

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/187

10:00 a.m., November 24, 1986

R. D. Erb, Acting Chairman

Executive Directors

Alternate Executive Directors

A. Abdallah

E. T. El Kogali

Yang W., Temporary

M. K. Bush

L. Hubloue, Temporary

C. A. Salinas, Temporary

M. B. Chatah, Temporary

M. Sugita

G. Grosche

J. Reddy

J. E. Ismael

H. A. Arias

M. Foot

H. Fugmann

M. Massé

C. V. Santos

I. Al-Assaf

G. Ortiz

V. Rousset, Temporary

G. A. Posthumus

J. de Beaufort Wijnholds

C.-Y. Lim

O. Kabbaj

A. Vasudevan, Temporary

N. Kyriazidis

L. Van Houtven, Secretary

K. S. Friedman, Assistant

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Also Present

IBRD: G. Gebhart, Acting Division Chief and Loan Officer for Zambia.
African Department: R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy
Director; L. M. Goreux, Deputy Director; P. A. Acquah, B. W. Ames,
E. A. Calamitsis, C. V. Callender, T. Munzondo. Exchange and trade
Relations Department: L. Hansen, S. Kanesa-Thasan. Fiscal Affairs
Department: M. Shadman. Legal Department: A. O. Liuksila, J. M. Ogoola.
Treasurer's Department: T. Leddy, Deputy Treasurer; D. Berthet,
J. E. Blalock, J. P. Caskey. Advisors to Executive Directors:
A. Bertuch-Samuels, L. P. Ebrill, J.-C. Obame, I. Puro. Assistants to
Executive Directors: J. de la Herrán, W. N. Engert, G. K. Hodges,
M. Lundsager, T. Morita, J. A. K. Munthali, A. V. Romuáldez, G. Schurr,
H. van der Burg.

1. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION
ON COMPLAINT UNDER RULE K-1

The Executive Directors considered a staff paper on the review of Decision No. 8370-(86/137) on the complaint under Rule K-1 with respect to Zambia's overdue obligations to the General Department (EBS/86/260, 11/21/86).

The staff representative from the Treasurer's Department said that the payment of SDR 1 million mentioned in footnote 2 on page 1 of EBS/86/260 had been received. As a result, Zambia's payments to the Fund since the issuance of the complaint under Rule K-1 totaled SDR 36.2 million. At the same time, however, the repurchase obligation that was also mentioned in that footnote had become due and had not been paid. Therefore, Zambia's arrears as of November 24, 1986 totaled SDR 91.7 million. In addition, a further repurchase obligation of SDR 12.2 million fell due on November 24, 1986.

Mr. Abdallah commented that his authorities deeply regretted that arrears to the Fund remained outstanding and that the present Executive Board meeting to discuss those arrears had become necessary. The situation was unavoidable, as Zambia faced a critical shortage of foreign exchange owing mainly to a combination of three factors that were virtually beyond the authorities' control.

First, as the authorities recognized, slippages in the implementation of policy measures that were specified under the present stand-by arrangement had not only caused the arrangement to become inoperative, but had also contributed to delays in disbursements in external aid, Mr. Abdallah continued. The authorities had emphasized that the slippages should not be interpreted as a lack of commitment to adjustment on their part. Implementation of the adjustment program under the stand-by arrangement had been unsatisfactory because it had touched on sensitive policy areas. Nevertheless, the authorities had been engaged in concerted efforts to muster the political consensus that was needed to ensure successful implementation of the program, and that consensus had been largely secured.

Second, and perhaps more important, was the shortfall in export earnings amounting to the difference between the target for such earnings of SDR 849 million under the program and the present earnings of SDR 687 million, a difference of about 40 percent, Mr. Abdallah went on. The shortfall was caused by a further weakening in the export prices of copper and cobalt, Zambia's principal export commodities. Third, there had been a significant shortfall in aid inflows. As a result of all those factors, the program had gone off track, and Zambia had been forced to incur arrears on its financial obligations to the Fund. The authorities had made three attempts to meet some of those obligations through cash payments from their own meager resources. Those payments had amounted to SDR 36.2 million--a not insignificant sum in Zambia's circumstances, although the payments had not cleared all the arrears, and some additional obligations had since become due.

In addition to making whatever payments they could, the authorities had continued to collaborate with the staff in finding a durable solution to the underlying economic problems facing Zambia, Mr. Abdallah said. The authorities were determined to bring the stand-by arrangement back on track. Following a series of intensive meetings with the staff, a new package of strong and comprehensive measures had been agreed. Despite the measures already in place and those that were to be implemented in the context of the 1987 budget, the authorities had indicated that the program could face further difficulties without the provision of further financial support by the donor community. They recognized that the financing gaps were wide but felt confident that the donor community would show understanding and sympathy at the Consultative Group meeting that was to be held in Paris in mid-December 1986 to consider Zambia's very difficult situation.

Since the staff was satisfied that the new package of measures to be implemented by the authorities would lead to an improved external situation, it was imperative that the needed external resources to support the program should be made available, Mr. Abdallah stated. The aid package must be of the right size, and should be quick disbursing and highly concessional. The authorities stood ready to take additional measures, if necessary.

The interval between the present review and the next review of Zambia's situation should be three months rather than the two months that the staff had proposed in the draft decision, Mr. Abdallah considered. The longer period would send the correct signal to the authorities, who were making every effort to build up the needed consensus in favor of the adjustment program. The longer period also would make it more convenient for the next staff mission, in January 1987, by providing the mission with ample time to prepare a report on its discussions with the authorities. The report could be considered by the Executive Board in February.

Mr. Santos said that the staff paper clearly showed that the authorities wished to eliminate the overdue obligations. In fact, the authorities had made substantial payments to the Fund since July 1986 in order to reduce their overdue obligations. Furthermore, they had reached understandings with the staff on the appropriate policies that could be implemented to bring the adjustment program back on track. There was no doubt that the economic and financial problems facing Zambia were serious. He welcomed the efforts that the authorities were making--especially to mobilize external resources--to enable them to close the substantial external financing gaps. In view of those efforts and for the reasons that Mr. Abdallah had mentioned, the authorities needed more time to adjust to the changing circumstances. Therefore, the draft decision should be accepted with a provision for a further review in three months instead of two months.

Mr. Foot stated that the efforts that were being made by the Fund, the World Bank, and the Zambian authorities to revive Zambia's adjustment efforts were welcome. He recognized that many of Zambia's difficulties stemmed from external circumstances that were beyond the authorities'

control. However, there had been substantial departures from the stand-by arrangement--none of the performance criteria had been observed--and the staff had noted that a significant number of the breaches of the criteria had resulted from inappropriate domestic policies. That fact was particularly evident in the foreign exchange auctions, as attempts to keep the exchange rate artificially high had resulted in the accumulation of arrears and probably in an eventually weaker exchange rate than would otherwise have been the case. In addition, until very recently, domestic monetary policy had been implemented without due regard to the current situation in Zambia and, as a result, excess liquidity had accumulated and interest rates had been well below the necessary level. He was pleased that the recent package of measures included both a commitment to have clean auctions and a substantial rise in interest rates through the proper use of the treasury bill auction.

The authorities were clearly making a determined effort to come to grips with the problems in policy implementation, Mr. Foot remarked. He intended to look sympathetically but objectively at proposals that management might make during the review under the stand-by arrangement, provided that Zambia would have cleared its arrears by then. In that connection, there were two important questions. First, would it be appropriate to revive the stand-by arrangement rather than to negotiate a fresh arrangement? Second, what was the prospect for the continued viability of the present adjustment program? It would do neither the Fund nor Zambia any good to restart a program that financial limitations were likely to disrupt within a matter of weeks. The coming meeting of the Consultative Group for Zambia would be crucial. His authorities already had on hand £5 million in special joint financing that would be available contingent upon the restoration of normal relations with the Fund and upon the implementation of the World Bank's recovery program for Zambia. There was also £8 million of undistributed 1986 program aid that would follow at an appropriate pace the restoration of relations with the Fund and the World Bank. His authorities intended to review their aid program for Zambia before the coming Consultative Group meeting. As a rule, the provision of aid took time to arrange; that period could be limited only by the full cooperation and urgent action by the Zambian authorities.

As he understood it, a number of donors had promised aid to Zambia in the form of food shipments, Mr. Foot commented. At present, that particular form of aid for Zambia was inappropriate. The European Community had recently decided to make \$1 million of aid available in the form of technical assistance rather than food aid, and the U.K. authorities wondered whether the Fund and the World Bank could draw the attention of donors with sizable amounts of food aid outstanding to the need to consider providing a more appropriate form of aid for Zambia.

The special joint financing that had been arranged by the U.K. authorities would actually be available only after the new World Bank loan had been approved and after a debt refinancing grant arrangement had been signed with the United Kingdom to clear current arrears on aid loans, Mr. Foot remarked. In the past, the Zambian authorities had not

been as quick to deal with those matters as they should have been, owing undoubtedly to pressure on administrative resources. That problem should be called to their attention.

In recent cases involving substantial debt, such as Romania and Jamaica, the Executive Board had agreed on a short review period when the countries' arrears to the Fund were rising quickly, Mr. Foot recalled. Agreement by the Executive Board at the present meeting on a period of two months rather than three months should not be seen as a sign of increasing pressure on the Zambian authorities but rather as a sign of the mutual concern of the Fund and the authorities about Zambia's arrears. If the arrears were not settled within two months, they might well become uncontrollable. Zambia's unpaid arrears could likely exceed SDR 130 million by early 1987.

Mr. Salinas remarked that the situation in Zambia could not be more difficult: the authorities faced enormous export shortfalls, less than expected financial assistance from donors, and great difficulty in adopting the measures that were needed to correct the internal and external imbalances that were the root causes of the deep financial crisis. The authorities were willing to implement a comprehensive set of measures that would involve significant adjustment that, at the present stage, appeared to be unavoidable if sustainable economic growth were to be achieved. The authorities must eliminate the arrears to the Fund as soon as possible, so that they could benefit from the Fund's cooperation and support more fully than at present. Despite the present difficult circumstances, the authorities had found ways in which to make payments to the Fund and had reached understandings to bring the adjustment program back on track. It was difficult for the authorities to eliminate their arrears to the Fund, but they obviously were keenly interested in so doing. The proposed decision was acceptable.

Mr. Massé commented that the problems facing Zambia were due, to a significant extent, to the fall in the prices of Zambia's main exports. The proposed decision was acceptable; he could go along with the view of the majority on the question whether the next review should be held in three months rather than in two months.

The Canadian authorities still had nearly \$4 million in aid to Zambia that was to be disbursed by the end of fiscal year 1987, and they intended to increase their disbursements to Zambia in FY 1988 by nearly 25 percent, Mr. Massé said. In addition, the Canadian authorities were implementing a special program for Zambia that would provide rolling stock for the railway project valued at about Can\$24 million. Canada usually did not make cash available for balance of payments assistance; over time, of course, Canada's development assistance program played an analogous role. He hoped that the authorities would be able to bring their adjustment program back on track in the near future.

Ms. Bush stated that the recent payments by Zambia to the Fund were important and welcome. It was important to note that over the previous year the authorities had undertaken an adjustment effort that should help to correct the imbalances in the economy. There had been some slippages, which were reflected in the authorities' difficulty in meeting the performance criteria under the current stand-by arrangement. In particular, there had been problems in implementing the auction system that had resulted in a substantial real effective appreciation of the currency during a period of serious deterioration in the balance of payments. The understandings that had been reached on the functioning of the auction system and the reversal of the appreciation of the real exchange rate that had recently taken place were welcome. Another important step was the discussion of the budgetary problems that had been taking place and the efforts to correct to some extent monetary policy in Zambia.

The situation in Zambia was clearly difficult, Ms. Bush continued. The decline in export prices had adversely affected economic performance. Certain exogenous factors, such as the slowness of donor disbursements, had also adversely affected the economy. Despite the authorities' efforts, the financing gaps remained large. There was still some question about how the financing needs for 1987 would be fully met and how a recurrence of arrears could be avoided once the present arrears were cleared.

The proposed decision was acceptable as it stood, Ms. Bush said. A review period of two months was appropriate in Zambia's case, given the current size of the arrears and the possible substantial growth in those arrears through the rest of 1986.

Mr. Grosche considered that the package of policy measures that the authorities had recently adopted was commendable and would go some way toward addressing the country's serious economic and financial imbalances. He stood ready to consider a proposal to reactivate the stand-by arrangement, which seemed to be essential for the successful continuation of international financial support for Zambia's reform efforts. It was not clear to him how the additional financial support could best be organized within the limited time that was available. It might be ambitious to expect to close the 1986 financing gap before the coming meeting of the Consultative Group. Donors were likely to be reluctant to commit themselves to specific amounts of support before the total financing package that was being discussed was finalized. His authorities had assisted Zambia for a number of years through the Paris Club and through direct financial assistance. They had recently approved a package of DM 20 million in quick-disbursing aid; the first disbursement was expected to be made before the end of 1986. Finally, the proposed decision was appropriate; the next review should take place within two months.

Mr. Vasudevan said that he, too, welcomed the payments that Zambia had made out of its meager foreign exchange resources. The present difficult situation in Zambia was due mainly to external circumstances that were beyond the control of the authorities. However, the authorities had shown their commitment to the adjustment effort; it was reflected in

their continued contacts with the staff and in understandings that had been reached in order to bring the program back on track. The political consensus in favor of the needed adjustment efforts was crucial for the reversal of the present difficult situation, and in his opening statement Mr. Abdallah had suggested that some progress had been made in that area.

To ensure that the program would be feasible, it seemed best to give the authorities time to implement it, and he could therefore support Mr. Abdallah's request to hold the next review in three months rather than in two months, Mr. Vasudevan commented. With that modification, the proposed decision was acceptable. While the present package of measures was welcome, the adjustment program might have to be altered in response to the external circumstances that had affected Zambia's adjustment efforts. In that connection, a contingency mechanism might prove to be useful.

Mr. Ortiz said that it was clear that the economic situation in Zambia was very difficult. It was also clear that the authorities had made an effort to make payments to the Fund in those difficult circumstances. He could go along with Mr. Abdallah's suggestion to hold the next review in three months rather than in two months. Most Executive Directors apparently favored the period proposed by the staff--two months--and he could go along with the majority view, although he agreed with Mr. Foot that agreement on the shorter period should not be seen as intensifying the pressure on the authorities but rather as a sign of the Executive Board's concern about the size of Zambia's arrears.

Mr. Yang noted that since the previous review of Zambia's overdue financial obligations, the country had made substantial payments to the Fund and had implemented strong and comprehensive measures to strengthen the adjustment program. In addition, the efforts to obtain external financing to eliminate the arrears to the Fund and to close the balance of payments financing gap were continuing, and positive results might well be achieved soon. In view of those welcome developments, he had no difficulty in accepting the proposed decision, with the amendment that the next review should be held in three months rather than in two months.

The staff representative from the African Department said that a major issue was whether it would be appropriate to reactivate the stand-by arrangement at the present stage. The staff wished to get a better grasp of the adjustment efforts by the authorities. In that connection, the staff had recently made several visits to Zambia and wished to ensure that the authorities would maintain the momentum of adjustment. There had been some slippages in domestic policy implementation, and they had been the major subject of the discussions between the staff and the authorities. The program that had been agreed between the authorities and the staff was a forward-looking one, in the sense that monetary and fiscal policies under the program not only covered 1986 but also reflected the outlook for 1987. Time was of the essence; the financing issues should be addressed so that the authorities could maintain the momentum of the ongoing adjustment and achieve their objectives.

The Executive Board then took the following decision:

1. The Fund has reviewed Decision No. 8370-(86/137), adopted August 25, 1986, in light of the facts described in EBS/86/260 (11/21/86) pertaining to Zambia's overdue financial obligations to the Fund.

2. The Fund welcomes the payments that have been made by Zambia. However, the Fund regrets the continuing nonobservance by Zambia of its financial obligations to the Fund in the General Resources Account and notes that further substantial obligations will fall due in the near future. The Fund urges Zambia to make full and prompt settlement of the overdue financial obligations to the Fund.

3. The Fund notes the economic measures implemented recently by Zambia and calls upon the authorities to adopt the further measures needed to bring about necessary economic adjustment.

4. The Fund shall review further Decision No. 8370-(86/137) within a period of two months.

Decision No. 8455-(86/187), adopted
November 24, 1986

The Acting Chairman said that he would ask the staff to contact the Executive Directors from the major donor countries in order to prepare a status report on the prospects for closing the financing gap for 1986. That information would help management and staff in drawing conclusions about the possibility of having an Executive Board discussion on Zambia before the Consultative Group meeting that was scheduled for mid-December 1986.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/186 (11/21/86) and EBM/86/187 (11/24/86).

2. STAFF COMPENSATION - 1986 ADJUSTMENT

1. Salaries will be increased by 1.4 percent for Fund staff in Grades A1-A8 and by 2.9 percent for staff in Grades A9-B5 with effect from May 1, 1986. The adjustments will be applied to the minima and maxima of the salary scale in accordance with the revised interim salary structure attached to EBAP/86/266, Supplement 1 (11/20/86).

2. The estimated cost of the increases under paragraph 1 above would amount to \$3,400,000 for FY 1986 and appropriations for the Administrative Budget for FY 1987 shall be increased as follows:

<u>Budget Category</u>	<u>Approved Budget</u>	<u>Additional Appropriations</u>	<u>Revised Budget</u>
1. Personnel expenses			
A. Salaries	\$99,210,000	\$2,100,000	\$101,310,000
B. Other personnel expenses	64,990,000	<u>1,300,000</u>	66,290,000
		\$3,400,000	

Adopted November 21, 1986

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/86/292 (11/20/86) is approved.

APPROVED: July 7, 1987

LEO VAN HOUTVEN
Secretary