform. Strict adherence to the fiscal objectives is a key to the success of the program, and I agree with the staff that decisions regarding salary levels should be incorporated closely into the budget process.

My authorities welcome the new rights accumulation program for Zambia. The main objectives and targets of the proposed program are close to those of the originally endorsed program. The prospects for the immediate future have, however, deteriorated further, and the large imbalances in the economy and the sizable outstanding arrears underscore the importance of a full and timely implementation of the program.

The immediate concerns and problems facing the new Zambian Government--although overwhelming--must not distract attention from the importance of maintaining the momentum in the implementation of structural reforms. Increased private participation in the economy as well as improvements in the management of state-owned enterprises are of fundamental importance for ensuring improved performance of the Zambian economy.

According to the staff, risks still exist with respect to the financing of the program. In order to close the financing gap, it is essential to alleviate Zambia's formidable debt burden. For Zambia to be able to mobilize sufficient resources for its development efforts, the debt service burden has to be reduced to a manageable size. We consider it essential that concerted efforts be made to close Zambia's financing gaps, and the forthcoming meeting of the Paris Club will be important in this respect.

It is positive that the program rests on substantial policy action up front and that the financing assurances will be reviewed before the accumulation of rights. The build-up--although moderate--of foreign exchange reserves also represents an improved buffer against external shocks. We are, in light of the additional financial problems caused by the drought, prepared to show flexibility with respect to the pace of reduction of the arrears level, and we support the proposed phased build-down of arrears to the July 1990 level. The proposed timetable must, however, be strictly adhered to.

Even with a successful implementation of the new rights accumulation program, sizable financing gaps remain in the medium-term perspective. Substantial further adjustments are therefore required before external viability is eventually achieved, and continued donor support of significant magnitude will be needed.

In conclusion, we are pleased to witness the recent positive political developments in Zambia. Although some uncertainties still exist concerning economic policies and the financial situation, we can support endorsement of the rights accumulation program.

Ms. Da Costa made the following statement:

From the outset, let me express our support for the proposed decisions, as well as our acknowledgement of the commitment shown by the new Government of Zambia to normalize its relations with the international financial community. We are pleased to be able to examine today a revised rights accumulation program for this country; however, like Mr. Landau and others, we have some reservations related to the short period of time in which a positive track record was established, as well as with the up-front accumulation of rights, a matter that should be taken into account in future similar cases in order to maintain equality of treatment.

Regrettably, Zambia has little room for slippages. Past policy mismanagement must have negatively affected the confidence of the international community, and the associated external assistance to the country. Current slippages could prove even more dangerous, since copper, Zambia's principal export commodity, is at the mercy of decreasing international prices. Simultaneously, the country is suffering from the generalized drought that is affecting the region. In this context, the message that should be sent to the authorities must be clear: there is an urgent need to start implementing tight adjustment policies, and to stand ready to take any necessary steps in order to maintain stronger adjustment. In the past, management of monetary policy has been subordinated to a lax fiscal policy; this cannot be repeated. If the new program is to be implemented successfully, the ambitious targeted reduction of the fiscal deficit must remain the first priority of the authorities. Consequently, we welcome the news of the decision of the authorities to progressively phase out state subsidies. Also welcome is the announced scheme for the privatization of state firms, even though we would have liked to see a more ambitious program.

We note the efforts of the authorities to enhance fiscal expenditure control with the creation of a new budget office. We hope that this office is effective in the short term, since the reduction of the deficit will have to concentrate mostly on the expenditure side. In this regard, the recent government decision to grant a generalized salary increase to civil servants is confusing. These kinds of signal are precisely the ones that should be avoided in an adjustment effort where inflation represents a major cause for concern, and in times when the authorities need to build up confidence in their commitment. As I said before, there is no room for slippages, particularly given the extreme dependence on external financing.

Adherence to the fiscal program will be a prerequisite to the much-needed deceleration of inflation. The economy currently suffers from a monetary overhang as a result of the previous monetization of fiscal deficits, which must be avoided. If the targeted growth of the M2 aggregate is to be maintained, net recourse to the banking system by the Government should be kept to a minimum. We welcome the recent steps taken to improve monetary control, and the authorities' intention to introduce market-oriented instruments in the future. We nevertheless remain skeptical about the effectiveness of that move until positive real interest rates are allowed to operate, and a further and deeper reform of the financial system is under way. In our view, this is also essential for the viability of the program.

Zambia's external sector remains extremely fragile even after consideration of already firm official transfers. We know that today's Board discussion should allow Zambia to reschedule part of its official bilateral external debt. This concessional debt rescheduling should complete the efforts already made by donors.

Nevertheless, we are still somewhat pessimistic as to how Zambia will be able to honor its commitment to lower its arrears with the Fund to the July 1990 level.

With these remarks, we urge the Zambian authorities to remain committed to this new program, and to make every effort to regain the much-needed confidence in their efforts. We wish them every success in taking advantage of this new opportunity.

Mr. Fernando made the following statement:

At the time of the Board's review of Zambia's policy framework paper last March, this chair made its observations on the macroeconomic and structural reform content for this year. Hence, we would focus on implementation thus far and on the question of endorsing the program as deserving of rights accumulation.

Before registering certain concerns, let me first briefly refer to the positive elements that form the basis of our support for this rights accumulation program. As designed, we consider this to be a good and strong program that justifies the level of access implicit in the schedule of rights accumulation. The pervasive and unprecedented drought is a most hostile environment in which to transform the economy of a country that relies on agriculture for its basic food requirements and to provide the basis for future sustainable growth. A projected growth environment of 2 percent has now been translated into a contraction of the order of 9 percent. Consequently, the actions that substantially raised the consumer prices of maize and oil products, and that were necessitated by virtue of their macroeconomic importance at a time of hardship on account of economic reform and the drought, indeed call for a strong political resolve--even if Zambia's options were exhausted. The continued steady progress in trade liberalization and exchange market reform--which, under normal circumstances, is a prime candidate for Fund financial support but, in Zambia's case is not--is of particular note. There are many instances of economic programs, even in advanced stages of implementation, still lagging behind in the external trade and exchange system areas. The complete relaxation of the requirement to surrender export proceeds--apart from those of the copper company--is a bold move, and we hope that monetary and financial policies will be such as to make the voluntary repatriation of export proceeds attractive. Finally, the sharp reduction of marginal income tax rates and the proposed reduction of the maximum import tariffs that would, at first sight, favor the upper income brackets, is noteworthy, and, we hope, would not undermine either the budget by reason of reduced revenues or the political support essential to sustain economic reform.

As stressed by practically all speakers, we are concerned over wage developments. It may be recalled that the income tax reform, which broadened the income base for tax purposes, was made revenue neutral through a sharp reduction of marginal rates in order to avoid a major round of wage increases. Although the authorities have attempted to justify the excessive increase in wages on account of the unexpected surge in prices--despite the budget and money being broadly on track--the risks to program objectives and maintenance of competitiveness are obvious. It is also best to caution at this early stage against any further general wage increases in the expectation of budgetary savings through civil service retrenchment. Examples of actual civil service reform in accordance with the theoretical underpinnings of such an exercise are badly lacking. On the exercise in retrenchment conducted under the guidance of the World Bank, could we have an assurance that the severance package would not also drain away managerial and technical personnel? Program implementation would critically depend on a competent and dedicated civil service.

In the context of reducing the budget deficit through cutbacks and the elimination of subsidies, mention is made of upward adjustment of fertilizer prices and shifting fertilizer imports to the OGL system. It is further expected that the fertilizer parastatal will import two thirds of the national requirement, defined as the usage by small farmers. We would like to know about the effect of the price increases on usage. There are many instances of the usage of fertilizer, especially in small agricultural farming, having sharply declined. The drought might perhaps mask the effect this year, but we would be concerned if a decline in fertilizer usage occurs to the point of risking the drive toward diversification of the product and export base. Clearly, this aspect should be assessed along with other incentives, except to note that fertilizer is a powerful determinant of productivity.

On the reform of parastatals, we note the steps taken to eliminate their dependence on budgetary resources, except for some specific instances, such as Zambia Airways. We welcome the steps taken toward divestiture. What we are not so clear about is whether the enterprises can broadly be considered as viable, with sufficient operating autonomy to be run on commercial criteria. Specifically, although shifted out of the budget, is there any Government involvement in the credit decision of banks toward the parastatals?

Finally, we can endorse the proposed decision on the review of Zambia's overdue financial obligations.

Ms. Duan made the following statement:

The Zambian authorities have achieved impressive progress in adjusting their economy in adverse circumstances. Zambia is experiencing a severe and prolonged drought which has resulted in a sharp decline of GDP growth to around 9 percent for this year. As we are in broad agreement with the staff appraisal, we shall make only a few brief comments.

The authorities are to be commended for their determination in adhering to the adjustment policies. On the fiscal side, they have implemented fundamental reforms in personal income tax and introduced a sales tax on beer, soft drinks, and cigarettes. These measures will increase government revenue by at least 0.5 percent of GDP and, in the long term, the increase could be higher. The fivefold increase in the consumer price of maize meal has also substantially reduced the burden on the budget. However, the authorities should stand firm with their tight fiscal policies to meet the program target as stated in the PFP, and to enable the Government's primary deficit to be reduced to 1.9 percent of GDP. In particular, the Government should not overspend.

On the monetary side, the Government should implement tight monetary policies to control the money supply. On this aspect, we are pleased to note that the authorities have placed quarterly limits on reserve money. The staff is accurate in pointing out that it is critical that these limits are strictly in adherence to the fiscal program. We note that the maximum bank lending rate remains significantly negative in real terms against the actual inflation rate. We encourage the authorities to take decisive action to raise the maximum rate to a rate at least equal to the actual rate of inflation. This is one of the important factors in combatting inflation.

On social policies, we believe the five-pronged approach devised by the authorities is correct and necessary in order to reduce the negative consequences for the poor of the price adjustment and some structural changes.

In conclusion, given that the country has so far made its best efforts to meet all obligations falling due to the Fund and has made a serious commitment to implement the reform policies, the Fund should play an important role in bringing much-needed assistance to fill in the financing gap for 1992. We fully support the proposed decisions and wish the authorities well in their future endeavors.

Mr. Rouai stated that his chair welcomed the adoption by Zambia of a new rights accumulation program, and hoped that the authorities could maintain their resolve to tackle the protracted structural deficiencies of the economy and reduce the financial imbalances to manageable levels. The early indications of policy implementation by the new Government in the areas of subsidies, tax reform, and liberalization of the exchange system were encouraging. However, he was concerned about the slippages on the financial side of the program, owing mainly to the sizable increase in wages awarded prior to the initiation of the civil service reform, and by the very large number of import duty exemptions granted under the Investment Act. The staff rightly recalled that wage policy was an important element in the slippages under previous programs, and he hoped that the authorities would avoid further accommodative financial policies that could hamper their efforts to reduce the budget deficit and inflation and attract donor support.

His chair supported the proposed decisions, encouraged the authorities to adhere to the program objectives, and wished them every success.

Mr. Jamnik made the following statement:

> Let me say at the outset that we welcome the actions recently taken by the Zambian authorities, and we are encouraged that the staff found that implementation of the program to date is generally proceeding on course. We are of the view that this program has the appropriate elements, and we support Zambia's request for a rights accumulation program.
>
> Since we are in virtually full agreement with the staff appraisal and share many of the views expressed by previous speakers, I would simply like to make a few points of emphasis and raise some questions. As in the past, the reduction of the fiscal deficit is key to the elimination of domestic and external imbalances. In this regard, the public sector wage bill has always been one of the major problems in achieving financial discipline in Zambia. It is with regret, therefore, that we have witnessed a 130 percent pay increase for the civil service, effective April 1, 1992. The increase is all the more troublesome, coming as it did on the heels of the Board's discussion of Zambia's PFP on March 19, 1992, at which time Directors placed a high priority on wage restraint. Simply put, Zambia cannot afford the burden on its fiscal position of additional expenditures equivalent to 1.3 percent of GDP.
>
> As Mr. Solheim has said, wage policy in Zambia must become an integral part of the budgetary process; it cannot be determined in isolation or without due regard to other expenditure and revenue components of the budget. Some might be tempted to argue that the wage increase was not as destabilizing as it might have been because it was partly offset by higher revenues stemming from income tax reform measures, but the fact remains that the fiscal deficit is higher than that envisaged in the original program.

Could staff comment on whether additional measures are being considered to offset the impact of the wage increase? Obviously, the benefits arising from civil service reform are a longer-term proposition, but are there any savings to be had in 1992 with the planned reduction of central government workers?

My second question is with respect to the further liberalization of the foreign exchange regime. One of the new measures, which became effective in mid-June, could touch on a number of countries' development assistance programs. It is our understanding that inward remittances for nongovernmental organizations may now be purchased by authorized dealers at the retention market rate rather than the official rate. Ironically, the effect of the new regulation would appear to be that nongovernmental organizations, many of which are financially supported by aid agencies, can now transfer funds to Zambia on terms far more favorable than can governments under their own aid programs. Since, for the same amount of foreign currency, nongovernmental organizations' remittances will earn about one third more local currency than government aid remittances will, could staff comment on the logic behind this change and the possible implications for donors? Might we see a shift in bilateral aid delivery mechanisms in order to access the more favorable exchange rate?

In conclusion, while the new Government has made an impressive start, it is clear that much remains to be done. Moreover, the impact of the drought will render the authorities' task especially difficult. We urge the Zambian authorities to persevere with their adjustment efforts and trust that these efforts will be intensified under the rights accumulation program.

Mr. Chatah made the following statement:

When the policy on rights accumulation was first introduced two years ago, most of us recognized that its implementation was likely to be somewhat bumpy. Nevertheless, last year's experience with Zambia's program proved particularly disappointing. Serious policy slippage and other adverse developments have set Zambia's recovery program back significantly and may have also indirectly cast some doubt on the rights approach in general. This said, like other speakers, we are pleased to see that the attempts in recent months to put together a new medium-term program have borne fruit. This has obviously required exceptional effort on the part of the Zambian authorities, creditors, and donors, as well as the Fund. It has also entailed a considerable degree of flexibility on the part of this institution. In our view, such flexibility is probably inevitable if the rights approach is to succeed in achieving its objectives. Of course, there are certain basics that should not be compromised, including the credibility of programs. But for the current arrears strategy to succeed, there must be a certain leeway to adapt some of its less critical elements to fit the circumstances of individual cases.

On the whole, given the authorities' bold actions over the past six or seven months, and their policy commitments under the program, we believe there is a good basis for approving a new rights program for Zambia. Since I share many of the comments already made by Directors on the various aspects of the program, I will limit my statement to a few selective remarks and questions.

First, many Directors have already referred to the fiscal slippage that has occurred in the second quarter of this year, at least partly as a result of the larger than expected increase in public sector wages. Although this may be partly justified--from the authorities' standpoint--by the higher than expected inflation, the fact remains that the increase in nominal wages, which will not lead to any improvement in real disposable income, has made it necessary to squeeze a larger measure of financial adjustment into the remaining part of the year, and has strengthened the need for effective mechanisms of fiscal monitoring and control.

And this brings me to my second point. There is no question that the policy priority in the period ahead should be to bring down the rate of inflation. The programmed decline in net credit to the Government is therefore appropriate, particularly in light of the slippage that occurred in recent months. However, looking at the monetary program as a whole, it is not clear what the targets imply for private sector credit. The staff indicates on page 15 of EBS/92/114 that bank credit to the nongovernment sector will be maintained in real terms. From Table 2 on page 16 of the same paper, we notice that bank claims on the nongovernment sector are programmed to increase by much less than the rate of inflation projected for 1992. The staff may wish to clarify this point.

One reason I raise this issue is the substantial downward adjustment in investment in 1992 compared with the projections made in the policy framework a few months ago, from 19 percent of GDP to 14 percent of GDP. Given that government capital spending is more or less the same, private investment will be lower than had been projected earlier, by about 5 percent of GDP. While the severity of the drought may provide a partial explanation for this large downward adjustment, perhaps the staff can provide a fuller explanation.

My fourth point is that we should not underestimate the risks involved in trying to track a particular fiscal and monetary scenario in a high-inflation environment. The price developments in the first part of this year illustrate the difficulties in predicting the path of inflation, and the potential risks associated with unexpected price movements resulting from lags or other factors.

Finally, regarding exchange rates, and more specifically the authorities' strategy of moving toward unification through pre-specified weekly devaluations of the official rate, taking into account movements in the retention market rate, I wonder whether consideration has been given to basing the adjustments in the official rate on the magnitude of the gap between that rate and the retention market rate. It seems to me that such an approach is more likely to ensure progress in bridging the gap, notwithstanding the staff representative's comment on the fiscal implications of exchange rate adjustments.

To conclude, we fully recognize that the program before us is filled with uncertainties. We are also aware that even under optimistic assumptions, immense efforts will be required for a long time to come from the Zambian authorities as well as from the international community. But, as I said earlier, we see in the authorities' recent actions and in their strong commitment to follow a corrective path a good basis for approving this program.

Mr. Shimizu stated that he wished to begin, like other speakers, by commending the authorities for implementing adjustment policies under difficult circumstances since they took office last October, and for reaching agreement on a new rights accumulation program. He hoped that the authorities would continue their adjustment efforts in accordance with the program and establish a good track record. As he was in general agreement with the staff appraisal, he would make a few comments for emphasis.

With respect to fiscal policy, like other speakers, he regretted the large financial slippage caused by the wage increases in April, Mr. Shimizu said. That deviation was causing the Government to resort to bank financing and was increasing the money supply. Those developments, coupled with the relatively low wage level in Zambia, pointed up the importance of the authorities formulating a comprehensive civil service reform program.

On the revenue side, Mr. Shimizu continued, he welcomed the fact that the authorities had implemented a number of tax reforms, including income tax reform. However, there was a need to broaden the tax base, which would be best accomplished by the early introduction of a value-added tax. In addition, the authorities were urged to improve tax administration.

In order to give the correct price signals to the Zambian economy, early unification of the official exchange rate and the retention rate was called for, Mr. Shimizu observed. Notwithstanding the staff representative's explanation, it was not clear to him how the rates would be unified after the spread between the two rates narrowed to 20 percent in

September 1992. He asked the staff to comment on the schedule or the strategy of unification.

As a matter of principle, arrears to the Fund should be reduced as much as possible during the rights accumulation program period, Mr. Shimizu noted. The deadline for reducing Zambia's arrears to the Fund to the July 1990 level had been postponed for two years from end-1991 under the previous arrangement to end-1993 under the proposed arrangement. Like Mr. Landau and Mr. Goos, he strongly encouraged the authorities to make every effort to reduce their arrears to the Fund by more than required under the arrangement, especially if export earnings exceeded the program target. He hoped that such a mechanism would be incorporated in the program in the future.

With respect to the rather front-loaded accumulation of rights, he shared the concern expressed by Mr. Landau, because owing mainly to the larger than programmed increase in the wage bill, the authorities had failed to observe the end-June benchmarks by a wide margin. He supported the proposed decision.

The staff representative from the African Department observed that in comparing certain ratios to GDP in the projections for 1992 and 1994, Mr. Goos had mentioned, in particular, the current account and national savings ratios. It should be noted that the current account figures cited included grants, as did the figures on national savings, at least implicitly because of the way they were calculated as a residual. To illustrate the staff's presentation, a grant by Germany to Zambia to pay its arrears to the World Bank would show up as a reduction in Zambia's current account deficit and an increase in national savings. If, instead, Germany gave Zambia a 100-year, zero-interest loan, the current account deficit would not be affected, nor would national savings. In the PFP, it was explained in a footnote to Table 3 that it was assumed that the financing gaps in the PFP would be filled on highly concessional terms; indeed it was assumed that most would be grants. Since that time, the staff had obtained a better idea of how the financing was breaking down between grants and highly concessional loans, the latter of which in fact accounted for much of the additional financing. The changes in the numbers between the PFP and the rights accumulation program, particularly on the current account, were due to the much lower amount of grants, which raised the current account deficit, and lowered national savings. The current account deficit for 1994, excluding interest and grants, was exactly the same as it had been in the PFP in nominal terms. Only the ratios including the grants had changed. For 1992, the deficit was higher but only because of the drought's effects.

With respect to the national accounts, the lower amount of grants accounted for only about half of the decline in national savings relative to GDP, the staff representative added. As Mr. Chatah had indicated, the earlier projection of investment was ambitious, and the updated assessment reflected both the drought and the criticism directed at staff by Fund and World Bank Directors, when Zambia's PFP had been discussed in February 1992, for being too optimistic about what could be achieved in terms of a rapid increase in domestic savings and investment. The staff had been a little more cautious in setting the goals for the outer years.

As for privatization being a long, difficult process, the official goal in the Privatization Act as approved by parliament was to privatize 130 to 140 firms within five years, the staff representative stated. How successful Zambia would be in accomplishing that objective was open to some question, but it was certainly a goal to be encouraged.

It was important to underscore that the abolition of fertilizer subsidies had taken place alongside a major increase in maize producer prices, the staff representative said. Previously, fertilizer had been subsidized and producer prices had been repressed. With producer prices going to border levels, to the extent that the price of the crop increased by more than the cost of the associated fertilizer, it should be profitable to use fertilizer without the subsidy. Having said that, it was significant that in a drought year, many small-scale farmers would not have a crop to sell and would not have the money to buy fertilizer. The program included a major provision for credit for fertilizer, but no subsidy, and extensive use would have to be made of that provision.

On the extent to which the civil service reform might offset the wage increase, unfortunately, such reforms came at a price, especially at the outset, owing to the costs of separating employees, the staff representative commented. The 10,000 employees to be laid off initially, at the end of August, were daily workers, who received fewer benefits than those who would be laid off subsequently, but they were entitled to at least six months' pay plus certain other benefits. Specific provision had been made in the budget for the net cost of civil service reform. Once the initial termination package had been paid for, the savings from the dismissal of those 10,000 people would be approximately one-half percent of GDP a year thereafter. Meanwhile, in the first year of the reform, the costs would exceed the savings in salaries.

As she had already mentioned, the staff representative noted, OGL money, even if there was a unified system, would still be selling at a discount. From an accounting point of view, to the extent that donor money came in under the OGL, the counterpart funds would be less. While it was true that nongovernmental organizations did benefit from more generous treatment, the spread between the two rates was already down to 20 percent, which had been the goal for September. An exact schedule of how unification should take place had not been worked out. However, as long as the OGL was at the official rate, it was unlikely that the spread could be reduced below 10-15 percent. At the next stage of unification, it would be necessary to shift oil, the copper company, and the government to the free market rate. In the first review, the schedule for unification would be worked out based on such shifts rather than a steady reduction in the spread.

The figure in the staff report was not private sector credit but rather credit to the nongovernment sector and included the copper company, the staff representative from the African Department explained. The copper company received a major loan at the end of 1991, which it was supposed to start repaying in 1992. Credit to the nongovernment sector would rise by 110 percent if one excluded the copper company loan.

The Deputy Director of the Policy Development and Review Department said that the staff had not intended to convey the idea that the Fund would need to be financially involved in Zambia for the next 10-15 years, as Mr. Goos had suggested. The staff had indeed noted in its report that owing to the obviously difficult outlook, there was a risk of the need for continuing Fund involvement under successor arrangements. That would certainly be so immediately following the rights program but not necessarily over the longer term. Regarding the projections, the assumptions about adjustment might prove to be too conservative; moreover, a number of possible developments on the financing side could well improve the outlook.

Mr. Fernando remarked that although parastatals might have been shifted out of the budget in terms of budgetary financing, it would be reassuring to know that the heavy hand of the government was not involved in banking transactions between parastatals.

The staff representative from the African Department responded that the attitude of the Government probably offered the best assurance. The staff had not been aware lately of the type of government intervention in the activities of parastatals that had been prevalent under the previous Government. One problem, however, was that parastatals tended to rely too much on the Government in reaching decisions. Parastatal managers were not used to taking responsibility for politically unpopular decisions, and constantly tried to shift it onto the Government. The new Government had been fairly successful in resisting that pressure, but the existence of monopoly firms and parastatals inevitably led to politicization. That was one of the best arguments for privatization.

Mr. Mwananshiku thanked Directors for their comments, which he would convey to his authorities.

He agreed with the assessment of Directors that the implementation of the rights accumulation program was only a first step in a long program of adjustment, Mr. Mwananshiku said. The problems in the economy, as Executive Directors had correctly noted, were very severe, and it would be a long time before they were finally resolved. The new Government appreciated that fact, and had been undertaking measures which, as the Board would recall, had created great problems under the previous Government, leading to delays in implementation which had eventually brought the program close to abandonment.

Reference had also rightly been made to the importance of the Government maintaining a strong fiscal position, Mr. Mwananshiku commented. As far as the wage award was concerned, there was no doubt that its timing had been wrong. As the staff had noted on many occasions in its discussions with the authorities, wage increases after the budget had been presented had serious consequences for the budget deficit. In the present case, compensating action had been taken to ensure that the recent wage increase did not raise the budget deficit. It should be pointed out, however, that there were mitigating circumstances in the case of the recent wage increase. As noted in the staff report, the cost of the basic food item in Zambia, maize, had increased fivefold since November. Moreover, since the new Government took office, the price of oil had also been increased, and bus fares had been raised, reflecting the requirement that parastatals pass on the full cost in the prices they charged to consumers for their goods and services. Workers were very sensitive to the consequent reduction in their real income. Those were the two main factors that had led the Government to grant the wage increase, although as the Board had noted, whatever the justification, the resulting problem should have been foreseen and prevented in the interest of maintaining a firm fiscal stance.

The need to reduce inflation was also discussed extensively with the authorities, Mr. Mwananshiku noted. The authorities understood the views of the staff, and the position of the Board. While he, too, had emphasized the need to tackle the problem, it seemed to him that the impact of some of the measures taken earlier in the year had been underestimated. He had in mind, in particular, the increase in the price of food, which was an important component in the index of inflation in Zambia, and the money supply problem, which had been carried over from the previous year. In spite of the authorities' efforts, inflation, as the staff had reported, seemed to have picked up slightly at the beginning of the second quarter of 1992.

He wished to emphasize, Mr. Mwananshiku said, that the authorities were taking all the measures that had been agreed with the staff. The new Governor of the Bank of Zambia had informed him that agreement had been reached with the mining industry to ensure that its excess liquidity could be transferred within the next few days from the commercial banks to the central bank. Barring any other large problem, a reduction in inflation was possible in the months to come.

The drought, of course, had created an enormous problem in Zambia and in other countries in the region, Mr. Mwananshiku remarked. He wished to take the opportunity to thank those countries that had contributed to financing the importation of food by Zambia. Without that support, it would have been extremely difficult to cope with the effects of the drought, which had other costs as well. The Government had embarked on an active program to deal with some of the consequences of the drought, including the construction of water wells in a number of areas where the drought had been particularly severe. Part of the cost was being borne within the existing, non-drought budget. Of course, as the staff had emphasized, the two budgets--the drought and the regular budgets--must be separated, despite the linkages between the two.

Estimates of the balance of payments indicated the continued existence of a financing problem for Zambia in the future, Mr. Mwananshiku observed.

The transition from a mining economy to an economy that was more broadly based had been very severe, as Directors were aware. Every effort was being made to increase nontraditional exports. It was probably necessary, with the support of the World Bank, to move away from considering the overall situation to evaluating the constraints in the individual sectors, including the agricultural and industrial sectors, in order to identify and deal with the underlying problems.

While those efforts were being made, Zambia would continue to need the support of the international community in two areas: direct aid to address the balance of payments problem, and debt relief, Mr. Mwananshiku stated. In that connection, he wished to express thanks to Mr. Peretz and Mr. Landau and their authorities, for the indications they had given at the previous meeting relating to the forthcoming Paris Club meeting on Zambia. His authorities hoped that many other donors would join in that effort; at the same time, they were anxious to continue with their efforts to resolve the issues that were currently facing the economy to permit the economy to be turned around over time, so that Zambia's heavy dependence on external assistance could be reduced.

The Acting Chairman made the following summing up:

Directors commended the new Government of Zambia for having acted swiftly in taking the measures needed to re-establish macroeconomic stability and set the stage for economic recovery, especially against the particularly difficult situation that the new Government had inherited. In this connection, they regretted the policy slippages that had occurred in 1991, which confronted the new Government with serious demand pressures that were subsequently compounded by the supply shock emanating from the drought. Directors welcomed the intention of the authorities to accelerate the pace of structural reform within the framework of a new rights accumulation program.

Directors were encouraged by the Government's courageous decision to abolish fertilizer subsidies and sharply cut maize subsidies. They noted that these actions, together with the proportionately smaller increases in maize meal prices that are slated for the remainder of this year, should ensure that subsidies, other than targeted assistance for the poor, will not be required after 1992. In this regard, Directors stressed the importance of meeting the overall budgetary targets and the timely implementation of the stated Government policies with respect to maize pricing and the official exchange rate. Also noteworthy was the implementation of a fundamental reform in the income tax, bringing cash allowances and other fringe benefits within the tax framework. This reform was essential to achieving a viable income tax system. Notwithstanding these positive steps, Directors regretted the magnitude of the recent public sector wage action which threatened to undermine the implementation of financial policies. Directors underscored the need to integrate public service wage decisions fully into the budget process and to proceed determinedly with civil service reform, if efforts to bring the budget deficit under control are to succeed. Directors also called on the authorities to re-examine the generous import duty exemptions being granted under the new Investment Act, with a view to preserving revenues and to ensuring that Zambia's development is not inappropriately capital intensive.

Directors underscored the importance of strict adherence to the fiscal targets if the program's monetary and inflation objectives are to be met. Noting that the Government had raised interest rates twice since taking office, Directors still considered that interest rates remained significantly negative in real terms and encouraged the authorities to act quickly to correct this. In that regard, they welcomed the authorities' intention to increase the maximum lending rate as necessary to achieve positive real interest rates before the end of the year and to permit interest rates to become market determined.

Directors strongly endorsed the Government's intention to move to a unified market-determined exchange rate and the Government's decision, during the transition, to use the retention market exchange rate as a guide for adjustments in the official rate and to progressively narrow the spread between the two rates. They advised the authorities to adopt a firm timetable for exchange rate unification. Directors were encouraged by recent actions to liberalize the exchange and trade system, as well as by the Government's intention to put the OGL system on a negative list basis later this year and to broaden further the coverage of OGL.

Directors noted the determination of the Government to move rapidly to dismantle the system of state intervention and state ownership and welcomed the early actions to get the privatization process under way. To help attain the fiscal objectives for 1992 and to lay the groundwork for further improvements in 1993, the authorities need to ensure that both Zambia Airways and the largest local councils are taking measures necessary to end their reliance on budgetary support. Also, Directors urged that the parastatal sector set prices and control costs so as to provide the Government with a reasonable rate of return on its investment.

Directors commended the generous response of the international donor community to Zambia's request for assistance, both to support its program and to meet the additional requirements resulting from the drought. They noted, however, that efforts will need to continue to firm up donor commitments and to seek additional assistance to close the remaining financing gap in 1992. Favorable treatment from bilateral and private creditors would facilitate the completion of the program's financing requirements. Directors regretted that Zambia's arrears to the Fund were at present above the July 1, 1990 level. However, they noted the record of the new Government in meeting obligations falling due thus far in 1992, and its intention to continue to acquire SDRs in advance of payment dates. They stressed the importance of timely reduction of Zambia's arrears to the Fund to at least the July 1, 1990 level, and, indeed, should favorable balance of payments opportunities provide the basis for a more accelerated reduction of its arrears, encouraged the authorities to do so.

Directors emphasized the need for close monitoring and firm implementation of the rights program if Zambia is to accumulate rights and normalize its relations with the Fund according to the envisaged timetable. The international community will need to provide continued strong support for Zambia's efforts. In order to maintain the confidence of the donor community, as well as in Zambia's own basic interest, consistent and full implementation of the corrective policies is essential. Directors emphasized that there is no room for slippage, and that any deviation from the agreed policies should be promptly corrected. The restoration of reasonable price stability and progress toward balance of payments viability remain daunting tasks, and would depend importantly on steady progress in implementing structural reforms and a substantial effort by Zambia to mobilize domestic savings, increase the growth of nontraditional exports, and reduce import dependency.

It is expected that the next Article IV consultation with Zambia will be held on the standard 12-month cycle.

The Executive Board then turned to the proposed decisions, which it approved.

The decisions were:

<u>Decision Concluding Article XIV Consultation</u>

1. The Fund takes this decision relating to Zambia's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1992 Article XIV consultation with Zambia, in the light of the 1992 Article IV consultation with Zambia conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Zambia continues to maintain restrictions on the making of payments and transfers for current international transactions as described in EBS/92/114, in accordance with Article XIV, except that the multiple currency practice arising from the spread between the official exchange rate and the rates for foreign exchange in the export

retention market are subject to Fund approval under Article VIII, Sections 2(a) and 3, and that the limitations on the availability of foreign exchange for certain current transactions, including limitations on personal remittances and the nonavailability of foreign exchange for tourism, and the restrictions evidenced by some external payments arrears are subject to Fund approval under Article VIII, Section 2(a). The Fund approves the retention by Zambia of the multiple currency practice arising from the spread between the official rate for foreign exchange and the rates in the export retention market until March 31, 1993 or the conclusion of the 1993 Article IV consultation with Zambia, whichever is earlier. The Fund encourages the authorities to remove the other exchange restrictions as soon as possible.

Decision No. 10082-(92/91), adopted
July 17, 1992

Accumulation of Rights

1. The Fund notes that, in accordance with the authorities' request, the accumulation of rights for Zambia in the amount equivalent to SDR 836.9 million approved on April 17, 1991 (EBS/91/59, Supplement 2) has been canceled as of the date of this decision.

2. The Fund approves the accumulation of rights for Zambia as set forth in EBS/92/114, Supplement 2.

Decision No. 10083-(92/91), adopted
July 17, 1992

Overdue Financial Obligations - Review Following Declaration of Ineligibility

1. The Fund has reviewed further the matter of Zambia's overdue financial obligations to the Fund in the light of the facts and developments described in EBS/92/117 (7/10/92).

2. The Fund welcomes the active cooperation of the Zambian authorities with respect to the adoption and implementation of the comprehensive adjustment policies contained in EBS/92/114. The Fund also welcomes the authorities' intention to pursue a rights accumulation program during the period through March 1995. The Fund calls on external donors and creditors to augment flows of grants and concessional lending in support of Zambia's adjustment efforts on a timely basis. The Fund intends to continue to collaborate actively with Zambia under the intensified collaborative approach.

3. The Fund regrets the continued existence of Zambia's arrears to the Fund, which places a financial burden upon other members and

reduces Fund resources needed to help others. In this regard, the Fund welcomes the payments made by Zambia in 1992. The Fund notes Zambia's intention, under the rights accumulation program, to make payments equivalent to obligations falling due to the Fund in the remainder of 1992 and reduce arrears to the Fund at least to SDR 898.7 million by December 31, 1992 and at least to SDR 836.9 million by December 31, 1993. The Fund stresses that full and prompt settlement of these arrears should be given the highest priority.

4. The Fund will review the matter of Zambia's overdue financial obligations to the Fund again at the time of the first review of the rights accumulation program or within six months of the date of this decision, whichever is earlier, in the light of the actions taken by Zambia in the meantime regarding payments to the Fund and implementation of the rights accumulation program.

Decision No. 10084-(92/91), adopted
July 17, 1992

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/92/90 (7/17/92) and EBM/92/91 (7/17/92).

2. EXECUTIVE BOARD TRAVEL

Travel by Assistants to Executive Directors as set forth in EBAM/92/46 (7/16/92) and EBAM/92/47 (7/16/92) is approved.

APPROVED: March 19, 1993

LEO VAN HOUTVEN
Secretary