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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/158

10:00 a.m., October 30, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
C. H. Dallara	M. Lundsager, Temporary
	H. G. Schneider
	S. de Forges
M. Finaish	
	M. Sugita
G. Grosche	
J. E. Ismael	
	L. Leonard
	J. Hospedales, Temporary
T. P. Lankester	
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	
	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	
	A. S. Jayawardena
	N. Coumbis
	Jiang H.

L. Van Houtven, Secretary
B. W. A. Ames, Assistant

Also Present

IBRD: H. Messenger, Eastern and Southern Africa Regional Office. Administration Department: J. G. Keyes. African Department: A. D. Ouattara, Director; G. E. Gondwe, Deputy Director; P. A. Acquah, J. Artus, E. L. Bornemann, J. E. Greene, T. Muzondo. Exchange and Trade Relations Department: M. Fisher, S. Kanesa-Thasan. Fiscal Affairs Department: J. Diamond. IMF Institute: S. C. K. Lilanda, Participant. Legal Department: A. O. Liuksila. Research Department: H. C. Kim. Treasurer's Department: M. F. Melhem. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, S. M. Hassan, G. W. K. Pickering, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, W.-R. Bengs, R. Fox, V. Govindarajan, L. Hubloue, S. King, H. Kobayashi, J. A. K. Munthali, A. Mustafa, J. K. Orleans-Lindsay, J. E. Rodríguez, V. Rousset, A. A. Scholten, B. D. White.

1. REPORT BY MANAGING DIRECTOR AND DEPUTY MANAGING DIRECTOR

The Chairman mentioned that he had participated in the meeting of the United Nations Administrative Committee on Coordination held in New York on October 28. The text of his remarks on the Annual Meetings in Seoul would be circulated in the usual way. On October 29, he had opened the inaugural meeting of the Canadian Council on Foreign Relations in Montreal; the text of his address had been circulated. He had also had a number of talks with Canadian bankers on the follow-up of the debt strategy discussed in Seoul; his impression was that they were most desirous of cooperating.

The Deputy Managing Director said that on October 28 he had participated in a meeting of the Institute for International Finance that had brought together the member banks of the Institute for a preliminary discussion of the debt initiative proposed by the U.S. authorities during the course of the Seoul meetings. The membership was broad based and included commercial banks from a large number of countries outside the United States, which had been given its first opportunity to make a presentation of the debt initiative to non-U.S. banks. Assistant Secretary Mulford had outlined the basic thrust of the initiative, which as Executive Directors were aware, was based on the need for commercial banks to be prepared to give an indication that new money would be made available to countries which continued to be faced with serious debt problems and which had not yet made the full transition to voluntary commercial lending. Mr. Mulford's presentation had followed the lines of Secretary Baker's presentation at the Annual Meetings. The meeting had also been attended by Mr. Ernest Stern, Senior Vice President of the World Bank, and by Mr. Michael Curtin, Executive Vice President of the Inter-American Development Bank.

He had not made a prepared statement as a participant in the afternoon session but had followed up Mr. Mulford's presentation with a few short observations, the Deputy Managing Director continued. He had indicated that from the perspective of the Fund staff and management, the U.S. initiative was a positive development. It had fully and clearly identified the need for financing by countries faced with serious debt problems. The approach outlined by the U.S. authorities was broad based and included not only additional commercial bank financing but additional World Bank financing, as well as initiatives by export credit agencies and regulatory authorities to develop a broader understanding of the need to provide additional resources to countries that had not yet regained access to financial markets but that were taking adjustment measures. Indeed, a great deal of emphasis had been given during the session to the importance that was attached to the need for countries to undertake appropriate policies to restore their access to international capital markets, which was of course one aspect of Mr. Mulford's presentation.

The meeting had not been geared toward obtaining commitments by the commercial banks, the Deputy Managing Director explained. Rather, commercial banks had been given an opportunity to hear more about the U.S.

initiative. Considerable additional work would have to be carried out within the Institute and in other forums before the commercial banks could agree on the modalities for responding to the debt initiative. The banks were in fact planning further discussions to develop their views, in part under the aegis of the Institute.

2. ZAMBIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Zambia, together with a proposed decision concluding the Article XIV consultation (SM/85/273, 10/1/85; and Sup. 1, 10/29/85). They also had before them a report on recent economic developments in Zambia (SM/85/279, 10/9/85).

Mr. Mtei made the following statement:

After an elaborate and incisive presentation made by L. K. Mwananshiku, Minister of Finance, at the Executive Board's meeting held in Seoul, South Korea, on October 10, 1985, Executive Directors are familiar with the extremely difficult economic and financial conditions that the economy of Zambia has experienced in recent years. The Minister was forthright in agreeing with the staff's assessment of recent economic developments and was emphatic in indicating the authorities' willingness and determination to introduce needed adjustments and policy reforms to achieve long-run changes in the economy.

The Zambian economy has been experiencing sharp declines in economic activity in recent years during which internal and external imbalances increased considerably. Real GDP has been persistently showing negative rates of growth while inflationary pressures were intensifying. The financial position of the Government has weakened considerably with expenditure outpacing revenue in the face of a shrinking revenue base. Meanwhile, the external payments position weakened progressively as external reserves were virtually depleted, forcing the country to incur enormous arrears on its external obligations including repurchases due to the Fund. The current state of economic and financial conditions reflects to a large extent the poor performance of the mining sector, particularly copper, which accounts for about 90 percent of the country's exports and whose international prices have fallen precipitously over the years to an average of SDR 0.61 per lb. in 1984, the lowest price recorded in the last several years. In fact, Zambia's overall terms of trade deteriorated by as much as 70 percent in nominal terms in the last ten years to 1984. At the same time copper production, which accounts for a significant proportion of GDP, has also been declining, and the authorities expect output to fall to about 500,000 tons in 1985 compared with 712,000 tons in 1976 and 612,000 tons in 1980. Zambia has also been affected in recent years by a severe and prolonged drought that hit most of southern Africa and which forced the country to import a lot of its domestic food requirements, thereby exacerbating the balance of payments position.

The Zambian authorities did not foresee such a prolonged weakness in international price for copper, which meant that certain policies adopted in the past proved to be unsustainable. They are convinced that the present economic situation leaves no alternative but to implement drastic policy changes. The steps they are taking are aimed at relieving the critical shortage of foreign exchange in the short term and restoring a viable balance of payments position in the medium term. They hope to achieve this objective by reducing domestic financial imbalances, restructuring economic incentives, promoting the efficient mobilization and allocation of domestic savings, and creating conditions for the resumption of economic growth.

By far the most fundamental and significant step already taken to this effect is the introduction of a market determined exchange rate system through weekly auction of foreign exchange. As reported by the Minister, the initial auction was successfully launched on October 11, and another auction was conducted a week later. The Zambian kwacha was devalued by about 56 percent during the first auction, and the cumulative devaluation after the second one amounted to 64 percent.

The Zambian authorities recognize that the new system could not operate smoothly under highly restrictive trade and payments system that had been maintained hitherto. Accordingly, they have already taken action concurrently to liberalize the system. To this end, they have introduced a new import license that will be issued without restrictions and will be applicable to all categories of imports. At the same time, import prohibitions for protective purposes have been abolished. As regards the exchange system, profits and dividends declared after October 31, 1985 will be remitted abroad through bidding at the auctions subject, of course, to satisfying existing laws governing the repatriation of dividends and profits. Furthermore, payments for airline tickets in respect of routes directly served by airlines operating to and from Zambia may be made in kwacha without prior exchange control approval. In addition, holiday travel allowance has been reinstated. As regards commercial payments arrears, the authorities have employed the services of consultants to prepare mutually acceptable schemes for their elimination. The consultants' recommendations will be submitted to the Bank of Zambia by December 31, 1985.

It is also recognized that in order to achieve desired results, the devaluation of the kwacha should be allowed to permeate throughout the entire domestic price structure. With the liberalization of the pricing system and the dismantling of all outside interventions in pricing decisions in parastatal organizations, the authorities hope that a prompt and full pass-through of the effects of the exchange rate changes will be effected. They have emphasized, in this connection, that domestic prices of petroleum products will fully reflect changes in the exchange rate. As regards maize and fertilizer, the only two commodities which are still subject to administrative controls, the authorities have indicated that they will announce new prices at the end of October after a full assessment of the effects of exchange rate changes and other cost developments.

Meanwhile, it is the intention of the Government to pursue financial policies that are supportive of the balance of payments objective. In the fiscal sector, the authorities have stated that they will implement measures that should promote fiscal discipline by restraining the growth of expenditure and raising additional revenue. To this effect, a bold and significant step was taken on September 13, 1985 to eliminate the marketing subsidy on maize when the retail price of maize meal was raised by 51 percent. Furthermore, both the producer and the consumer price of maize will be reviewed following the introduction of the new exchange rate system with a view to limiting the impact on the budget. This and other budgetary issues will be further examined with the staff during the next mission to Zambia. The wage increase awarded to civil servants at the beginning of October was to retain highly trained and skilled personnel, and such increases have been kept below the rate of inflation and depreciation of the kwacha. Meanwhile the authorities have undertaken to progressively reduce the work force in the public service beginning in 1986.

On the revenue side, legislative authority has already been granted to increase the mineral export tax from 10 to 20 percent. In taking this action, the authorities intend to consider the financial needs of the mining sector. Other revenue-raising measures include changing the tax on petroleum products from a specific to an ad valorem rate. A 10 percent customs duty will be levied on those commodities not yet subject to duty excepting for those items classified as essential for agriculture, scientific research, education and health. It is hoped that this will also come into effect by mid-November.

In the area of monetary and credit policy, the Zambian authorities agree that this should not only take a central role but should also be implemented more flexibly with the development of such instruments that should facilitiate prompt response to the changing circumstances in the financial market. To this end, they have already removed controls on banks' interest rates. On September 2, they intoduced a daily auction for treasury bills which raised the treasury bill rate from 9.5 percent to

16 percent. This open market operation of treasury bills will provide a mechanism by which control over money supply can be exercised. Meanwhile the bank rate was raised from 14.5 percent to 17.5 percent, and deposit as well as lending rates for commercial banks were also increased.

Directors will recall that the Minister indicated that in implementing these and other measures, the authorities hope that this could be used as a basis for discussing the possibility of the a Fund-supported program subject, of course, to meeting outstanding obligations. They view the support from the Fund to be crucial if the reforms introduced are to be effective. The Government feels that there is a link between the implementation of such an adjustment program and the eventual elimination of arrears to the Fund. In supporting the program, the Fund would undoubtedly help in facilitating the Government's efforts to mobile external financial resources. To this end, contacts have already been established with some commercial banks which, as the Minister indicated in Seoul, were awaiting Fund's endorsement of the program. The authorities also feel that support from the Fund would help to unlock funds from the World Bank and other donors. The quick disbursement of these resources will be crucial in buttressing the supply of foreign exchange if the auction is to be sustained and work efficiently. The appeal for financial support made directly to donors by the Minister at the Board's meeting in Seoul does not need to be overemphasized.

In conclusion, I wish to reiterate that the Zambian authorities have taken very courageous steps which deserve the support of the Fund and the donor community at large. The measures are comprehensive and far reaching and, in my view, constitute a genuine desire on the part of the authorities to address the funamental problems facing the economy.

Extending his remarks, Mr. Mtei referred to the supplement to the staff report, which provided more recent information than he had received following the implementation of the new exchange system. As that updated information did not change the substance and thrust of his statement, he wished only to draw attention to certain aspects that would no doubt have a bearing on the discussion.

First, the estimates of copper production in 1985 had been scaled down to 480,000 tons, implying a further worsening of the trade balance in the external accounts, Mr. Mtei observed. Second, the cumulative devaluation of the Zambian kwacha after the third auction had been 68 percent, against the cumulative devaluation of 64 percent after the second auction, as mentioned in his opening statement. Third, the increase in the price of maize meal, to which he had referred in his statement, was the maximum applicable increase. It was also worth noting that the treasury bill rate had continued to rise following the introduction of the auction system, reaching 21 percent as opposed to the rate of 16 percent reached earlier.

Finally, Mr. Mtei reiterated that he concurred fully with the staff assessment of the recent actions taken by the Zambian authorities. In particular, he drew attention to the statement in the supplement to the staff report calling for assistance to Zambia in the form of quick-disbursing aid to support the new foreign exchange auction system and to help Zambia become current on its obligations to the Fund, thereby setting the stage for a possible stand-by arrangement with the Fund.

Mr. Lankester observed that Zambia's adjustment effort over the past decade had had to aim at a constantly moving target: an almost continuous deterioration in the terms of trade on a scale unanticipated either by the Zambian authorities or international financial institutions. Consequently, the adjustment measures taken over the years, even when implemented as planned, had not proved adequate. For instance, as the staff had made clear, under the latest Fund-supported program, "the authorities continued to implement adjustment policies broadly in line with the policy package supported by the Fund." But because of the further deterioration in Zambia's balance of payments, that policy package had not proved sufficient, and still more fundamental adjustment was needed.

In retrospect, if some of the changes in structural policy that were currently being introduced had been made earlier, Mr. Lankester continued, the economy might already have become more efficient and diversified, with a stronger agricultural sector, a more efficient industrial sector, and less dependence on a single export. In turn, Zambia would have become less vulnerable to adverse movements in the copper price. Nevertheless, such regret over the inadequate policies of the past had to be tempered by the realization that Zambia's current difficulties were overwhelmingly the result of factors--namely, developments in the copper market--over which the authorities had had no control.

The misfortune that had befallen the economy was reflected in numerous statistics, Mr. Lankester noted. The volume of imports had fallen by 40 percent since 1980, and living standards had fallen by 25 percent since 1974. A measure of the task facing the authorities was provided by the staff's medium-term projections. Even on what seemed to be relatively optimistic assumptions, the debt service ratio was still put at over 60 percent at the end of the decade, with large financing gaps left to be filled somehow. The scale of the required adjustment would call for an exceptional effort on the part of the Zambian authorities and the international community in its support.

There were grounds for hope, however, Mr. Lankester remarked. The authorities' immediate response to the crisis they faced had been a courageous one. Steps had been taken to liberalize the trade and payments system, subsidies on the few remaining regulated prices had been reduced substantially, and procedures had been introduced to permit the market determination of interest rates and the exchange rate. Those were radical moves which he supported wholeheartedly. But they were only a start and the authorities must act quickly to devise and then implement essential supporting fiscal and monetary policies.

Referring to the various measures that were being taken, Mr. Lankester commented that it had been of some concern to him that the authorities had decided initially to limit the supply of treasury bills so as to keep the interest rate at 13 percent. Fortunately, rates had been allowed to rise to around 20 percent, although they were still negative in real terms and not sufficiently high to prevent a substantial expansion in the monetary base. Monetary control was essential not only to mitigate the inflationary consequences of recent measures but to prevent excess liquidity spilling over into the foreign exchange market and causing an unnecessarily large depreciation of the kwacha. He urged the authorities to finance the government deficit in future by active sales in the new treasury-bill market rather than by recourse to the overdraft with the Bank of Zambia. The staff's views in that connection would be helpful.

As far as the foreign exchange auction was concerned, to work efficiently and to avoid too much exchange volatility, it would require a regular and adequate supply of foreign exchange, Mr. Lankester observed. The authorities should keep the number of exemptions from the auction to a minimum. He understood that so far, $5 million had been set aside for each of the three auctions that had been held, yet the rate determined in those auctions for the kwacha against the dollar had slipped from 5 percent to 7 percent. Worries were being expressed in some quarters that it might not be possible for the authorities to maintain a flow of $5 million per auction, a figure that was already on the low side. As he understood it, the intention had been to find a significant portion of the $5 million weekly allocation from World Bank sources, initially from the agricultural credit and in due course, when it became effective, from the industrial reorientation credit approved recently by the Executive Directors of the World Bank. Apparently, because bidders from the agricultural sector had not been bidding at a high enough kwacha rate, only a small amount of dollars had become available from the operations of the World Bank Group. He would be interested in having the staff's latest assessment of the immediate prospects for the availability of foreign exchange for the auction and for the kwacha rate, especially if structural problems arose as a result of the lack of bidding by the agricultural sector at a sufficient rate to draw down the agricultural credit from the World Bank. The success of the auction system was critical to Zambia's current efforts. He strongly supported Mr. Mtei's point that it was essential for adequate foreign exchange to be made available to the auction, inter alia, by donors.

He welcomed the liberalization of the trade and payments system, in particular the end of import licensing as a means of protection, Mr. Lankester continued. He attached considerable importance to the review of the trade and payments system that was promised for later in the year with the assistance of the World Bank Group.

On fiscal policy, the immediate effect of the recent rise in interest rates and the devaluation would be to exacerbate a situation which, according to the staff report, had already been slipping out of control at the beginning of the year, Mr. Lankester noted. He understood from the staff paper that the authorities were planning to make expenditure cuts, especially in the public service. Those cuts might not be quick-acting enough, difficult as they were to implement. Measures were needed that would have an early impact both on the expenditure and revenue sides of the budget. The authorities' recent decision to raise certain public sector wages in anticipation of an increase in the rate of inflation had not made their task any easier.

The budget for 1986, which the forthcoming Fund mission would be discussing with the authorities, would be critical, Mr. Lankester remarked. He endorsed the staff view that the measures needed included the complete pass-through of higher import costs to those domestic prices that remained controlled, restraint on the growth of the civil service wage bill, and more economic pricing in the parastatal sector.

The buildup of Zambia's arrears to the Fund was of course regrettable and had complicated the task of putting together a new Fund-supported program, Mr. Lankester said. Those arrears would have to be paid off before an arrangement with the Fund could be agreed.

In sum, Mr. Lankester concluded, the economic crisis in Zambia presented a challenge to the authorities and to the international community. The Zambian authorities seemed to have risen to that challenge and their efforts so far deserved support and encouragement. Yet there could be no certainty, especially after the disappointments of the past, that the efforts would succeed in bringing about recovery. The policies that were being pursued seemed to be the best available, however. Thus he urged the authorities to build on their recent initiatives by reaching agreement with the Fund on a sufficiently robust package to win the support of donors and pave the way for the clearing of Zambia's arrears to the Fund and the approval of a new Fund-supported program. In that connection, he commended the staffs of the World Bank and the Fund for the excellence of their collaboration in assisting the Zambian authorities.

Mr. Leonard noted that there had been a recent renewal of interest in the debt and development problems of nonindustrial Fund members, especially those in Africa. Just how large and intractable those problems were was clearly illustrated by the staff report on Zambia; unfortunately, it was equally clear how far away were fully satisfactory solutions to those problems.

Zambia had encountered increasing difficulties over the past decade, with a marked and continuing deterioration of its current external balance and a progressive clouding of its future trading prospects, Mr. Leonard continued. The source of the problem could be traced to excessive dependence on a single commodity for which world markets had weakened, the failure to adjust to that fundamental change in the trading environment, and the consequent accumulation of a large debt burden. A disturbing feature of the debt situation had been the inexorable growth of external arrears. A further source of disquiet was that the adjustment efforts and progress achieved since 1983 were faltering and in danger of being reversed. Admittedly, the failure of copper as a source of economic strength had been greater and more far reaching than had seemed likely at one stage, but it had been compounded by delays and inadequacies in the policy measures taken to respond to it.

In the period covered by the staff report under discussion, Zambia's problems had not disappeared or been eased but had intensified, Mr. Leonard commented. He agreed wholeheartedly with the assessment that the severity of those problems required a radical departure from previous policies, and he had been heartened by the indications over the past few weeks that Zambia was undertaking policy measures, which, if supported by a comprehensive adjustment program, would lead to a decisive change in the trend over the medium term of the external accounts.

To some extent, recent events had overtaken the discussion reflected in the staff report, Mr. Leonard remarked, in the sense that the authorities had moved further toward accepting the need for adjustment than had been evidenced during the Article IV consultation discussions and had already carried through some action to that end. What was needed at present was a quantitative financial and fiscal framework for further measures and complementary action by the Fund and others. The analysis in the staff report had not been invalidated nor had the relevance of the staff's policy recommendations, with which he found himself in general agreement. But there were a few features of the approach advocated by the staff to which his chair attached importance.

First, the introduction of an auction-based exchange rate and a liberalized trading system earlier in October were extremely important and welcome developments, Mr. Leonard commented. The greater flexibility in the exchange market that would ensue was a necessary condition for increased economic efficiency and export diversification. Despite the liberalization, the exchange rate system was not completely free. For example, two important sources of demand--the Government and the mining and oil importing companies--not to speak of others, would continue to have their foreign exchange requirements determined administratively; whatever the merits of those exemptions, they did limit the amounts of foreign exchange available for auction for other purposes and they should thus be as short lived as possible. In addition, the system required forced foreign exchange surrender which also had its drawbacks. At the same time, it was obvious that it would be some years before the country could have a more normal exchange rate system. In the meantime, the auction arrangements were a useful step in that direction.

The experience of other Fund members demonstrated that it was important not only to get the exchange rate right but also to support exchange rate policies with firm demand-management policies, Mr. Leonard continued. On that point, no new information was available on the authorities' intentions since fiscal and monetary policies were to be worked out by the forthcoming Fund mission. The staff report did show that the budget adopted for 1985 had been inadequate and that unfortunate deviations from it had occurred. As things stood, there could be no escaping the need for a radical improvement in the fiscal accounts and a firm tightening of monetary policy. More specifically, immediate steps would have to be taken to reduce public expenditures and strengthen revenues. Furthermore, the capital program would have to be constrained and directed exclusively toward projects that contributed to growth and diversification of the export base; that had not always been the case in the past. Realistic pricing policies would help to improve the profit margins of parastatals and increase the Government's financial flexibility. The further increase in the consumer price of maize that was planned for January appeared unavoidable.

The move to a more market-oriented exchange rate regime required a freer system for determining interest rates, Mr. Leonard noted. The decision in September to move to a daily auction for treasury bills was important but needed to be implemented more wholeheartedly than at present. He had noted what he judged to be a reservation on the part of the staff in its remark that the demand for treasury bills seemed insufficient to prevent a substantial expansion in the monetary base. The already high rate of inflation and the prospect of its acceleration following the depreciation of the kwacha meant that the authorities would have to assess carefully whether interest rates of the order prevailing in Zambia were adequate or needed to be brought to the point where they would be positive.

The staff had made no secret of the fact that the medium-term outlook for the economy and for the balance of payments was uncertain, Mr. Leonard observed. The medium-term projection for the external account given in the staff report depended on assumptions that would be difficult to realize. Even if borne out, it would result in a situation that was no more than adequate. The projections in the supplement to the staff report had had to be revised already, and an even more tenuous prospect was indicated. Such an outlook was not unexpected in view of the weakening of the copper sector, but it did underline the urgent necessity of generating alternative sources of production and export earnings in order to enable the heavy debt burden to be serviced. In conjunction with vigorous action by the Fund in its sphere of competence, the World Bank had an obvious role to play and he had been glad to note its close relations with Zambia. World Bank support for economic diversification would be decisive, and it was encouraging to note the recent approval of a credit of $75 million for the Industrial Reorientation Project. Just as important was the adoption of the new Investment Act and the implementation of the investment program of the Industrial Development Corporations (INDECO). The reorientation of the manufacturing sector toward exports and the overcoming of marketing difficulties would not happen by themselves; on the contrary, they would have to be properly encouraged by government action if they were to substitute in a significant way for diminished receipts of foreign exchange from copper. He hoped that the Zambian authorities would receive the support from international donors that their new policy stand deserved. He supported the proposed decision.

Mr. A. R. Ismael remarked that it appeared from the staff report that the Zambian economy was going through a difficult period. Real GDP had been declining during the past three years, inflation had intensifed, and the external payments position had also come under severe pressure. There were two main reasons for Zambia's present predicament: first, overdependence on copper, whose price on the international market had dropped dramatically; and second, the delay in implementing a comprehensive package of adjustment policies.

It was encouraging to note from Mr. Mtei's statement that the Zambian authorities were determined to implement the adjustment measures required to restructure the economy and to reduce its dependence on copper exports, Mr. Ismael added. He welcomed the steps that were being taken, as outlined in the staff report, aimed at improving the performance of the economy, alleviating the foreign exchange shortage in the short run, and restoring balance of payments viability in the long run. Of particular significance was the introduction of a market-determined exchange rate system for auctioning foreign exchange. It was most gratifying to note that three auctions had already been held. To be effective, the new exchange rate system should be supported by appropriate policies in other sectors and by external financial flows. Action had been taken to eliminate the subsidy on maize, to raise the mineral export tax, and to decontrol interest rates.

The authorities needed to intensify their efforts to diversify exports, Mr. Ismael remarked, and World Bank assistance in that field was appropriate. Some success was being achieved already in the agricultural sector, which was showing a positive response to pricing policies adopted earlier. Such policies needed to be continued in other sectors as well, especially in the industrial sector, which had promising potential. In conclusion, he hoped that creditors and aid donors would support the Zambian authorities' determined efforts to implement the new adjustment program. He supported the proposed decisions.

Mr. Dallara said that the Board's discussion of the staff report for the 1985 Article IV consultation came at a critical time for Zambia. After several years of economic decline, owing significantly to the drop in copper prices and unfortunately exacerbated by the postponement of adequate adjustment measures, the Zambian authorities were taking wide-ranging steps to redirect economic policy and activity. That policy reorientation was welcome; successful implementation of a broad economic program could lead to a rebound of economic growth and a diversification of the economy that could enhance the apparently very difficult medium-term outlook. The various pricing measures already taken and the closely related introduction of a foreign exchange auction system were significant indications of the commitment on the part of the authorities to tackle their serious economic problems. In addition, the Zambian authorities had liberalized their trade and payments system, a step that should strengthen competitive forces in the economy and help to renew foreign investor interest. However, those measures must be complemented by other policies, including a realistic, conservative set of monetary and fiscal policies to be continued for several years if real economic activity was to recover and confidence in the economy returned.

One of the strongest incentives to increased production was the freedom to produce and to price as indicated by the market, Mr. Dallara observed, welcoming what he understood to be the almost complete decontrol of prices. However, he had some reservations about the continued control over fertilizer and maize prices--although the latter had been increased--since revitalization of the agricultural sector was of paramount importance. With the introduction of the foreign exchange auction system, the exchange rate had already depreciated substantially, implying that domestic prices of those products should be readjusted accordingly. Although the authorities had indicated that they would do so soon, if they fixed the prices for the entire crop year, additional exchange rate adjustment might erode the profitability of domestic production. Further comment by Mr. Mtei or the staff, especially on the authorities' intentions with respect to decontrolling the prices of the two products still under administrative control, would be helpful.

Those pricing issues were related to the matter of the budget, Mr. Dallara continued. While few details were given in the staff report about the future budgetary outlook, a significant degree of retrenchment was clearly needed. Exchange rate adjustments would have an adverse impact on the budget, since increases in expenditures--for instance, on debt service--were expected to outweigh increases in revenues. Strong offsetting measures would be required. In particular, subsidies, including transfers to the parastatals, would have to be contained if not eventually eliminated or restricted to only the lowest income groups. In that respect, he would welcome any additional information available on the reform of the public enterprises, including the possibility of divestiture.

He understood that one source of fiscal revenue would be an increase in the export tax on minerals, Mr. Dallara added. There might be some room for a temporary windfall profits tax, following the depreciation of the kwacha, but he was somewhat reluctant to support such a measure, which, in the long run, could erode the profitability of the mining company and perhaps even lead to disinvestment. He recognized the pressing need for revenue but urged caution because the process of structural adjustment of the economy would take several years; meanwhile mineral exports would remain extremely important.

Substantial adjustment was planned in respect of public sector employment, Mr. Dallara observed. The reductions expected in the number of temporary workers and the accelerated voluntary retirement plan could yield the longer-term benefits of a streamlined civil service and the attendant incentives toward private sector activity. Recent increases in civil service wages were, however, of some concern; the Government's desire to retain highly skilled workers was understandable but it might have been better to raise wages selectively following a reduction in total manpower. It would be of interest to know the actual size of the wage increases, which were apparently below the rate of inflation.

He had had some difficulty in piecing together the effects of the various fiscal measures, Mr. Dallara said, and thus remained somewhat concerned about the cohesiveness of the fiscal effort and its overall effect. It would be helpful to have any preliminary indications that Mr. Mtei or the staff might be able to give about the strength of the additional fiscal effort to be required for 1986, especially in view of the recent price and exchange rate measures that had been taken.

As for monetary management, the introduction of a daily auction for treasury bills and the adjustment in interest rates that had already occurred were welcome developments, Mr. Dallara observed. However, the staff report indicated that the authorities were limiting the sale of those bills, with the result that excess liquidity remained in the economy and interest rates had not yet become positive in real terms. He would welcome assurance that those limitations were being or had been eliminated.

On the foreign exchange auction system, which was of great importance, Mr. Dallara asked for confirmation that government transactions were not going through that market although they were being priced at the marginal rate set by the market. While the auction was a significant improvement over the previous system, it might not function smoothly for some period of time since it appeared to be based on the assumption that official sources of foreign exchange equaled official uses of foreign exchange. He doubted whether that could be the case for long, and he thus urged the authorities to move official transactions into the auction system as soon as was feasible. He also stressed the importance of continued implementation of the system without any interference.

In concluding, Mr. Dallara mentioned that the coordinated effort of the World Bank and the Fund in Zambia had been extremely gratifying, the two institutions having provided consistent policy advice to the authorities. Both stood willing to support the Zambian adjustment effort: the Bank had just approved an industrial reorientation loan, and the Fund stood ready to enter into a new stand-by arrangement with Zambia if agreement could be reached on a full package of measures and if Zambia's arrears were cleared. It was unfortunate that both internal and external factors had contributed to the substantial growth in those arrears, and a coordinated effort must be made to settle them and to prevent their recurrence. The task of the Zambian authorities was to implement a strong, structurally sound adjustment program, including an effort on their own part to reduce arrears. Donors also had the task of providing support. His authorities were making an effort to be responsive and would follow closely the discussions between the Fund and Zambian authorities in the period ahead and strongly encouraged other donors to make their best efforts as well. He hoped that it would be possible to move ahead on a comprehensive program in the months to come accompanied by agreement on the outstanding issues.

Mr. Schneider noted that the economic situation of Zambia was undoubtedly one of the most worrying that the Executive Board had faced so far. The continuous deterioration of the economy over the past decade was no longer solely the result of declining export prices and inadequate policies for dealing with those unfavorable trends. The emergence of an acute shortage of foreign exchange had deprived Zambia of the ability to pay even for those imports needed to sustain its domestic production and export industries. The result had been severely depressed growth and additional strains on the already weak current account. In addition, the accumulation of arrears with practically all groups of creditors had made it increasingly difficult to rectify the long-standing balance of payments problem by means of adjustment policies, supported by the additional financial resources from donors and international financial institutions that were urgently required.

The recent introduction of an auction-based exchange rate system and the liberalization of the trade and payments system were certainly important steps in the attack on Zambia's constrained external position, Mr. Schneider went on. Together with the gradual removal of controls on domestic interest rates, those measures might make a significant contribution to a more efficient allocation of the scarce domestic and foreign resources at Zambia's disposal. It was clear however that those measures alone would not suffice: they would have to be embodied in a comprehensive adjustment program to ensure that they generated durable effects. It was also clear that Zambia would continue to need additional financial support from its donors in order to avoid the accumulation of new arrears.

Despite the measures recently taken, Zambia's economy continued to suffer from serious weaknesses on both the supply and the demand sides, Mr. Schneider observed. The weak performance of the large parastatal sector was a serious matter of concern since the sizable transfers and budget subsidies to that sector had placed a heavy burden on the government budget and diverted resources from more competitive industries. Yet the staff report left the impression that no firm measures were being planned to reverse that situation in the near term. Therefore, he would welcome any additional comment on the authorities' intentions in that respect and on possible World Bank action to deal directly with the inefficiencies of the leading industrial sectors.

A firmer fiscal policy stance was also called for, Mr. Schneider continued. On the revenue side, he urged the authorities to give further thought to the staff's proposal to offset the adverse effect of the sharp depreciation of the kwacha on public outlays by appropriate taxation of the mining industry's gains from the depreciation. With respect to public expenditures, it would be necessary to adopt a scheme of priorities for capital outlays, as the staff suggested, and to reduce speedily the widespread system of subsidies. More generally, the repeated slippages from fiscal targets and the lack of transparency of budget operations suggested that a more consistent system of budget control should be put in place if a Fund-supported adjustment program was to be considered in the near future.

As for monetary policy, Mr. Schneider said that he welcomed the recent introduction of a daily auction of treasury bills and the Government's policy intention of liberalizing the structure of interest rates and of subjecting the financing of the budget deficit to market forces. It was a matter of some concern to him that a certain degree of administrative control had been imposed on those auctions in the first weeks in order to keep interest rates from rising too sharply. In the meantime, interest rates had been allowed to reflect more fully the scarcity of financial resources although they remained negative in real terms. The staff had recommended rightly that monetary policy should be tightened and should assume a much greater role in the financial markets. In that context, he wondered whether the mission scheduled for early November planned to have a thorough discussion with the Bank of Zambia of a system of credit ceilings.

With respect to Zambia's external situation, it could not be overlooked that even if strict adjustment policies were adopted, sizable financing gaps would remain in the years ahead, Mr. Schneider noted. Zambia would have to make every possible effort to mobilize financial assistance of the magnitude required from donor countries and the Fund. For 1986, the financing gap was expected to be SDR 266 million, including the rescheduling of current maturities on the one hand and the elimination of arrears to foreign creditors on the other. To ensure that the gap could be filled partly by financial assistance from the Fund, the authorities planned to make a short-term bridging loan from commercial banks in order to eliminate Zambia's overdue obligations to the Fund. If successful, that operation would still leave a gap of more than SDR 100 million that would have to be financed by exceptional assistance from official donors. To obtain that additional support, it was vitally important for the Zambian authorities to demonstrate not only their willingness but their firm intention of adopting and implementing a comprehensive adjustment program. The measures taken in recent weeks would have to be supplemented without delay by additional measures even though it might take some time before a Fund-supported program could be put in place.

In conclusion, Mr. Schneider added that he could conceive of a Fund-supported program only as part of a coordinated approach by the Fund and the Bank aimed at addressing the longer-term, deep-rooted structural weaknesses in the Zambian economy. A joint approach seemed to be working well in Zambia; the positive results obtained in the agricultural sector and in respect of the export of nontraditional goods, together with the policy adjustments outlined in the supplement to the staff report, should convince the Zambian authorities that the reversal of their precarious economic situation was possible and that the outlook was not altogether hopeless.

Mr. Suraisry said that he was in general agreement with the staff analysis of the Zambian economy, which faced serious problems. The severity of the extended period of contraction of the real economy was linked to Zambia's heavy reliance on copper, the price of which had declined sharply in recent years, a problem that was all the more serious given the recent downward revision in the forecast of output. On the financial side, there was the related problem of a precarious liquidity position. Furthermore, even with the introduction of fundamental policy reforms at the present juncture, the prospect was for a large external financing gap over the medium term. Zambia's external arrears to many creditors, including the Fund, had shown a large increase. The arrears to the Fund were particularly regrettable since they impeded efforts to assist the Zambian authorities in the resolution of their difficulties.

However, the authorities had recently adopted courageous measures to deal with their economic and financial problems, Mr. Suraisry went on. In particular, they had agreed to allow the value of the exchange rate to be determined by weekly auction and had concurrently liberalized the trade and payments system; an auction mechanism had been introduced into the market for treasury bills as well; and further progress had been and was to be made toward the removal of subsidies. Those and other measures constituted a major effort to ensure more realistic prices in Zambia.

The implementation of such a package of measures was not an easy undertaking, Mr. Suraisry remarked, and the authorities were to be commended for its adoption. However, Zambia's arrears to the Fund were currently increasing at a rapid rate. If the economy was to gain the full benefits from the reforms, it was imperative that those arrears be discharged, thereby setting the stage for the negotiation of a program that, given the extent of Zambia's financing needs, was crucial. The momentum established by the recent reforms must be sustained. Therefore, he hoped that the Fund staff and the authorities would be able to come to a common view on appropriate policies and measures for 1986, particularly in the monetary and fiscal areas.

Bearing in mind the substantial devaluation of the kwacha, Mr. Suraisry said that he endorsed the staff position that monetary policy should assume a central role and he urged that the stance of monetary policy be one of extreme caution. The kwacha had depreciated in three weeks by about 69 percent in foreign currency terms, or over 200 percent in terms of domestic currency. The lack of reserves at the disposal of the Zambian authorities and the possibility of large private demand for foreign exchange called for great care to ensure that the exchange rate stabilized at a reasonable value.

Any increase in the rate of inflation as a result of the devaluation might add to fiscal pressures, Mr. Suraisry mentioned. On the expenditure side, foreign debt service obligations would increase. Moreover, there might be a tendency for public sector wage and salary demands to be inflated. Finally, it was not clear what the impact of such a large devaluation would be on the budgets of the parastatals. Whatever the prospective magnitude of those various effects--on which he would appreciate some comment by the staff--it was essential to keep expenditures under control.

On the revenue side, there was evidence of a lack of buoyancy, Mr. Suraisry commented. Further tax rate increases were clearly necessary in the short run. A major step had been taken with the passage of enabling legislation permitting an increase in the mineral export tax. However, from a longer-term perspective, heavy reliance on discretionary tax changes--for instance, the several recent increases in the mineral export tax--to generate revenue was of concern. In his judgment, there was a need to broaden the tax base even further, thereby making it more buoyant. Again, he would be interested in the staff's comment.

The issue of diversifying the productive base in Zambia was often raised, Mr. Suraisry noted. He took the occasion to re-emphasize the importance of diversification, and the vital role of the World Bank in that respect. He supported the proposed decisions.

Mr. Rye remarked that although he had nothing particularly new to say, it seemed more than usually helpful in the case of Zambia for the Executive Board to express its view clearly and widely. No one who had heard the Minister of Finance for Zambia make his presentation to the Executive Board at the meeting held in Seoul (EBM/85/153, 10/10/85) could have failed to be impressed by his candid acknowledgment of his country's massive economic problems, his clear-eyed grasp of the realities that those problems imposed, and his evident determination to address them fully.

The Zambian economy had been beset by extreme difficulties stemming largely from a massive sustained deterioration in its external terms of trade, Mr. Rye noted. On the basis of the staff assumption that the price of copper, in SDR terms, would recover at the rate of 4 percent a year--a modest but possibly an optimistic estimate--it was difficult to see any prospect of an upturn. On the contrary, with the foreign exchange constraint impinging on the availability on vital inputs for copper production, the position had become critical. Zambia had of course been making an effort to adjust and, as noted in the staff report, policies had been implemented over the past year or two that were broadly in line with the requirements of Fund-supported programs. But as the staff had also observed, and as the authorities had evidently come to accept, more fundamental adjustment was needed in view of the further deterioration in Zambia's medium-term balance of payments prospects.

A critical step in that long and difficult adjustment process was the shift earlier in October to a market-determined exchange rate based on weekly foreign exchange auctions, Mr. Rye said. The resultant substantial depreciation of the kwacha would be the key to the diversification of the Zambian economy that in his view was absolutely essential to the restoration of any semblance of prosperity. The exchange rate move would, however, need to be supported by action in four other areas.

First, an effective budgeting system would be required to ensure that appropriate amounts of foreign exchange were auctioned or, in other words, to ensure that priority obligations to creditors, including the Fund, were met. In that respect, it would be helpful if the staff could clarify its assumptions relating to the foreign exchange budget and exchange rate that underlay the revised medium-term balance of payments projections in the supplement to the staff report.

The second area in which complementary action would be required concerned the need for the relative price effects of the exchange rate adjustment to be allowed to work through in full into the domestic economy, Mr. Rye stated. The staff comment that "rigidities such as administered prices now present in the domestic pricing system should be rapidly reduced to allow for economic pricing throughout the economy, including the parastatal sector," bore particular emphasis, and it was encouraging that the action the authorities had already taken and the further action they proposed to take were in accord with that judgment.

Third, it would be desirable for import restrictions to be liberalized concurrently with those other measures, again as the staff had suggested, Mr. Rye added. He had noted from Mr. Mtei's statement that the authorities had moved already to liberalize the system but more should be done as circumstances permitted.

Fourth, Zambia would need to maintain firm monetary and fiscal policies, Mr. Rye declared. Anything less would raise a grave risk of the needed relative price changes being undermined by domestic cost and price inflation. The authorities had taken some appropriate fiscal and monetary measures but scope remained for further action, especially as real interest rates were apparently still substantially negative. Meanwhile, slippages in fiscal policy were threatening achievement of the objectives for 1985. The further removal of subsidies seemed necessary, and, in that connection, he would be interested to know what significance the elimination of the subsidy on maize meal had for the fiscal position. Decisive action in the monetary and fiscal fields was all the more urgent since inflationary pressures were clearly on the rise. That the annual rate of increase in the consumer price index had been 44 percent in the six months to June 1985--a rate double that for the 1984 calendar year--was a cause for concern.

All those matters would need to be high on the agenda for the forthcoming staff mission, Mr. Rye considered. He did not wish to be thought of as underestimating the difficulties that would be encountered in implementing a comprehensive program. However, Zambia could not ignore the consequences--some of which were already only too evident--of not adopting such a program. However, substantial assistance from donors, creditors, and multilateral institutions would be needed for some years ahead. It was to be hoped that it would be possible to finalize shortly the remaining elements of a program that could be supported by use of the Fund's resources, and that concurrently--or at least shortly thereafter--

sufficient assistance would be forthcoming from other sources to enable Zambia to clear its arrears to the Fund to make such an arrangement possible.

Looking a little further ahead, the question was whether Zambia might be eligible to use Trust Fund reflows, Mr. Rye remarked. Based on the strict application of the possible criteria that had been mentioned for determining actual access to those resources--a 1983 per capita income below $550 or IDA only, status--Zambia probably would not qualify, being a "blend" country with a 1983 per capita income of $580. However, the deep-seated and structural nature of Zambia's problems, its chronic balance of payments need, and the fall in its per capita income since 1983--particularly if the latest exchange rate adjustment was taken into account--as well as the efforts the authorities were making, provided a good illustration of the need for flexibility in applying any such criteria.

Zambia was one of the countries selected for enhanced Fund/Bank collaboration, Mr. Rye observed. The medium-term structural nature of Zambia's adjustment requirements made that entirely appropriate, and he had been pleased to note that the level of Bank involvement in Zambia in recent years had been increasing. He had found the brief appendix describing World Bank operations in Zambia useful and would be interested in any additional information that might be appropriate; in particular, he would like to know whether the World Bank projects were having their desired effects in opening up possibilities for diversification in the agricultural and manufacturing sectors. He supported the proposed decisions.

Mr. Wijnholds said that there was no doubt that the economic crisis confronting Zambia had major external causes. It was necessary only to note that in 1984, Zambia's terms of trade had been but one fifth of what they had been during the period from 1964 to 1970. The fact that the economic deterioration had been dictated largely by external events offered little consolation. The truth was that Zambia would have to adjust to reality. For a number of years, donors and external creditors had been willing to share with the authorities the hope that that shift in the terms of trade would be temporary and short lived. Such optimism had not proved warranted. The need for comprehensive adjustment was therefore inevitable and had to be met immediately before the situation became unmanageable.

Zambia had every right to seek assistance from those who had extended the credit that had reached such high levels in relation to its exports and national income, Mr. Wijnholds continued. However, that assistance should be the result of a cooperative effort, which should recognize the particular circumstances of different creditors. In the case of the Fund, which had become Zambia's single largest creditor, with claims equal to almost 25 percent of its GDP, those circumstances implied that new credit could be extended only upon the settlement of arrears and the adoption of the fundamental policy measures that gave the best chance of setting Zambia on the road to sustainable adjustment.

The task would not be easy, Mr. Wijnholds remarked, although it might be recalled that Zambia had faced low copper prices in the past, especially during the mid-1950s when real GDP had declined by one third in the space of only three years. Although that setback had not been overcome until the mid-1960s, it had been achieved basically on the back of a long upward trend in copper prices. The long downward swing in the terms of trade that had begun at the end of the 1960s had not resulted in a severe decline in GDP but in a serious enough stagnation, with per capita output having fallen to a level not much above that prevailing three decades previously. Over the intervening period, other sectors of the economy had been relatively neglected; understandably, the task of rebuilding them into dependable pillars of the Zambian economy would also take many years. Nevertheless, it was essential that the task be undertaken immediately, in order to reinforce the measures already implemented over the past couple of years. Otherwise, the cooperative effort required to avoid imminent disaster simply would not materialize.

Recent measures, in particular those relating to the exchange system, as well as the clear statement of the Minister of Finance of Zambia before the Executive Board in Seoul, provided evidence that that view was shared by the authorities, Mr. Wijnholds remarked. It should thus be possible for the authorities to explain the situation to the public and muster the political support to implement the required follow-up measures.

With respect to the new exchange system, the auctions would have to be allowed to operate freely, Mr. Wijnholds emphasized. The unfortunate efforts witnessed in other countries to influence such auctions had undermined the intended effects. It was also essential to allow the effects of exchange rate changes to pass through to domestic prices. However, it had to be recognized that that course was not without risks; care should be taken that it did not land Zambia in a vicious circle of inflation and depreciation. To avoid that pitfall, it was imperative that immediate steps be taken to gear monetary and fiscal policy to the containment of the inflationary impulse emanating from the exchange rate depreciation.

As far as monetary policy was concerned, free operation of the newly instituted market for treasury bills was an essential counterpart of the exchange auction system. Although initially high real interest rates could be expected to result, the fiscal burden of those rates should not be a reason to shy away from such an approach. As for fiscal policy, he fully shared the staff assessment of the measures needed to reduce fiscal imbalances and enhance economic pricing. He was glad that the authorities had overcome their hesitations with respect to taxing windfall profits in the mining sector.

He had outlined the main macroeconomic policy issues for the short run, Mr. Wijnholds commented. While they would be essential they would only provide the setting for the needed real adjustments in the economic structure of Zambia. Therefore, he welcomed the intensified collaboration between the World Bank and Zambia because it could serve to develop and implement plans to achieve those adjustments. The industrial reorientation project approved by the Executive Directors of the World Bank recently deserved special mention, as it was the result of "enhanced collaboration" between the Bank and Fund in Africa. He wondered to which other countries such enhanced collaboration applied. The Zambian project had been "closely interfaced" with the introduction of the exchange auction and other measures, according to the staff report, but he would appreciate some explanation of the precise meaning of that computer language.

As he had already mentioned, Zambia would need to receive a full measure of assistance from its creditors--both official and commercial--in providing the necessary debt relief to enable it to cope with its present extremely serious situation, Mr. Wijnholds remarked. In that connection, it should not go unnoticed that the December 1984 rescheduling agreement with the banks had carried a margin above the London interbank offered rate (LIBOR) of no less than 2 1/4 percent. Obviously, domestic adjustment would be a key factor in determining the position of official creditors and donors. However, the arrears incurred after the most recent agreement with the Paris Club were a complicating factor; he hoped that that issue could be resolved as soon as possible.

Mr. Finaish observed that Zambia's economic performance had deteriorated considerably over the past decade owing in large part to a sharp decline in external terms of trade caused by a steep decline in the prices of copper exports and a steady rise in the cost of imports. The adverse impact on the Zambian economy had been substantial in view of the dominant role of copper in exports and the heavy dependence of domestic economic activity on imported inputs. The magnitude and duration of the fall in the price of copper had been underestimated initially and, coupled with the desire to contain the decline in economic activity, had led to the pursuit of relatively expansionary financial policies. As a result, along with the decline in real per capita GDP that Zambia had experienced, inflation had accelerated and the pressure upon the external payments position had increased greatly, leading to an unmanageable debt service burden and the accumulation of substantial external arrears.

The magnitude of Zambia's imbalances and the difficult medium-term outlook indicated that the economic adjustment undertaken earlier had proved inadequate, Mr. Finaish continued. The nature and the acuteness of existing economic difficulties pointed to the need to strengthening and sustaining the ongoing economic adjustment efforts, preferably within the context of a comprehensive economic recovery program, with particular emphasis on structural reforms to promote export diversification and import substitution on the basis of the efficient allocation of resources. However, the immediate task of economic adjustment and the focus of donors' support should be upon alleviating the severe shortage of foreign exchange which had already affected the expansion of output in the mining and manufacturing sectors, and even the marketing of agricultural output. The increasing difficulties faced by Zambia in securing inputs and spare parts, if it continued, threatened to paralyze domestic resource mobilization and economic adjustment efforts.

Under the pressure of adverse economic circumstances, Zambia had initiated recently a policy shift toward a market-oriented economic strategy, Mr. Finaish noted. That shift might prove useful over the longer run but its immediate impact could involve transitional costs in terms of production and income distribution that could be reduced if appropriate adjustment policies were chosen. In conformity with the new strategy, major changes had already taken place in the exchange and payments systems. The recent adoption of a market-oriented exchange rate system was a step in the right direction toward balancing the demand for and supply of foreign exchange. However, the staff might wish to comment on the practical viability of the auction system to determine the exchange rate, particularly in light of the question whether adequate amounts of foreign exchange would be left for auctioning after administratively determined requirements for foreign exchange had been met.

Zambia's external payments position and medium-term prospects were cause for concern, Mr. Finaish considered. Thus, recent changes in the exchange and payments systems needed to be supplemented with appropriate pricing policies and adequate demand restraint to promote domestic production and contain the external financing gap. Important action had been taken along those lines, and further steps were planned as indicated in Mr. Mtei's statement. However, for the adjustment effort to be successful and sustainable, it needed to be supported by the necessary debt relief and donor support. Finally, it should be remembered that despite its present difficulties, Zambia had considerable economic potential that was awaiting effective utilization.

Mr. Grosche remarked that the staff report made it very clear that Zambia's economy was at a most critical stage. While a large part of the country's difficulties could be traced to adverse exogenous factors, it had to be acknowledged that the severe and deep-seated problems had been aggravated by inadequate and unsustained adjustment efforts, as evidenced by the interruption of a number of arrangements with the Fund. It was disappointing to note that the previous year's stand-by arrangement had become inoperative after only a few months. Despite some measures of adjustment taken under that arrangement, the effort had again fallen short of what was required.

It was most unfortunate that only limited progress had been made so far in getting a hold on the grave and deep-rooted structural problems of the economy, Mr. Grosche said. Zambia continued to rely heavily on a single commodity which was affected by a protracted, declining price trend. Facing a continuing rapid deterioration of its economic situation since the beginning of 1985 and an increasingly precarious external position, Zambia clearly needed urgently to make a radical change in its domestic and external policies to prevent a further downward spiral of the economy. He was glad to note that the authorities had recognized that need and that they had decided to undertake a number of radical policy changes that were long overdue. It had become evident that Zambia's experiment in running a controlled economy had failed.

The latest action taken in respect of exchange rates, import licensing, prices, interest rates, and taxes were greatly welcome, Mr. Grosche added. Nevertheless, as other Directors had pointed out, the measures taken so far could only be the first step in working out a comprehensive macroeconomic adjustment package. There was considerable scope for further action. Therefore, he attached great importance to the forthcoming staff mission which intended to assist the authorities in the formulation of a comprehensive package of fiscal and monetary policies. He hoped sincerely that the measures taken so far, and the firm determination of the authorities to implement a full range of policy changes, would pave the way for the necessary support of donors and creditors that was badly needed to finance the large balance of payments gap and to settle Zambia's external arrears.

Adjustment in Zambia's case necessitated not only appropriate demand-management policies but above all profound structural changes, Mr. Grosche stated. A lasting improvement of the economic situation could be brought about only by a determined effort to restructure the country's productive base away from overdependence on copper. The World Bank was taking an important part in that effort, and the close collaboration between the Fund and the Bank would be instrumental in ensuring that the policy recommendations of the two institutions would be consistent and mutually supportive. He had been particularly pleased by the recent approval by the Executive Directors of the World Bank of a $75 million loan for the reorientation of the industrial sector. Zambia was among the most industrialized countries in sub-Saharan Africa, and the chances for diversifying its economic base were not bad, once the shortage of imported inputs and spare parts had been overcome and remaining price controls lifted.

In addition, measures to strengthen the agricultural sector should play a major role in the restructuring effort, Mr. Grosche considered. While he had noted from the staff report that the authorities had already undertaken some welcome steps, it remained questionable whether the price increases introduced so far were adequate to provide sufficient incentives for the production of export crops and for import substitution. More also had to be done to increase the acreage used for farming. He had been astonished to read in the Economist of October 19, 1985 that only 20 percent of existing farmland was cultivated. He wondered whether the staff or the staff representative from the World Bank could comment on that figure. In conclusion, he supported the proposed decision.

Mr. Salehkhou observed that the continued deterioration in Zambia's economic and financial position over the past decade had reached alarming proportions in 1984 and 1985 despite a succession of Fund-supported adjustment programs. Notwithstanding a strong recovery in the agricultural sector, which had only partly been due to improved weather conditions, Zambia had recorded a contraction of real GDP for the third consecutive year in 1984 with no prospects for a better performance in 1985. Fiscal and external imbalances had been increasing since 1983, although they remained below the record levels of 1982. More important, the country's extremely difficult liquidity position had worsened in the past two years, with a virtual depletion of international reserves and a substantial accumulation of arrears on foreign debt, including obligations to the Fund and previously rescheduled official and commercial debt.

Such a poor performance could be attributed to a large extent to the impact of the unfavorable international environment and to the sharp decline in Zambia's terms of trade, Mr. Salehkhou continued. However, the deterioration was obviously also indicative of the fact that Zambia's economic and financial policies, and the long period of cooperation with the Fund and the World Bank, had not significantly altered or corrected the major structural weaknesses of the economy, particularly with respect to the excessive dependence of the balance of payments on mineral exports, the heavy burden of external debt, and the reliance of the manufacturing sector on imported inputs. Major progress had taken place in a number of areas, with a significant improvement in the competitiveness of local industries and a record agricultural performance in 1984. However, even that progress seemed to have been undermined by the tight liquidity situation of the economy as the shortage of imported inputs and spare parts had adversely affected the operations and development of local industries, as well as the transportation and storage of the harvest.

He had noted in the staff report that the authorities largely concurred with the staff views with respect to the structural imbalances of the Zambian economy and the nature of the required reforms and policies, Mr. Salehkhou said. In fact, many of those reforms had been implemented since the staff report had been issued, underlying the authorities' determination to tackle their current difficulties. The elements and the objectives of the new adjustment program initiated earlier in October seemed to have been analyzed adequately in the staff report and its supplement as well as by Mr. Mtei; he would therefore limit his comments to a few specific points.

First, given the scope of the adjustment measures undertaken since the staff report had been circulated, it would have been helpful to receive information on the specific measures and to have the staff assessment at least a few days in advance of the Executive Board meeting to allow for their proper evaluation, Mr. Salehkhou remarked.

Second, while the effects of the recently implemented drastic measures on inflation, government expenditure, external debt, and imports would be immediate, it should be recognized that their positive impact on exports and on government revenue would be felt only in the much longer term, Mr. Salehkhou stated. That was particularly true of the reform of the exchange rate aimed at determining the value of the kwacha through periodic auctions of foreign exchange. In that respect, some caution in the formulation of other policies was obviously in order to cushion some of the negative effects of the major devaluation that resulted from the auction system, especially with respect to trade and public finances.

Trade liberalization, which was expected to complement the new exchange rate policy, should allow for some gradualism in order to take into account the tight liquidity position of the economy and the need for imported inputs, spare parts, and equipment for the rehabilitation of the productive base, Mr. Salehkhou added. Unless limitations were imposed, at least in the early stages of liberalization, on the importation of luxury and nonessential products, more efficient use of the scarce foreign exchange resources available to Zambia would not be secured. On the other hand, in reducing the scope of Zambia's system for protecting industry, it would be essential to allow sufficient time for local producers to recover from the current recession and adjust to the recent sweeping reforms.

As for public finances, further significant savings and revenue-enhancing measures were required to counter the impact of the recent depreciation of the kwacha, Mr. Salehkhou said. The measures announced with respect to employment in the civil service, to wage restraint, and to budgetary subsidies and transfers would contain the projected fiscal deficit. While those measures would have to be supplemented by increased taxation to avoid or limit possible cuts in capital expenditures, it was appropriate that the additional taxes should take into account the need for adequate cash flow in the mining sector. At the same time, the staff concern with respect to excessively high tariffs should not apply to customs or excise duties on luxury goods.

The third specific point that he wished to emphasize, Mr. Salehkhou stated, was that in light of Zambia's considerable agricultural potential and the need to move decisively toward a diversification of production and exports, it was appropriate for monetary policy, in addition to contributing to overall demand management, to be geared also toward the development of the agricultural sector, even if that entailed temporary recourse to subsidies.

Finally, Mr. Salehkhou observed, it was obvious that the success of Zambia's new policies in the short and medium term would be related directly to its ability to improve the supply situation, to attract additional foreign resources at concessional terms, and to receive adequate and realistic debt relief from its creditors, including the Fund. Recent developments clearly underlined Zambia's willingness to cooperate with creditors in seeking a durable solution to its acute liquidity problem and its evident inability to face current debt obligations. In that respect, he reiterated his chair's support for Mr. Kafka's proposal at the meeting of the Executive Board held in Seoul, which, in line with

Article V, Sections 7(g) and 8(e), would enable Zambia to settle its obligations to the Fund in its national currency. Such relief, and Fund support in general, were justified by Zambia's extremely difficult situation and its record of cooperation with the Fund. As Mr. Mtei had emphasized, it would also encourage other creditors and donors to unlock financial assistance to Zambia. Finally, he supported the proposed decision.

Mr. Jayawardena said that he was greatly impressed by the substantial adjustment measures being undertaken in Zambia. The deterioration in the terms of trade of about 70 percent since the 1970s was massive by any standard. The near total dependence of the economy on copper, the prospects for which had dwindled dramatically, made the prospect of a copper-based recovery unthinkable. The sluggish agricultural growth, presumably due to the long-standing drought to which Mr. Mtei had referred, had rendered the situation almost impossible. Hence, Zambia had had no option but to adjust, however harsh the adjustment had become, because the necessary measures had been deferred for so long.

The crucial issue was to make the adjustment process not only effective but also bearable and sustainable, given the low income levels in the country, Mr. Jayawardena added. It was his strong belief that the support of the international community was crucial to the success of Zambia's adjustment process. Clearly, the courageous adjustment measures being taken deserved such support. He also hoped that Zambia would soon become eligible for Fund support. He urged the authorities to persevere, and to be particularly mindful of supply-side responses that could greatly ameliorate the harshness of adjustment, contain inflationary pressures, and lay the foundation for a more viable, diversified economy in the future. He supported the proposed decision.

The staff representative from the African Department explained that the lateness with which the supplement to the staff report had been issued was due in part to concern about ensuring that accurate, detailed information was provided to the Executive Board.

The foreign exchange auction system had been designed to follow closely the advice given by the staff to the Zambian authorities, the staff representative noted. Its viability would depend of course upon the availability of foreign exchange. Given Zambia's present external payments position and its critical foreign exchange situation for the few months ahead, the authorities had agreed to make a commitment to allocate a minimum amount of about $2-3 million per week to the auction system on a regular basis. Allocations of foreign exchange to the Government and other agencies that were not required to participate in the system would not be allowed to affect that commitment. The projected stringency in the flow of foreign exchange resources into Zambia meant that the authorities would have serious problems in finding the necessary amount of foreign exchange. Thus, the recent loan approved by the World Bank was critical; the proceeds of the loan were expected to be channeled through the auction system, permitting those sectors of the economy that were particularly starved of foreign exchange—mainly the industrial sector--to have access to the resources stemming from that loan by making regular bids. Although precise data on the outcome of the first three auctions was not available, the initial demand for foreign exchange by the agricultural sector had been rather limited, possibly because of unfamiliarity with the type of system.

Likewise, the decision of the Zambian authorities to exclude foreign exchange transactions by the Government and various agencies from the auction system had been based on their need for assurance that certain essential transactions would be fully provided for, the staff representative explained. For instance, essential imports such as medical supplies and textbooks had been excluded, at least in the initial stages. Debt service payments were also not included in the auction system. The Zambia Consolidated Copper Mines (ZCCM) had not been required to carry out its foreign exchange transactions through the auction system in the interests of stabilizing the market. If the ZCCM were allowed to participate in the auction, it would be able to surrender its foreign exchange earnings to the central bank in exchange for counterpart funds in domestic currency; then it would be able to bid for foreign exchange and crowd out other bidders. A certain degree of compromise had been built into the design of the system in the hope that the merits of a market-determined system would in due course allay any apprehensions that the authorities might feel about the new system.

In determining the minimum amount of resources that the authorities should commit to the auction system on a regular basis, projections had had to be made of export earnings and of import payments, the staff representative added. The authorities had recognized the need for effective foreign exchange budgeting on a systematic basis, and for that purpose they had requested technical assistance from the World Bank. At the same time, the Central Banking Department had identified an expert to assist the authorities in that area. Meanwhile, a Fund expert was serving in an advisory capacity to the auction committee, one of his functions being to ensure that the system was operated in a technically efficient way.

Several factors would have an influence on the movement of the exchange rate for the kwacha, the staff representative said. The rapid initial depreciation from K 2.2011 per $1 to K 7.0 per $1 during the first three auctions was not unexpected, considering that the rate prevailing on the parallel market before the introduction of the auction system had been close to K 8 per $1. In a sense, it was somewhat surprising that the rate that had emerged initially had been closer to K 5 than to K 7 or to K 8. It was possible that the rate was stabilizing at about K 7, based on indications that the spread of the bids made by participants was narrowing considerably, even based on the present policy mix and before revised fiscal and monetary policies were put in place. As a matter of fact, the introduction in September of the daily auction for treasury bills, in advance of the introduction of the foreign exchange auction system, had been influencing the exchange rate and would continue to do so.

The reservation expressed in the staff report with respect to the performance of the treasury bill market had been based on an apparent initial reluctance on the part of the authorities to accept quick changes in the interest rate structure after having followed a policy of vigorously controlling interest rates, which had been varied only occasionally, the staff representative stated. However, over the past few weeks, the treasury bill market system had begun to work well. Once the authorities had familiarized themselves with the system, many of the initial technical difficulties that might have impeded its functioning should be surmounted.

As for the cohesiveness of various measures introduced by the authorities, the staff representative reiterated that the treasury bill market had a potentially important role to play in putting in place a tight monetary policy because it would enable the authorities to exert effective leverage on the growth of the reserve base. As a result, the authorities could aim at a specific well-defined monetary growth target that would be consistent with the fiscal program to be devised. Similarly, adjustments in producer prices were essential, and a relatively large adjustment in consumer prices for maize had also been called for, in light of the exchange rate and interest rate changes. Otherwise, the administrative and marketing costs of the millers and the cooperatives, respectively, would have led to a large increase in the economic subsidy, which would have become an effective fiscal subsidy.

The authorities had also agreed to introduce certain tax measures, the most important one being the tax on mineral exports, the staff representative noted. A minimum tax of 10 percent had been imposed on imports that were presently exempt from import tax. Those measures, together with a commitment to change a number of taxes from a specific to an ad valorem base, had the potential of making the tax regime more buoyant; in the past, the domestic tax system had not been very buoyant. It had been impossible to determine the impact in terms of the revenue yield until the exchange rate effects of the introduction of the foreign exchange auction system had become known. Therefore, as a practical matter, it had been necessary first to establish the framework for the effort to mobilize fiscal revenue.

As Mr. Mtei had stated, the Zambian authorities had recently announced a wage increase for civil servants in order to retain highly trained and skilled personnel, the staff representative said. As mentioned in the staff report, the wages of lower paid civil servants had also been increased before the comprehensive fiscal program had been drawn up. Although the staff had no precise indications of the latest wage increase, it would apparently amount in total to about K 140 million over a 15-month period, representing an increase of about 25 percent of the base amount of K 460 million for personnel emoluments in the 1985 budget. Those estimates had to be adjusted to allow for the potential inflation rate for 1986, which might reach 50 percent, based on preliminary calculations, when account was taken of the full pass-through of the effects of the exchange rate depreciation. The administered prices for maize and fertilizers were also to be adjusted. The increase in the price of petroleum products was of the order of 150 percent in relation to the prices prevailing prior to the inception of the foreign exchange auction system, and other prices were expected to be adjusted quickly, especially in the parastatal sector, which had had much more freedom since 1984 to set prices under the new policy of price decontrol. As a matter of fact, economic pricing was being practiced in all sectors of the economy.

Taken together, those measures constituted the framework within which revenue and expenditure in the 1986 budget had to be forecast, the staff representative stated. However, among the variables to be taken into account, the impact of the interest rate on debt service would be of particular importance. Interest rates were expected to continue to move, especially if monetary growth was to be reined in, so that debt service payments in local currency terms would be increased significantly. The other side of the coin was that simulations of the possible impact of the exchange rate adjustment showed that the higher the depreciation, the greater the positive net impact on the budget, provided that the necessary change in the tax base was brought about. As for the effect of the exchange rate adjustment on the maize subsidy, much would depend upon whether or not the producer price increase to be announced preserved the real value of that price in foreign currency terms in order to bring it close to the import parity price. Much would also depend on the size of the consumer price increases for maize. Therefore, while it might be slightly misleading to attempt to calculate the precise subsidy at the present stage, on the extreme assumption of no adjustment in consumer prices and of a full pass-through of the exchange rate effect to producers, the subsidy bill could become almost three times the amount budgeted for 1985.

Studies on the parastatal sector had been conducted by the World Bank, which had distinguished three categories of parastatals: those that were considered no longer viable, those that were considered marginally viable, and those that were definitely unprofitable, the staff representative said. In principle, the parastatals had been run on a commercial basis for some time, and had been given considerable freedom to determine their pricing policies--which had nevertheless been constrained by a measure of administrative interference--and their investment policies. If economic efficiency was to rule the day, parastatals that were not viable might have difficulty surviving. In consultation with the World Bank, the authorities were developing an effective investment budget for the parastatal sector, under the umbrella of INDECO, and the staff expected that a rolling three-year investment plan would soon be put in place as a guide to future investment activities. The parastatals themselves, in anticipation of having to compete in a market system, had begun already to seek technical managerial support for selected enterprises, a strategy that should be extended to make it possible for them to look for increased foreign equity participation in the parastatal sector. In that way, additional capital could be obtained. As for the mining sector, notwithstanding the gloomy prospects that had been mentioned during the discussion, the World Bank had been assisting Zambia by extending a loan with cofinancing from the African Development Bank, designed to rehabilitate some mining operations. The staff hoped that that project would help to maintain output at the levels projected in the medium-term scenarios.

The objective for fiscal policy for 1986 would be to devise a budget that was sufficiently restrictive to limit the borrowing requirement of the Central Government and keep monetary growth within a low target range in order to ensure that the exchange rate remained stable, the staff representative indicated. Elements of that policy were the reduction of subsidies; an adequate wage policy; an appropriate capital expenditure program; and the reform of the civil service, including its scaling down, to reduce expenditure on personnel emoluments. Firm targets would be set within a well-defined timetable to ensure that they were met and that overall targets consistent with the balance of payments objectives and stability of the exchange rate were also observed. The treasury bill market would be a crucial complement to fiscal policy because it introduced a measure of cooperation between the use of the instruments of the central bank of Zambia and the Government's budget. Interest rates should be allowed to move in response to the open market operations, and the authorities should not allow the interest cost to the budget to prevent the interest rate from reaching rates that would be close to positive in real terms and that would help pre-empt speculative demand for foreign exchange. If the authorities were able to use the sale of treasury bills to influence effectively the reserve base of the commercial banks and to achieve the target rates of monetary growth that would be imposed, it would become easier to use both direct and indirect methods of remaining within whatever credit ceilings were established.

During its forthcoming visit to Zambia, the staff expected to be able to pull together all those various elements into a comprehensive package of measures that would be mutually consistent and form a monetary and fiscal program worthy of support by the international community, the staff representative from the African Department noted. Such a program would provide an opportunity to monitor developments in various sectors of the Zambian economy, enabling Zambia to tackle the problems facing it more effectively.

The staff representative from the Exchange and Trade Relations Department said that the central issue with respect to the foreign exchange auction system was the adequacy of the supply of exchange. While a major movement in the exchange rate had been expected in the initial stages, the staff was also concerned that the rate should stabilize in future, not so much in terms of the rate itself as in terms of a slower movement in the rate. The minimum amount of $2-3 million in foreign exchange to be made available for the auction each week would come from Zambia's own foreign exchange resources. It was absolutely essential for that supply of foreign exchange to be augmented, mainly from additional external support, including loans from the World Bank. The rate of utilization of the agricultural credit loan from the World Bank would have to be examined carefully--first, to determine whether or not the agricultural sector was geared institutionally to mesh with the auction system, and second, to verify that a potentially effective source of supply of foreign exchange to the auction market would effectively materialize. He recalled that it had been necessary to put certain institutional arrangements in place in another country where an auction system had been introduced--Uganda--for the purpose of streamlining the rate of utilization of a World Bank loan. The Fund expert who was at present in Lusaka in order to assist the authorities in the operation of the exchange market had been involved in operating the system in Uganda.

A major reason for the authorities' recourse to a tax on mineral exports had its origin in the freedom of the mining sector to retain a certain proportion of its gross export earnings to finance its own foreign exchange requirements, the staff representative explained. The balance of the sector's foreign exchange earnings was thus readily available for encashment at the auction rate, and the consequent considerable increase in kwacha cash flow would be at the mining sector's disposition for financing domestic operations, including wages and investment. One concern of the authorities in that context was that if the mining company were to show large profits, pressure from the trade unions, which were strong in the mining sector, would result in increased wages.

In regard to a system of credit ceilings referred to by Mr. Schneider, the staff representative observed that the staff did indeed intend to discuss in quantitative terms a broad macroeconomic program for 1986 to make it possible for rapid progress toward adjustment to be made when Zambia's arrears to the Fund were settled.

In response to Mr. Wijnholds, the staff representative from the Exchange and Trade Relations Department said that eight countries had been selected by the World Bank for enhanced collaboration between the World Bank and the Fund. Those countries were: Dominican Republic, Ghana, Peru, Philippines, Senegal, Sri Lanka, Sudan, and Zambia.

The staff representative from the African Department, in response to a question by the Chairman about the availability of sufficient foreign exchange to operate the auction system, said that an attempt had been made to devise a foreign exchange budget under which foreign exchange allocations to meet certain requirements of the Government and other sectors would not in principle crowd out other transactions, to the extent possible, by providing a given amount of resources for general imports. The central bank would provide between $2-3 million from its own resources to the auction system, to be supplemented by aid targeted to certain sectors--namely, the industrial sector. The agricultural loan from the World Bank had in a sense been used to establish a source for financing the demand for imported inputs and other private sector imports. The staff had attempted in its projections to take into account the level of imports that would need to be financed through the auction system, plus the level of imports to be financed through project assistance, which would be financed by foreign resources in any event. By establishing that additional channel through which foreign exchange receipts from aid would be made available for imports, over and above the $2-3 million to be provided by the central bank, allocations of foreign exchange to the sectors that were exempt from participating in the auction system would at the same time be squeezed. Nevertheless, the administrative allocation of a certain amount of foreign exchange to meet the requirements of what might be called preferred sectors did create a certain rigidity within the system that would have to be dealt with in due course.

The staff representative from the Exchange and Trade Relations Department added that a measure of control was called for insofar as the foreign exchange transactions of the public sector were concerned. The operation would be a difficult one, but its underlying assumption was that the cash flow would be so managed that the foreign exchange available for auction--after whatever foreign exchange was made available by administrative allocation from aid flows for certain specified sectors--would be a minimum of $2-3 million, which implied that the foreign exchange used by those specified sectors would have to be managed on a week-to-week basis in such a way as to produce that result.

In response to a question by the Chairman, the staff representative from the Exchange and Trade Relations Department said that there might be occasions, on a week-to-week basis, when the Government was not able to make all the necessary payments, but the underlying assumption was that over the year as a whole, the demand and supply for foreign exchange would be in balance. With the support of external assistance, the pressures on the foreign exchange budget should not be acute.

Mr. Lankester reiterated his remarks about the critical importance of ensuring that the auction system did not fail, particularly in its early stages. He had drawn attention to the problems with respect to the rate at which the agricultural credit from the World Bank could be used as source of foreign exchange. As he understood it, similar problems might arise with respect to the industrial reorientation credit because it would be usable for only limited items. He asked whether the staff was concerned that restrictions on the use of that industrial credit would in any way undermine the success of the auctions.

The staff representative from the Exchange and Trade Relations Department responded that it would not be safe to claim that the system was without inherent tensions, given the severe shortage of foreign exchange. It had been programmed that the Bank of Zambia would provide a limited amount of $2-3 million from its own resources in the hope that external support would make available a larger supply of foreign exchange from other sources. The rate of utilization of such additional resources, especially if they were linked to specific imports or for use by specific sectors, could clearly pose a problem. As he had mentioned, similar problems had been experienced by Uganda when it had introduced an auction system. Uganda had put in place a system to streamline the rate of use of resources emanating from a World Bank loan. Such a scheme would no doubt be a central point in the discussion between the Fund staff and the authorities during the forthcoming mission, as well as with the World Bank staff. The system was based upon certain assumptions and it would have to be adapted to ensure sufficient resources were available to contain the rate of depreciation of the kwacha.

Ms. Lundsager asked how Zambia was going to be able to settle its arrears to the Fund, if the resources to be made available from the World Bank loan and from cofinancing were to be used to operate the foreign exchange auction system.

The staff representative from the African Department said that the cash flow problem had two aspects. First, there was the question of whether the resource gap over the year as a whole would be filled and if so, how the disbursement of the additional balance of payments support would be timed; thus, if the extra financial assistance was forthcoming, it would be a matter of cash flow management. The second aspect concerned the short-run viability of the system. In that connection, the system had been introduced, upon advice from the staff, with a view to ensuring that a certain amount of reserves were accumulated--at least for the first six weeks--so that the system could be funded until disbursements of foreign resources were received, in particular, from the World Bank. In determining the volume of resources that should be auctioned on a weekly basis, the authorities had had two options. First, the amount auctioned during each of the first three weeks could have been limited to $2.5-3 million, to be made available entirely from Zambia's own foreign exchange resources. The second option had been to provide sufficient foreign exchange to ensure that the auction system acquired the necessary degree of credibility to sustain the system in its initial phases. Thus, the authorities had used their own resources to fund the system during the first three to four weeks and might continue to do so during the four weeks ahead, in the expectation that additional resources would be released in subsequent auctions--once the industrial reorientation credit from the World Bank had been approved--to keep the system going. However, consideration also had to be given to resolving the problem of how to finance the longer-term balance of payments gap. Therefore, it was possible that the authorities might be forced to reduce the resources available for auction, if additional support was not forthcoming, with a consequent impact on the exchange rate itself. The issue was twofold: that of the viability of the auction system in terms of the zone of stability of the exchange rate and that of the stability of the volume of quasi-permanent resources available for auction. Both issues gave rise to concern, but to the extent that additional foreign assistance became available, the issue of the short-term stability of the system, plus the longer-term financeability of the balance of payments, could be addressed.

In response to a question by Mr. Lankester, the staff representative from the African Department said that the Zambian authorities had so far sold approximately $15 million in the three auctions, from their own resources, with the exception of $500,000 from the agricultural sector credit.

The staff representative from the World Bank noted that the Executive Directors of the World Bank had approved the industrial reorientation credit on October 22, and it should be possible to declare the credit effective as of that day, October 30. Disbursements would be made forthwith from the revolving fund in which payments under credits from the Special Facility for Sub-Saharan Africa and IDA were also made. The industrial reorientation credit was the third of the three major policy packages on which the World Bank had been working, the other two being the agricultural rehabilitation credit and the export diversification loan, which was more popularly known as the mining loan. The latter loan was for $75 million; the first tranche of $40 million was expected to have been fully committed by the end of 1985; a staff mission would visit Zambia in December to explore the conditions for the release of the second tranche. The loan was to finance mining inputs and supplies, which were beginning to be delivered. There was unavoidably a long delay in dealing with the mining sector because much of its equipment was designed specifically for the company ordering it. Thus, the production impact of the operation could not yet be assessed. However, the staff had seen the results of 13 studies financed under the loan and carried out by ZCCM and consultants with the specific aim of finding ways to make the operations of the company more cost-effective. Those studies were currently being considered in Zambia and the World Bank was expecting a visit during the first week of November from the chairman of ZCCM and one of his principal staff members to discuss the results. He understood that quite dramatic recommendations were being made as a result of those studies--for instance, to cut staffing, to close down uneconomic operations, and to achieve an overall increase in profitability.

The conditions for the agricultural credit had all been met and the funds had been released, the staff representative added. Unlike the mining loan, both the industrial reorientation and the agricultural credits would be disbursed through the foreign exchange auction system. Disbursements up to a limit of $3 million a month and $8 million a month could be made under the agricultural and the industrial credits, respectively, for a total of $11 million if the available amounts were fully drawn in any particular month. Thus, in combination with the Government's own resources, about $20-22 million would be available on a monthly basis to the foreign exchange system; on a yearly basis, that was approximately the amount that the staff of the Fund and of the World Bank had determined jointly would be available and be necessary for the economy to show some growth. In particular, it was the amount considered necessary for the reforms being undertaken in the agricultural and industrial sectors to take hold. Again, while the actual production response had not yet been felt, the combination of good weather in 1985 and the agricultural pricing reform had resulted in a bumper harvest. However, figures were not yet available on the size of the crop and it would also be necessary to determine to what extent the policy reforms that had been undertaken recently might have led to high output in the agricultural sector.

The serious liquidity problem in Zambia at the present time was a result of two factors, the staff representative from the World Bank remarked. First, ZCCM production had been less than expected, and revenue from copper sales had thus been lower. In addition, sales of copper tended to be lower in July and August when many plants in Europe were closed for retooling or for vacation. That resulted in reduced copper receipts in September and October. The shortage of foreign exchange threatened to jeopardize the Government's ability to provide the funds that it was committed to make available for the foreign exchange auction. In an effort to deal with that problem, the World Bank was examining the possibility of making retroactive payments for items that should have been but had not been made at the time of the first two auctions because the loan had not come on stream in time. In that way, the Government could be reimbursed for funds which it had paid out of its limited foreign exchange resources.

A precise breakdown of the results of the first foreign exchange auction was not available, the staff representative from the World Bank said. However, observers in Zambia had indicated that about 30 percent of the successful bids had been made to pay for intermediate goods and 32 percent for machinery and equipment, suggesting that almost two thirds of the successful bids had been made by participants in the industrial and agricultural sectors. Therefore, it would probably be possible to use the full amount of the industrial reorientation credit for the period covered by those auctions to reimburse successful bids. With respect to the agricultural sector, eligible items in the first auction had accounted for only about $100,000 and $400,000, respectively; no figures were available yet for the third auction. Whether or not those figures represented a trend that would soon reach the levels expected by the staff was a matter that would be taken up shortly by a World Bank mission, in cooperation with the Fund staff mission. It should be noted that because the price of maize was still controlled and because a large share of agricultural output was in maize, there was some suggestion that people were unwilling to bid on agricultural inputs without some assurance that the price at which they would sell the output would be sufficient to enable them to recover their costs fully, plus a margin. Some of the donor countries had been contacted to see whether they might be in a position to help the Zambian authorities deal with the temporary or more cyclical aspect of the liquidity crisis.

In response to a question by the Chairman, the staff representative from the World Bank confirmed that the mining loan would be used directly by the mining sector for a specific list of goods associated with the rehabilitation of the mining companies. The proceeds would not go through the foreign exchange auction system.

Mr. Mtei said that he had noted Executive Directors' commendation of the Zambian authorities' new auction system for foreign exchange. As he had mentioned in his opening statement, the decision to introduce that new system represented a bold move demonstrating the desire of the authorities to find durable solutions to their current economic problems. However, he reiterated that the smooth functioning of the system would depend critically on the steady supply of foreign exchange. The virtual exhaustion of Zambia's international reserves posed a serious and a real threat to the system that had been put in place. Quick-disbursing financial assistance on highly concessional terms was thus essential. It was in the interest of all parties to ensure the success of the system because failure to carry out the reforms would undoubtedly result in a loss of the Government's domestic credibility. Both the Fund and the World Bank should take full advantage of the authorities' current willingness and the momentum that had been gained to press ahead with a program. He had been glad to learn from some Executive Directors that their governments were willing to provide assistance in that connection. He hoped that that assistance could be made promptly so that the new foreign exchange system would not be interrupted, thereby helping the Government to vindicate its position in the country. After all, the success of the new system introduced in Zambia could prove useful to many interested observers outside the Zambian borders.

In response to the concern that had been expressed by Directors about the speed of fiscal adjustment, the slippages that had occurred in the past, and measures adopted so far to contain the fiscal deficit within sustainable limits, Mr. Mtei reiterated that his authorities stood ready both to take all the necessary measures and accordingly to discuss details of the fiscal program during the forthcoming staff visit to Lusaka, including an assessment of the effect of exchange rate changes on the budget. Similarly, the authorities took a flexible attitude to monetary policy and were watching developments before further modifications were made. He was confident that a workable arrangement on both those counts would be agreed upon between the staff and the Zambian Government. The authorities themselves believed that the budget would remain an essential element of the adjustment process if the stated objectives were to be achieved.

The Chairman made the following summing up:

> Executive Directors agreed with the views expressed in the staff report for, and supplement to, the 1985 Article IV consultation. They noted that over the past decade the Zambian economy had been in a protracted state of contraction. The decline in output and in incomes had continued in recent years and the rate of inflation had remained high. The external liquidity position had also become critical, with Zambia having been unable to meet its external debt obligations despite recent debt reschedulings.
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> Directors expressed grave concern that Zambia was seriously in arrears to the Fund and that its overdue obligations were accumulating rapidly. They urged the authorities to implement policies that would permit the discharge of the overdue obligations and to remain current thereafter. Directors noted that

the economy was overly dependent on copper. Although the country's difficulties were influenced heavily by the protracted sharp decline in copper prices, Zambia's problems were also attributed to inappropriate policies, to the lack of timely and adequate adjustment and economic diversification, and to the failure to raise efficiency in agriculture and industry.

Directors acknowledged that revised forecasts for copper output and exports during the remainder of the decade held out little hope for a revival of that sector. They commended therefore the authorities' recent radical change in domestic and external policies to promote structural adjustment, to diversify production and exports away from copper, and to increase nontraditional exports. In particular, Directors welcomed the introduction of a foreign exchange auction system and the increased liberalization of the restrictive trade and payments system. They emphasized the importance of allowing the auction system to operate freely. Directors urged the authorities to avoid administrative measures which could influence the exchange rate and to minimize the number of transactions exempted from the auction. They also emphasized the need for quick disbursement of aid flows to support the auction system. Directors insisted that the effects of exchange rate movements be transmitted without hindrance to domestic prices, and that the remaining rigidities in the pricing system be reduced in order to promote economic pricing in the private and parastatal sectors. In that regard, Directors welcomed the recent increases in the prices of petroleum, maize, and maize products. But, they underlined the need to adjust agricultural producer prices to remunerative levels in order to strengthen producer incentives, as well as to keep the subsidies implicit in consumer prices under control. In particular, several Directors urged early action toward the complete decontrol of maize and fertilizer prices.

Directors encouraged the authorities to implement strong fiscal and monetary measures to support the exchange rate and trade policies. That would, in their view, limit the inflationary impulse which emanated from the exchange rate depreciation. A tightening of fiscal policy included improved expenditure control, as well as restraint on the growth of personnel emoluments, containment of budgetary subsidies (particularly on maize and fertilizer), and control of current transfers to parastatals would be important in that regard. Directors acknowledged the authorities' intention to contain expenditures through various measures, including a reduction in government employment over the next three years. The recent increase in public sector wages made that task more difficult and more urgent. On the revenue side, Directors believed that the tax system's buoyancy should be increased by converting most specific taxes to ad valorem taxes. Selective tax increases and actions that broadened the tax base would also be necessary.

Directors praised the authorities' move to decontrol interest rates and to introduce a daily treasury bill auction. They underscored the crucial role that monetary stringency was to play in a system where the exchange rate and the domestic interest rates were to be determined freely. Several Directors observed, however, that real interest rates remained negative and urged that market forces be allowed to play a greater role. In that regard, the treasury bill market would serve as a flexible and effective instrument for controlling reserve money and monetary growth. Sufficient treasury bill sales and minimal central bank overdraft financing would be essential to restraining the rate of growth of liquidity, stabilizing the exchange rate, and avoiding an inflationary spiral.

Directors noted Zambia's extremely difficult external liquidity situation. Large gaps in external financing were projected for 1985-89, in part due to the onerous debt servicing burden which would absorb more than 60 percent of export receipts for goods and services by the end of the decade. Thus, Directors underscored the country's need for successive debt reschedulings on exceptionally generous terms, and its need for the prompt disbursement of additional concessional donor assistance. The Directors therefore urged the authorities to implement fully the recently commenced economic reforms and to quickly design and implement a strong and comprehensive adjustment program worthy of increased donor support. The restoration of confidence in the economy should be bolstered by other measures to attract foreign investor interest in Zambia, several Directors said.

The close collaboration between the Bank and the Fund was warmly welcomed, as was the Bank's recent approval of an industrial reorientation loan, and its role in the diversification of the economy.

All Directors expressed the hope that Zambia would be able to eliminate its overdue obligations to the Fund with external assistance, so that a comprehensive adjustment package could then form the foundation for an early Fund stand-by arrangement.

It is expected that the next Article IV consultation discussion will take place on a 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Zambia's exchange measures subject to Article VIII, Sections 2(a) and 3, in concluding the 1985 Article XIV consultation with Zambia, 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 the counterpart deposit scheme for external payments arrears and from the temporary arrangement in regard to personal remittances as described in SM/85/273, Supplement 1, 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.

Decision No. 8118-(85/158), adopted
October 30, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/157 (10/28/85) and EBM/85/158 (10/30/85).

3. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 85/11 and 85/12 are approved. (EBD/85/262, 10/21/85)

Adopted October 28, 1985

b. The minutes of Executive Board Meetings 85/13 through 85/15 are approved. (EBD/85/270, 10/22/85)

Adopted October 29, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/258 (10/25/85) is approved.

APPROVED: June 12, 1986

LEO VAN HOUTVEN
Secretary