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SM/85/273
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

October 29, 1985

To: Members of the Executive Board
From: The Secretary
Subject: Zambia - Staff Report for the 1985 Article IV Consultation

The attached supplement to the staff report for the 1985 Article IV consultation with Zambia has been prepared on the basis of additional information. A revised draft decision appears on page 6.

Mr. Acquah (ext. 8661) is available to answer technical or factual questions relating to this paper prior to the Board discussion tomorrow, Wednesday, October 30, 1985.

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INTERNATIONAL MONETARY FUND

ZAMBIA

Staff Report for the 1985 Article IV Consultation
Supplementary Information

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

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

October 29, 1985

Since the staff report for the 1985 Article IV consultation with Zambia (SM/85/273) was issued, the Zambian authorities have implemented a number of major policy measures, which, in the staff's view, constitute radical departures from past policies and a bold step toward a comprehensive adjustment in line with those discussed in the staff report. These changes are in the areas of (i) exchange rate and trade policy; (ii) prices; (iii) the Treasury bill market and interest rates; and (iv) taxation. On the other hand, there has been a reassessment of output trends in Zambia's copper mining sector, necessitating a significant downward revision of prospective export earnings and, consequently, the balance of payments for 1985-89.

I. Recent Developments

1. Economic policy measures

a. Exchange rate policy

On October 4, 1985, the Zambian authorities notified the Fund that an auction system was to be used to determine the exchange rate for the kwacha, instead of continuing to peg the kwacha to a basket of currencies. Under the auction system, the exchange rate would be determined by the marginal bid that exhausts the supply of foreign exchange to the market. The foreign exchange requirements of the Government, the mining and oil companies, Zambia Airways, and Tanzania-Zambia Railway (TAZARA), the joint railway company, will be allocated administratively in the context of an overall foreign exchange budget. These transactions will be made at the prevailing auction rate. All other transactions, with the exception of relatively small amounts of foreign exchange retentions by nontraditional exporters and agricultural incentive payments, are to be channelled through the auction system. The first three auctions were held at weekly intervals over the period October 11-25, resulting in the exchange rates for the kwacha of K 5.01 = US\$1, K 6.10 = US\$1, and

K 7.0 = US\$1, successively, compared with the official quotation of K 2.2011 = US\$1 and the parallel market rate of approximately K 8 = US\$1 prevailing prior to the introduction of the new system. Thus, there has been a cumulative depreciation of the kwacha of 68.6 percent in foreign currency terms over the three week period.

b. The trade and payments system

The Zambian authorities have significantly liberalized the highly restrictive import licensing system. The authorities have announced that, under the new system, licenses will be issued without restriction and will not be used for protection purposes. A flat nonrefundable fee of K 250 for each license is being considered to replace the present 5 percent tax on the value of a license; a license accompanying an unsuccessful bid at the auction may be reused at subsequent auctions.

(i) Profits and dividends declared after October 1985 will be remittable through the auction system subject to the existing exchange control regulations. Hitherto, most of the profits and dividends remittable under the exchange control regulations had fallen into arrears.

(ii) With effect from January 1, 1986, foreign exchange for remittances of expatriates will be made at the prevailing auction rate; the remittances of those employed by the private and parastatal sectors will be paid out of commercial banks' working balances without the need for the employee or employer to bid for foreign exchange, while the remittances of expatriate employees of the Government will be paid from the Government's allocation of foreign exchange. Moreover, with effect from January 1, 1986, the basis of remittances by expatriate personnel engaged under contracts approved for remittance purposes under the exchange control regulations will provide for (a) an "inducement allowance" denominated in U.S. dollars and limited to a maximum of US\$6,600 per year which will be remittable on a monthly basis; and (b) an end of contract gratuity denominated in U.S. dollars to be calculated at 25 percent of the earned inducement allowance during the contract. In the past, some remittances of expatriates had fallen into arrears. During the transition period from October 3 to end-December 1985, expatriate remittances will continue to be made at the pre-auction exchange rate ruling on October 3, 1985. The application of the pre-auction rate for expatriate remittances up to end-1985 gives rise to a temporary multiple currency practice which is subject to approval under Article VIII. Approval by the Fund up to end-1985 is recommended by the staff.

(iii) The allowance for holiday travel has been reinstated, and the 10 percent levy on the sales of foreign exchange for this purpose has been abolished, thus eliminating the existing multiple currency practice.

(iv) As regards commercial payments arrears, the Bank of Zambia has appointed a consultancy group which is preparing a mutually acceptable, multi-option scheme for their orderly liquidation. Claims in the arrears pipeline will be guaranteed at the exchange rate prevailing on October 3, 1985, but payments will be frozen until the details of the scheme for eliminating the arrears have been worked out and agreed upon. Kwacha counterpart funds held against the pipeline cannot be withdrawn for the purposes of bidding at the foreign exchange auction. Similarly, letters of credit established prior to the start of the auction cannot be retired through bidding at the auction. However, the staff understands that this issue is still being discussed with commercial banks. Exporters will continue to be allowed to use their share of foreign exchange receipts under the export retention scheme for dismantling their pipeline claims.

(v) Residents and nonresidents may, without restriction, remit or sell to authorized dealers in Zambia foreign currency held abroad by them, without any obligations to declare the source of such funds.

c. Prices

New consumer prices have been announced for maize and maize products. As a result, effective September 14, 1985, the price of maize to millers has been raised by 47.3 percent to K 38.3 per 90-kg bag, and the consumer prices of maize products have been increased by amounts ranging between 38.3 to 50.5 percent. The authorities have also indicated their intention to raise in November agricultural producer prices and the price of fertilizer for the 1985/86 agricultural season, taking into account the new exchange rate level. Also, with effect from October 15, 1985, ex-refinery prices of petroleum products were increased by 150 percent, and retail prices were nearly doubled, consistent with the policy of maintaining no subsidy on these products. Future increases in the price of petroleum to reflect, inter alia, the impact of movements of the kwacha will be determined by the Board of the Zambian Industrial and Mining Company (ZIMCO), the holding company for the oil company. All air fares have been increased by more than 100 percent in kwacha terms since the introduction of the auction system.

d. The Treasury bill market and interest rates

On September 2, the authorities introduced a daily auction for Treasury bills as part of a policy of removing controls on domestic interest rates and establishing an institutional framework for controlling the growth of the monetary base. Since then, the Treasury bill rate has increased from 9.5 to 21.0 percent; the Bank rate has been raised from 14.5 to 17.5 percent, and the maximum deposit and lending rates have risen from 15.0 and 17.5 percent to 20.0 and 21-25 percent, respectively. These rates, however, remain negative in real terms.

e. Taxation

On August 13, the Zambian Parliament approved the necessary legislation to raise the mineral export tax from 10 to 20 percent. The enabling legislation gives the Minister of Finance authority to modify the tax at his discretion. The authorities have also agreed, subject to Parliamentary approval (expected to be obtained in November 1985), to restructure external tariffs, including the imposition of a 10 percent duty on items which are presently exempt from duty.

2. The balance of payments

In light of the findings of a recent mining sector mission of the World Bank, the staff has revised downward the projections of the levels of production of copper and, consequently, the balance of payments estimates for 1985-86 provided in the staff report (SM/85/273). The revised balance of payments, along with other minor changes, are shown in the table. Copper production is now expected to be 480,000 tons for 1985, to rise to 500,000 tons in 1986, and to stabilize at 530,000 tons in 1987-89, whereas the initial estimates called for an output of 520,000 tons in 1985 and a rise to 590,000 tons by 1989. The effect of these changes is to reduce the value of copper exports by SDR 54 million in 1985 and SDR 98 million in 1986, contributing to a widening of the external current account deficit by SDR 33 million in 1985 (to SDR 330 million) and by SDR 107 million (to SDR 304 million) in 1986. The cumulative increase of the current account deficit for the ensuing three-year period is estimated to be SDR 438 million. The lower receipts from exports result in an increase in the projected debt service ratios; the revised projections show scheduled debt service obligations amounting to 87 percent of exports of goods and services in 1985 and 80 percent in 1986 and averaging 75 percent in 1987-89 (see table).

The cutback in copper production is attributed to the delayed effects of past low allocations of foreign exchange to ZCCM, the mining company. To forestall any further fall in copper production, the authorities have decided to raise ZCCM's allocation of foreign exchange from 25 percent of their export receipts to 35 percent. Within the existing tight overall foreign exchange constraint, this will place an additional squeeze on the resources available for other imports and exert strong pressures on the exchange rate. This underscores the need for the Government and the parastatals excluded from the auction to economize on their use of foreign exchange.

The authorities regard the recent measures as part of the needed comprehensive macro-economic adjustment package that will include, inter alia, fiscal and monetary policies to be worked out in consultation

with a Fund mission scheduled for early November 1985. In the context of the budget for 1986, the authorities have already indicated their intention to make the tax system more buoyant by converting the excise tax on petroleum from a specific to an ad valorem basis and introducing a duty on crude oil imports. In order to stem the drain of skilled and highly qualified civil servants, and taking into account the expected acceleration of the rate of inflation, the authorities have increased wages, salaries, and allowances with effect from October 1985, but the staff has no information on the details and budgetary implications of the increase. The authorities have, however, informed the staff that wage increases would be well below the inflation rate. The forthcoming mission will focus on all these issues, including a mechanism for limiting the maize subsidy for consumers. A further increase in the consumer price of maize is expected to be implemented in January 1986. A substantial increase would be unavoidable in light of the depreciation of the kwacha, if the budgetary subsidy on maize is to be limited.

3. Staff assessment

The staff believes that the policy adjustments already introduced or to be made shortly by the Zambian authorities constitute substantial progress toward comprehensive adjustment and diversification of the economy. While the parameters of the overall macro-economic adjustment policy for 1986 remain to be worked out by the next mission, principally in the context of the 1986 budget, the steps already taken by the authorities are broadly in line with those advocated by the staff in the staff's appraisal in SM/85/273. It is hoped that such a policy package would form the basis for a new arrangement with the Fund once Zambia has discharged its overdue obligations to the Fund.

The design of the auction system follows closely the advice given by the staff. The staff expects the authorities to allow the exchange rate to float freely and to avoid administrative measures to influence the exchange rate. The staff would also urge the authorities to abolish the foreign exchange retention scheme for nontraditional exports and the agricultural incentives payments scheme, and to broaden the coverage of transactions channelled through the auction. Moreover, to assure the effectiveness of the changes the staff urges the authorities to ensure that no further transactions are allowed to enter the "pipeline" of arrears on commercial payments.

At this stage, Zambia's external liquidity position is critical. If the momentum of adjustment is to be maintained, adequate external assistance will need to be mobilized to finance the relatively large gaps which have further widened because of reduced levels of copper production which are now projected through 1989. It is particularly important for Zambia to receive quick disbursing aid--both to ensure the viability of its foreign exchange auction system and to assist Zambia in becoming current on its financial obligations to the Fund.

II. Proposed Decision

In light of the reforms introduced in the areas of the exchange and trade policies the following draft decision is proposed for adoption by the Executive Board, instead of the draft proposed decision on page 26 of SM/85/273.

1. The Fund takes this decision relating to Zambia's exchange measures subject to Article VIII, Sections 2(c) and 3, in concluding the 1985 Article XIV consultation with Zambia and in the light of the 1985 Article IV consultation with Zambia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Zambia has substantially liberalized its exchange system. Zambia continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV. The exchange restrictions evidenced by external payments arrears and the overall foreign exchange budget, and the multiple currency practices arising from the maintenance of counterpart deposit scheme for external payments arrears and from the temporary arrangement in regard to personal remittances as described in SM/85/273, Supplement I, are subject to approval of the Fund under Article VIII, Sections 2(a) and 3. The Fund encourages the authorities to continue to implement comprehensive adjustment policies and to remove the remaining restrictions and multiple currency practices as soon as possible.

Table 1. Zambia: Balance of Payments, 1982-86

	1982	1983	1984			1985		1986	
			Original prog. 1/	Revised prog. 1/	Revised estimate	Staff report	Revised	Staff report	Revised
(In millions of SDRs)									
Trade balance	-225	92	77	48	111	127	86	227	138
Exports, f.o.b.	824	877	765	728	817	876	835	1,031	936
Of which: copper	(722)	(778)	(638)	(599)	(668)	(702)	(648)	(798)	(702)
Imports, c.i.f.	-1,049	-785	-688	-680	-706	-749	-749	-804	-798
Project-related and commodity aid	-353	-265	-298	-293	-226	-261	-261	-289	-283
Petroleum	-193	-171	-141	-141	-138	-128	-128	-134	-134
Other	-503	-349	-249	-246	-342	-360	-360	-380	-380
Services (net)	-338	-333	-390	-402	-357	-445	-437	-447	-465
Interest payments	-226	-236	-290	-302	-253	-350	-342	-360	-368
Other (net)	-112	-97	-100	-100	-104	-95	-95	-88	97
Receipts	110	94	84	80	90	95	95	112	103
Payments	-222	-191	-184	-180	-194	-190	-190	-200	-200
Unrequited transfers	-46	-17	-21	14	2	21	21	23	23
Private	-82	-51	-50	-50	-50	-50	-50	-53	-53
Official	36	34	29	64	52	71	71	75	75
Current account	-609	-258	-334	-340	-244	-297	-330	-197	-304
Nonmonetary capital	102	-57	-60	-70	-122	-143	-143	-76	-76
Public sector (net)	59	5	-82	-78	-136	-208	-208	-116	-107
Mining company (net)	43	-62	22	8	15	65	65	40	40
Other capital 2/	-60	29	--	--	-61	-50	-50	--	--
SDR alloc./Gold reval.	21	-8	--	--	--	--	--	--	--
Overall balance	-546	-294	-394	-410	-427	-489	-523	-273	-370
Financing	546	294	394	410	427	-245	-95	-148	-148
IMF (net)	-52	60	74	74	74	-95	-95	-148	-148
Purchases	34	174	148	148	148	--	--	--	--
Repurchases	-86	-114	-74	-79	-74	-95	-95	-148	-148
Other foreign assets (net) (increase -)	166	-11	-9	-1	15	--	--	--	--
Total debt relief	--	293	569	556	470	...	...	...	...
Scheduled obligations	--	96	367	317	244	...	...	...	...
Arrears	--	197	202	239	226	...	...	...	...
Arrears	432	-48	-240	-219	-132	-150	...	...	...
Incurrence/cash reduction (-)	432	149	-38	20	94	-30	-10	...	...
Commercial payments	225	-50	--	58	25	-30	...	...	...
Rescheduled debt	--	38	-38	-38	8	...	...	...	...
Other external debt	207	161	--	--	61	...	...	...	...
Rescheduled	--	-197	-202	-239	-226	-120	...	...	...
Financing gap						734	628	421	518
Memorandum items:									
External payments arrears 3/	725	597	597	620	568	...	...	...	...
Nonmonetary capital (net)	102	-57	-60	-70	-122	-143	-143	-76	-67
Disbursements	317	170	269	229	174	230	230	239	248
Amortization	-215	-227	-329	-299	-295	-373	-373	-315	-315
Cumulative new disb.						230	230	469	478
Interest on new disbs.			5.0%			33	...	17	18
Interest on financing gap			9.0%			33	25	86	93
Cumulative financing gap						734	628	1,167	1,692
Copper									
Volume (MT/000)	604	570	530	530	541	520	480	570	500
Price (SDR/lb)	0.61	0.68	0.65	0.61	0.61	0.66	0.66	0.69	0.69
(In percent of exports of goods and services)									
Current account/GDP (percent)	-17.4	-10.2	-14.6	-14.8	-10.6	...	...	...	...
Scheduled debt service	56.4	59.3	81.6	83.5	68.7	83.1	87.1	71.6	80.0
Debt service after debt relief	56.4	49.4	38.4	44.3	41.8	...	...	...	...

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

1/ The basic ratios and indicators are those specified in the programs in EBS/84/135 and EBS/84/229.

2/ Including errors and omissions.

3/ Consists of commercial payments arrears, including arrears of the mining company.