AGENCY FOR INTERNATIONAL DEVELOPMENT

611-K-604 (611-0757)

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PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

2. Country: Zambia	
3. Category: Cash Transfer	
4. Date: November 14, 1985	
5. To: M. L. Edelman, AA/AFR	6. OYB Change Number: N/A
7. From: L. Saiers, DAA/ESA	8. OYB Increase: N/A To be taken from:
9. Approval Requested for Commitment of $ $15,000,000	10. Appropriation Budget Plan Code 72-1161037 GESA-86-31611-KG31 (637-61-611-00-50-61)
11. Type Funding: ☐ Loan ☒ Grant	12. Local Currency Arrangement: ☐ Informal ☒ Formal ☐ None
13. Estimated Delivery Period: November 1985-September 1986	14. Transaction Eligibility Date: PAAD Approval Date

15. Commodities Financed

N/A

16. Permitted Source	17. Estimated Source
U.S. only	U.S.
Limited F.W.	Industrialized Countries
Free World	Local 15,000,000
Cash $15,000,000	Other

18. Summary Description

This program will provide $15 million to the GRZ in direct support of the foreign exchange auction system. AID funds will be disbursed monthly to a correspondent GRZ account, from which funds will be released into each weekly auction, until AID funds are exhausted. The GRZ will covenent that, except as AID may otherwise agree in writing, that:

(a) the auction system will operate in accordance with the general principles under which it was established, but in any case in a free market-determined manner;

(b) the auction system will be adequately publicized;

(c) THE GRZ will provide AID with evidence satisfactory to AID as to the proper operation of the auction system;

(d) the GRZ will establish and maintain strict budgetary controls as appropriate to preserve the viability of the auction system; and

(e) the GRZ will deposit the local currency equivalent of each disbursement of AID funds, calculated at the marginal rate of exchange as determined by the most recent auction, into a Special Account, to be available for joint programming by AID and the GRZ.

The program will be administered as a cash grant to the GRZ. Since the purpose of the program is to assist in the establishment and implementation of

19. Clearances	Date
REG/DP HJohnson	11/19/85
REG/GC TBork MAK	11/19/85
AA/PPC	
M/FM ESOwens	
~~SER/COM~~ AFR/PD:LHausman	11/19/85
~~AA/PRE~~	
AFR/SA: for RCarlson	11/19/85

20. Action

☒ APPROVED ☐ DISAPPROVED

Authorized Signature

Date

Title A A AFR

AID 1120-1 (5-82)

CLASSIFICATION:

18. Summary Description (Cont'd)

the auction system, and AID funds will be commingled with GRZ funds, AID's normal procurement requirements do not apply.

Local currency generated will be programmed for productive expenditures under the GRZ public sector budget.

ACTION MEMORANDUM FOR THE ADMINISTRATOR, A.I.D.
FROM: Mark Edelman, Assistant Administrator/ Africa Bureau
SUBJ: Zambia - Cash Transfer (611-0757)
DATE: November , 1985
PROBLEM:

Your approval is required for a cash transfer of ~~$22,500,000~~ 15,000 to the Government of the Republic of Zambia (GRZ) from the FY 1986 Economic Support Fund appropriations.

DISCUSSION:

Zambia's landlocked position and heavy economic dependence on a single commodity (copper), has made it particularly vulnerable to events outside its control. The dependence on copper and on imported goods, sectoral income differentials, wage adjustments which were often unrelated to productivity gains, and rapid urbanization have all been factors inhibiting growth. The manufacturing sector's dependency on imported inputs has placed increasing demands on scarce foreign exchange, and given the economy's inability to meet the sector's requirements, capacity utilization, manufacturing output and employment have fallen. Severe balance of payments deficits have made it necessary to search for sources of external financing, and this in turn has led to mounting foreign debt and debt service requirements which the economy has not been able to meet. The fall in mining revenues has impacted the domestic economy and contributed to large gaps between revenues and expenditures. The government's response was to reduce capital expenditures and borrow from the domestic banking system, which has led to monetary expansion and inflationary pressures. Faced with a declining mineral resource base, deteriorating terms of trade, falling incomes and level of living, and growing unemployment and underemployment, the need for economic diversification cannot be further postponed.

On October 1, 1985, the GRZ put a new foreign exchange rate auction system into effect to allow market forces to determine the kwacha value and the distribution of available foreign exchange. This major and bold reform, given that the kwacha was significantly and chronically overvalued under the previous, controlled system, is the lynchpin that underlies the viability of the agricultural pricing and marketing reforms supported by AID and World Bank programs in this country.

Under this program, AID will provide the GRZ with $22.5 million of financial support for a substantial revision of its foreign exchange rate policy -- the implementation of an auction system for available foreign exchange. The GRZ is obliged to make $10 million per month (in conjunction with the IBRD's $11 million per month) of foreign exchange available to public bids through the auction program. AID, to provide greater assurance that the auction program remains viable, and, to provide an additional periodic increment of foreign exchange, which may be bid on by any bidder, including private sector entities, intends to release weekly tranches of foreign exchange. These tranches will be additional to that foreign exchange made available by the GRZ and will vary from $.5 to $1.0 million weekly until US funds are exhausted.

In designing the program, the Mission reviewed the merits of a cash transfer versus a Commodity Import Program (CIP). The Mission concluded that the cash transfer mechanism consitutes the only appropriate means to achieve the desired support for the auction, for the following reasons: (a) provision of untied cash allows the auction to perform the function of allocating scarce foreign exchange more effectively, as use of a CIP would introduce source/origin requirements which could create pockets of slow moving currency (as is the experience with IBRD agricultural rehabilitation funds); (b) the requirement for foreign exchange to support the auction is immediate, and provision of a cash transfer is the quickest way to provide funds; and (c) with the imminent release of the first tranche of ZAMCAM ($7 million) tied to U.S. source/origin and transport sector, provision of additional CIP-type funds might create absorption difficulties.

The following conditions precedent and covenants are considered essential, have been discussed with the GRZ, and have been incorporated into program documentation. The GRZ will provide:

1. A statement representing and warranting that the named person or persons have the authority to act as the representative or representatives of the Grantee, together with a specimen signature of each person certified as to its authenticity;
2. A statement designating the bank and the special account number into which the foreign exchange disbursement is to be made.
3. Evidence that the GRZ has established a special account in the BOZ for deposit of kwacha generated by the AID-provided foreign exchange.

In addition to the above general conditions, USAID will provide confirmation to FM/PAD that the following conditions are fulfilled for release of each four-weekly tranche.

(a) that the auction program continues to operate in a manner consistent with the spirit of the guidelines published October 9, 1985 (reproduced as Annex E to this PAAD).
(b) that the GRZ has continued to adequately publicize the results of the auction.

The GRZ also covenants the following:

1. The Grantee agrees to immediately deposit in the BOZ special account currency of Zambia (Kwacha) equivalent to the US dollar disbursement made at each auction at the highest rate of exchange which is not unlawful in Zambia on the date of the US dollar disbursement is made. (i.e. exchange rate established by that respective auction).

2. AID and the Grantee agree that the kwacha funds deposited in the BOZ special account shall be used by the Grantee for the productive sectors of the GRZ budget.
3. The GRZ covenants that it will provide reports on the utilization of counterpart fund proceeds on a six-monthly basis relating to budget attribution. This report is to be certified as correct by an appropriate official within the Ministry of Finance or other Grantee agency, will be submitted to A.I.D. within thirty (30) days after the close of each six-month period, except as A.I.D. may otherwise agree in writing.

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Congress was notified of the program on October 1985 and the fifteen day waiting period expired on November , 1985.
AA/AFR has determined that the Program Grant does not require environmental evaluation as it satisfies criteria set forth in Section 216.2 (C) "Categorical Exclusions" of A.I.D. Regulation 16. There are no human rights issues in Zambia.

RECOMMENDATION:

That you approve the granting of $22.5 million to the GRZ from FY 1986 ESF funds as a cash transfer by signing the attached PAAD facesheet.

10/30/85

ZAMBIA AUCTION PROGRAM (ZAP) SUPPORT

(611-0757)

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ABBREVIATIONS AND ACRONYMS

AA/AFR	Assistant Administrator, Africa Bureau, AID/W
BOZ	Bank of Zambia
CDSS	Country Development Strategy Statement
CIP	Commodity import program
ESF	Economic support fund
FAO	Food and Agricultural Organization
FR	Financing Request
FX	foreign exchange
GDP	gross domestic product
GRZ	Government of the Republic of Zambia
IBRD	World Bank
IDA	International Development Association
IEE	Initial environmental examination
IMF	International Monetary Fund
INDECO	Industrial Development Corporation
K	Kwacha
L/C	local currency
MAWD	Ministry of Agriculture and Water Development
MOF	Ministry of Finance
NAMBoard	National Agricultural Marketing Board
NCDP	National Commission for Development Planning
NCZ	Nitrogen Chemicals of Zambia
PAAD	Program Assistance Approval Document
PCU	Provincial Cooperative Union
OYB	operating year budget
PTA	Preferential trade area
REDSO/ESA	Regional Economic Development Service Office/ E and S Africa
RFMC	Regional Financial Management Center
SADCC	Southern African Development Coordinating Conference
SDR	Special drawing rights
UNIP	United National Independence Party
USDH	U.S. direct hire employee
ZADB	Zambian Agricultural Development Bank
ZAMCAM	Zambia Multi-channel Agricultural Marketing
ZAP	Zambia Auction Program Support
ZATPID	Zambia Agricultural Training, Planning, and Institutional Development

ZAMBIA AUCTION PROGRAM (ZAP) SUPPORT

I. SUMMARY

Background: Zambia's landlocked position and heavy economic dependence on a single commodity (copper), has made it particularly vulnerable to events outside its control. The dependence on copper and on imported goods, sectoral income differentials, wage adjustments which were often unrelated to productivity gains, and rapid urbanization have all been factors inhibiting growth. The manufacturing sector's dependency on imported inputs has placed increasing demands on scarce foreign exchange, and given the economy's inability to meet the sector's requirements, capacity utilization, manufacturing output and employment have fallen. Severe balance of payments deficits have made it necessary to search for sources of external financing, and this in turn has led to mounting foreign debt and debt service requirements which the economy has not been able to meet. The fall in mining revenues has impacted the domestic economy and contributed to large gaps between revenues and expenditures. The government's response was to reduce capital expenditures and borrow from the domestic banking system, which has led to monetary expansion and inflationary pressures. Faced with a declining mineral resource base, deteriorating terms of trade, falling incomes and level of living, and growing unemployment and underemployment, the need for economic diversification cannot be further postponed.

The Government of the Republic of Zambia (GRZ) has recently undertaken a substantial number of pricing and other economic reforms and has agreed to implement still more reforms within the next two years. These include:

--Providing a system of incentives to producers and exporters of agricultural and industrial products in which prices are responsive to market forces;

--Ensuring the competitiveness of exports through an active exchange rate policy;

--Using tariffs and interest rate policies to reverse past trends of import dependence and capital intensity;

--Liberalizing administrative restrictions on foreign trade and the licensing of production, in order to improve the allocation of resources and to encourage investment in productive activities;

--Reducing the Government's deficit and recourse to domestic bank borrowing by reducing expenditure on personnel costs, subsidies and other non-development related activities;

--Improving planning and budgetary procedures to shift resources to productive uses and economic investments;

--Allowing greater competition in the procurement and selling of food crops. The National Agricultural Marketing Board (NAMBoard), will move towards the role of buyer and seller of last resort, using a system of floor and intervention-selling prices for agricultural produce and inputs, respectively;

--Strengthening the technical and managerial capacity of Zambia Industrial and Mining Corporation (ZIMCO), which is the holding company of most state-controlled enterprises;

·Restructuring the energy sector to bring about lesser dependence on imported oil.

On October 4, 1985, the GRZ put a new foreign exchange rate auction system into effect to allow market forces to determine the kwacha value and the distribution of available foreign exchange. This major and bold reform, given that the kwacha was significantly and chronically overvalued under the previous, controlled system, is the lynchpin that underlies the viability of the agricultural pricing and marketing reforms supported by AID and World Bank programs in this country.

Program Description: Under this program, AID will provide the GRZ with $22.5 million of financial support for a substantial revision of its foreign exchange rate policy -- the implementation of an auction system for available foreign exchange. The GRZ is obliged to make $10 million per month (in conjunction with the IBRD's $11 million per month) of foreign exchange available to public bids through the auction program. AID, to provide greater assurance that the auction program remains viable, and, to provide an additional periodic increment of foreign exchange, which may be bid on by any bidder, including private sector entities, intends to release weekly tranches of foreign exchange. These tranches will be additional to that foreign exchange made available by the GRZ and will vary from $.5 to $1.0 million weekly until US funds are exhausted.

The AID CDSS and recently approved support programs such as ZAMCAM strongly emphasize the need for Zambia to stimulate the agriculture sector. Recent policy changes in pricing, subsidies, etc. will only achieve an impact on the agriculture sector if the exchange rate is "correct." ZAP Support is expected to result in a more stabilized, and more likely successful, foreign exchange rate auction system, which in turn should result in the following;

a) more efficient allocation of available foreign exchange to priority economic uses according to operative market forces.

b) the conservation of scarce foreign exchange and promotion of export production and efficient import substitution, thus stimulating domestic employment and income generation in both agriculture and industry.

While the GRZ is the immediate beneficiary of this program, the real beneficiaries are those private entrepreneurs bidding for foreign exchange who will benefit from the knowledge that an enlarged foreign exchange auction pool will tend to promote a more stabilized exchange rate. Private entrepreneurs and their employees will also benefit from the greater availability of foreign exchange to purchase essential inputs, thus supporting a higher level of capacity utilization and employment.

II. POLITICAL SITUATION

For the decade 1954-1964, Zambia (then Northern Rhodesia) formed part of the Federation of Rhodesia and Nyasaland. Since independence in 1964 Zambia has been led by President Kenneth David Kaunda with a unicameral legislature and independent judiciary. The sole legal party is the United National Independent Party (UNIP). The UNIP Central Committee determines the broad guidelines of national policy which are undertaken by the Cabinet and Government.

Although President Kaunda possesses sweeping emergency powers to suspend certain rights in the "interest of state security," basic human rights are generally observed. Zambian institutions such as the judiciary, press, and labor movements have maintained their status and influence. Kenneth Kaunda was the sole presidential candidate in the 1983 elections receiving a "yes" vote of 93%, and was reelected for his fifth consecutive five-year term. While a one-party state, elections at the local level are heavily contested and over 760 candidates ran for the 125 national assembly seats in the 1983 Parliamentary elections.

In its international relations, Zambia has long had to pay the price of its sensitive position in the troubled southern African region. Thus, an important priority for Zambia has been the need to keep open its transportation and communications links while following a policy of nonalignment. Zambia has also played an important role in helping Southern African countries gain their independence (and in advocating majority rule in the Republic of South Africa). Zambia played a crucial role in the independence of Mozambique, Angola and Zimbabwe and currently is a key player in the discussions among the key parties involved in Namibian independence.

This mediatory role is further reinforced by Kaunda's emergence as one of Africa's elder statesmen, and active Zambian participation in the Southern African Development Conference (SADCC) and the Preferential Trade Area for Eastern and Southern Africa (PTA), a group of 14 countries which envisage the creation of a free trade area. Zambia is also a signatory to the Lome convention of the European Economic Commission.

Zambian bilateral relations with the United States are good. The two countries share many basic beliefs and ideals. In the southern African context there are differences of perception regarding U.S. tactics on the Namibian issue as well as the degree of leverage the U.S. can bring to bear on South Africa itself. Nevertheless, the U.S. is in agreement with the GRZ on the advocacy of peaceful change and the strategy of reaching settlement through negotiations.

U.S. objectives are to encourage Zambian stability, self-reliance, and growth so that the country can pursue economic development despite the political and military turmoil in the region. Given its strategic position in southern Africa, a secure and prosperous Zambia will help foster stability in the region as a whole, ensure continued access to Zambia's strategic minerals, and enable the country to continue in the active pursuit of initiatives seeking peaceful solutions to the conflicts in the area. As a leading member of the region's front line states, Zambia plays a vital role in efforts to resolve conflicts in Namibia, Mozambique and Angola.

III. MACROECONOMIC ANALYSIS*

A. Background

Zambia is a landlocked country in the southern half of Africa. Most of the country consists of a high plateau ranging in elevation from 1,000 to 1,500 meters. Its landlocked position has made the existence of secure and reliable routes to the sea of critical importance. The country covers and area of 750,000 square kilometers; and with a mid-1983 population of 6.3 million people, it has very low population densities of approximately 8 persons per square kilometer overall and 5 persons per square kilometer in rural areas. With 43% of its population in urban areas, Zambia is one of the most urbanized countries in Africa. With vast mineral resources and land area suitable for crops and livestock, Zambia possesses the potential for rapid, sustained growth; however, the contribution of agriculture to growth and development has been well below potential.

The Zambian economy is characterized by extreme dualism between an urban-oriented modern sector and the rural agricultural sector. Moreover, both the urban and rural sectors are dualistic. The urban sector is split between a formal and an informal sector: in general, the former consists of larger, more modern, capital-intensive higher wage firms, while the latter sector involves relatively low-skilled and more labor-intensive firms. The agricultural sector retains the same structure it had at independence (1964) On one hand are large state farms and commercial farmers, located mainly on the line-of-rail and other major arteries, using modern and capital-intensive methods to produce cereals, beef, poultry and tobacco. On the other hand, there are approximately 460,000-600,000 smallholder subsistence farmers, widely dispersed on land of varying quality, following traditional methods of farming to produce maize, cassava, millet, groundnuts, sorghum and free grazed beef. There is, however, a growing emerging farmer group which uses both traditional and modern techniques in producing for the market.

At independence Zambia inherited an economy created by the colonial system and characterized by: (a) the above mentioned extreme dualism between a rich export-oriented mining sector and a poor subsistence agricultural sector largely outside the money economy, as well as dualism within the agricultural sector between a small number of (largely expatriate) commercial farmers using modern, capital-intensive methods and the vast number of Africans using traditional, subsistence techniques; (b) dependence upon imported manufactures from Zimbabwe, South Africa, and Europe; (c) dependence upon an expatriate skilled labor force; and (d) large income differentials between expatriates and Zambians, African miners and non-miners, urban and rural workers. The latter characteristic had two unfortunate consequences: (1) it created pressure for Africans to use political and union power to improve living standards through money wage increases regardless of productivity gains; and (2) the incentive for rural-urban migration led to a rate of urban labor force growth faster than could be absorbed by the expansion of the modern sector and to an imbalanced age and sex structure in the rural labor force. The impact of these consequences is still being felt.

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* For a more detailed analysis of the Zambian economy the reader is referred to Hadley E. Smith, "Macroeconomic Analysis," Annex K of the "FY 1985 CIP PAAD," USAID/Zambia and REDSO/ESA, Nairobi, December 15, 1984.

Although the behavior of copper prices is notoriously fickle, resulting in Zambia's merchandise exports being very unstable, copper mining has continued to dominate the economy. This has perpetuated instability in foreign exchange earnings and tax receipts and led to difficulties in planning, not only for government but for the parastatal and the private sectors as well.

Beginning in the early 1970s, the Zambian economy has faced growing constraints in mobilizing domestic and foreign exchange resources for economic development. These difficulties have been due to the failure of the mineral resource base to grow, to deteriorating terms of trade, to rising real production costs in mining due to technological problems and increasing labor costs, and to government policies that have accentuated the economic dualism and prevented economic diversification.

The Zambian leadership has, nevertheless, made considerable progress in creating the economic and social infrastructure necessary to support more rapid economic growth. Major investments in power and transport have set the stage for growth in copper and the remainder of the modern sector. The rapid expansion in educational and health services in both rural and urban areas has increased welfare on a broad basis while improving the quality of human resources; but the increasing scarcity of budgetary resources is seriously eroding these gains.

B. The Need for Structural Adjustment and Diversification

1. The Current Economic Structure and Policy Environment

Zambia's failure to diversify its economy and thus reduce its dependence on copper has accentuated its vulnerability to external influences and reinforced the economic dualism that characterized the economy at independence

Previously high copper prices gave the illusion that Zambia was a wealthy country, allowing, among other things, the rapid growth of wages in the urban sectors, high levels of imports of raw materials, intermediate, and capital goods, large subsidies for domestic food consumption and agricultural imports, and the rapid expansion of government recurrent expenditure. The resulting pattern of development is characterized by high levels of urban consumption, growing capital-intensity of techniques in the modern formal sectors and a slow development of agriculture. Such an economic structure has a number of disadvantages:

- -the country is highly vulnerable to erratic fluctuations in resources generated by copper;
- -it hindered the development of other exports or import substituting industries more than would otherwise have been the case, because of the former relative abundance of foreign exchange;
- -the growth of the modern sector has been insufficient to provide employment for the expanding urban labor force; and
- -the fruits of development were maldistributed, with most of the gains accruing to Zambian and foreign owners of capital in the modern urban and commercial sectors and relatively less to those employed in the urban informal sector and in traditional agriculture.

Approximately 96% of Zambia's export earnings are generated from the mining sector, with copper alone accounting for almost 90%. Since production in the rest of the economy relies critically on imports of fuel oil products and on imported intermediate and finished goods for its mining, manufacturing, agricultural, transport and services sectors, mining revenues in effect finance the essential inputs for much of Zambia's economy.

The gradual exhaustion of high-grade ore deposits, shortages of spare parts, loss of skilled personnel, transport bottlenecks and labor conflicts have hampered mineral production and in particular, copper output has followed a downward trend during the past ten years. Copper, zinc, and lead exports in 1983 were 17%, 27% and 44% less than the respective export volumes achieved in 1970. The variations in Zambia's export earnings have, however, been affected more seriously by the cyclical changes in copper prices than by fluctuations in export volumes; and copper prices in constant 1982 prices fell from U.S.$ 1.95/lb. during the period average 1965-69 to U.S.$0.78/lb. for the period average 1980-83. They continued to fall in 1984 and in 1985 were only U.S.$ 0.65/lb. in current prices.

As the result of the sharp decline in copper prices, combined with declining export volumes, Zambia has experienced severe balance of payments crises during the past 5 years. In 1983, export earnings, both in real and nominal terms, were less than the levels achieved from 1974 to 1979, and the current account turned from a surplus position in 1979 to large deficits from 1980 to 1982, when current account deficits averaged 18.5% of GDP. With drastic reductions in import levels, which fell from US$1973 million in 1980 to $952 million in 1984 (preliminary figure), the deficit was reduced to about 8.5% of GDP in 1983 and 84. This represents substantial progress in the Government's financial stabilization program, obtained at a considerable cost in terms of production and consumption levels. Debt rescheduling contributed 2 to 3 percentage points to the 10-point reduction of the current account deficit.*

The protracted decline in export earnings and a sharp reduction in total external loan and grant commitments (which fell from U.S.$731.1 million in 1979 to U.S.$156.9 million in 1983), severely reduced the country's capacity to import (the 1983 import volume was about 45% of that in 1970); and, given Zambia's critical dependence on imports, the entire economy has been adversely affected. In fact, the critical shortage of foreign exchange that could be made available to the private sector caused some delay in initiating the new auction system, and is itself considered the most formidable constraint to its successful continuation.

Output growth over the period 1979-83 averaged only 0.4% a year in real terms, and in 1983 real GDP was barely above its 1974 level. As a result, there has been a drastic decline in per capita incomes. In 1983 real per capita GDP was 22% below its 1974 level, while real Gross Domestic Income (GDI, or GDP adjusted for changes in terms of trade) per capita had declined by 40% by 1983 and fell another 3% in 1984.

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* World Bank, "Report to the Consultative Group for Zambia on Progress Towards Economic Restructuring," April 30, 1985, p. 15. See also IMF Staff Report for the 1985 Article IV Consultation, October 1, 1985, for the most recent balance of payments projections. Comparable data for a useful text table are not available at post.

Total investment as a percentage of GDP decreased from 1980 onward, reaching 15.3% of GDP in 1983. As the fall in export earnings turned Zambia from a net exporter to a net importer of capital, domestic financing of investment decreased between 1979 and 1982. During the same period, the ratio of gross domestic savings to GDP fell steadily from 23.1 to 6.7%, while the ratio of national savings to total investment fell from 109% (i.e., they were saving more than investing) to -4.3%. Thus, by 1982 Zambia was effectively financing its entire investment effort with foreign funds.

Increasing reliance on foreign financing has resulted in the rapid growth of debt outstanding and debt service payments. The public sector's medium and long-term external debt outstanding (disbursed only) has increased from U.S.$ 622.5 million in 1970 (62% of total exports) to U.S.$2.6 billion in 1983 (264% of total exports). Total external debt outstanding on September 30, 1984, was US$4.5 billion. Debt service payments rose from U.S.$59.0 million in 1970 (6% of total exports) to U.S.$287.0 million in 1980 (18% of total exports), and scheduled total external debt service payments in 1983 were estimated to be U.S.$628 million (59% of total exports). Debt service payments, unless rescheduled, would amount to 70% of export earnings over the next 3 years. The decline in export earnings, coupled with the rapid growth in debt service payments and a trend toward harder loans (the grant element of external public debt has fallen from 41.6% in 1970 to 26% in 1982), made it increasingly difficult for Zambia to service its external debt obligations. By March of 1984 total external payments arrears were estimated at U.S.$ 636.0 million.

The accumulation of large external payments arrears have affected the country's creditworthiness and inhibited Zambia's ability to finance its current account deficits. As of December 1983, gross official reserves were estimated to have fallen to the equivalent of 3 weeks of estimated imports. By December, 1984, the gross official reserves stood at 4 weeks of estimated imports.

The budgetary crises of the past 10 years illustrate the domestic economy's vulnerability to its dependence upon mineral revenues. Mining revenues virtually disappeared in 1981 and 1982 (compared to 333 million kwachas in 1974). As a result, total recurrent revenue averaged only 25% of GDP during 1976-82 (from 27.6% of GDP during 1965-75), while the ratio of government expenditure to GDP increased from 30 to 35% prior to 1975 and to roughly 38% during 1976-82. As a consequence of these developments, the overall cash deficit has increased from 6% of GDP in 1975 to 11.4% of GDP in 1980 and to 18.9% of GDP in 1982, when Zambia was faced with an unprecedented deficit of K674.8 million. Since then the GRZ has increased revenue collections while holding expenditure constant in nominal terms. Of particular note was the Government's ability to contain its wage bill and reduce subsidies during a period of rapid domestic price inflation. Real capital and operating expenditures have fallen sharply, however, reducing the Government's ability to provide basic economic and social services and infrastructure. As a result, the overall fiscal deficit declined to 7.4 and 6.7% of GDP in 1983 and 84, respectively, and is budgetted at 5.9% of GDP in 1985, while borrowing from the domestic banking system was reduced from 14% of GDP in 1982 to 3-4% in 1983-84.**

** World Bank, op. cit., pp. 15-16.

An unfortunate effect of the foreign exchange rate devaluation, due to the high level of external debt service payments owed by the Government, is the large increase in the kwacha value of those payments, which are denominated in hard currency. Budgetted at K519 million in 1985, these payments rise to K1,269 million at K5.0/$1 and K1,817 million at K8.0/$1 and, together with other forex-related expenditures, this will increase the overall fiscal deficit from the budgetted level of -K305 million to -K1225 million and -K1698 million, respectively--an almost 6-fold increase at K8.0/$1. (See Table 1.) It will be difficult to bring this deficit back under control.

The Zambian Government has had to rely heavily on the monetary system to finance its domestic borrowing, which has contributed to monetary expansion and a sharp acceleration in prices. In 1983 and 1984 the consumer price index for low-income households rose by 20% annually, while the index for high-income families increased by 18%.

Despite Zambia's long-term basic economic and social goal of diversifying the economy to make it less dependent on copper, limited progress has been made. The agricultural sector, with plentiful land resources for crop and livestock development, is far from achieving the government's goal of making a contribution to diversifying the economy and the export base. Agricultural production contributed only 15% to GDP in 1984; and its growth has not kept pace with population growth, resulting in a continuing reliance on imported food and agricultural raw materials, most of which Zambia has the capacity to produce at home--i.e., maize, wheat, rice, barley, vegetable oils and dairy products (for a more detailed discussion of the agricultural sector, refer to Section III.B.2. below). Zambia's manufacturing sector is relatively large compared to other sub-Saharan countries. The sector's contribution to GDP increased from 6% of GDP in 1964 to 19% in 1984. Sectoral growth has largely stagnated since the late 1970s, however, and has been accompanied by problems that have accentuated the economy's dependence on imports: (a) the failure of manufactured exports to expand (they account for less than 1% of total exports and show little sign of growth); (b) the concentration of import substitution on final stage consumer goods, necessitating continued heavy reliance on the importation of intermediate and capital goods; (c) the growing capital-intensity of production and the failure to create sufficient employment opportunities; and (d) the continued concentration of industrial activity along the line-of-rail, and the failure to develop rural industries.

The manufacturing sector is highly dependent on imported inputs and spare parts. Imports account for 81% of all intermediaries and 40% of the value of gross output in the metal products industry. A World Bank sample of 24 firms showed that only the food, textile, and footwear industries import less than half their intermediate goods. The shortage of foreign exchange has reduced these imports and greatly inhibited capacity utilization (estimated at less than 50% in 1984).

In spite of various efforts to maintain a high rate of employment growth manufacturing employment grew at an average annual rate of only 1.1% from 1975-80. The sector has been unable to absorb the growing urban labor force (For a comprehensive analysis of the sector, refer to World Bank Report of August 6, 1984, Zambia Industrial Policy and Performance).

Table 1. Zambia: Central Government Operations, 1984-85
(in millions of kwacha)

	1984 Actuals	1985: Budget	at K2.5/$	at K5.0/$	at K8.0/$
Revenue and grants	1115	1442	1432	1712	1979
Tax revenue	970	1276	1320	1594	1846
Non-tax revenue	122	91	71	65	65
Grants	23	75	41	53	68
Expenditure & net lending	1527	1747	2333	2937	3677
Current expenditure	1338	1495	1865	2332	2907
of which:					
Interest: Foreign	129	300	422	833	1338
Capital expenditure and net lending	189	252	468	605	770
OVERALL DEFICIT	-412	-305	-901	-1225	-1698
Financing:					
External, net	88	27	85	0	-117
Gross	128	70	432	682	982
Amortization	40	43	347	682	1099
Domestic non-bank, net	98	37	6	6	6
Domestic bank	226	241	250	250	250
Financing gap	0	0	560	969	1559
Memorandum items: (%)					
Overall deficit/Total expend. (without debt rescheduling)	26.9	17.5	38.6	41.7	46.2
Revenue/Total expenditure	73.0	82.5	61.3	58.2	53.8

SOURCES: IMF staff estimates, data provided by Zambian authorities, 8/6/85

Expansion of the other formal sectors has also not been rapid enough to offer employment opportunities to an urban population whose growth rates are more than double the growth of population for the country as a whole. Preliminary data indicate that paid employment in mid-1984 was about 4% below the peak recorded in 1980. Hence, urban unemployment and informal sector activities have increased; and the rapidly growing urban population has strained the government's capacity to provide cheap food and social services, while making no direct contribution to the budget. In addition, the government's policy of protecting urban consumers from rising food prices by setting domestic agricultural prices below their corresponding world or border prices, has not only reduced incentives for domestic production but has also effectively lowered farmers' real incomes and further encouraged rural-urban migration.

In conclusion, two decades after independence the Zambian economy is as dualistic as before. The rapid wage increases in the urban areas, combined with price controls and subsidized food, has widened the urban-rural income gap. This will not be reduced without appropriate programs to raise productivity in the rural areas and restrain the growth of urban wages. The country is more urbanized than before, and government policies have accentuated the dualism. Budgetary and parastatal investments to support the urban economy have emphasized modern capital intensive technologies, and government pricing policies have discouraged production and depressed farmers' real incomes.

2. Agricultural Potential and Constraints

The development of Zambia's agriculture sector has lagged behind its potential. Zambia has approximately 60 million ha. of arable land but only about 12 million (20%) is currently cultivated. While much of the land is relatively infertile with a low Ph level and is suited mainly to extensive farming, there remain large areas of idle land with medium to high potential for production. The rainfall pattern tends to be erratic, but the climate is generally favorable for the cultivation of a wide range of crops. Maize is by far the most important crop and accounts for over 70% of the value of the marketed agricultural products. Cassava, millet, sorghum, groundnuts, sunflower, cotton, tobacco, sugar cane, rice, soyabeans, and a variety of legumes and vegetables are other significant crops. Zambia also has a sizeable number of the various types of livestock, and cattle are a major source of cash income and offer a considerable potential for animal draft power.

While the farm production sector remains essentially dualistic, it is actually composed of three basic groups of farmers: (1) traditional farmers (460,000 to 600,000), who use hand tools and produce little marketable surplus (cash value per family of K60-K70 in 1982); (2) emergent farmers (60,000-125,000), who use improved technology and some mechanization and produce an increasing marketable surplus (K1000-K3000 in 1982); and (3) the commercial farmers (600-800), who use capital intensive technology with a large foreign exchange component and produce 40-60% of the marketed production. The commercial farmers cultivate approximately 5% of the land, the emergent farmers 15% and the traditional farmers 80%.

Much of the growth in agriculture has been in the non-food sector. The food sector has grown at an annual rate of approximately 2%; however, population growth has been over 3% for the same period. Hence, Zambia's degree of food self-sufficiency in staple grains declined from 97% during 1964-66 to 79% during 1978-80 (IBRD Report No. 4764ZA). The declining food self-sufficiency has caused Zambia to turn to imports, the major imports being wheat, maize and vegetable oil. The decline in food self-sufficiency reflects the general stagnation in agricultural productivity due in large part to inappropriate policies, exacerbated by the strain of rapid population growth.

The decline in agricultural production has been aggravated by the rapid growth in the urban areas. Roughly 40% of all Zambians now live in urban areas, necessitating substantial movements of food from the outlying production regions to the urban areas. Further, it is the relatively large urban population to which the low mealie meal consumer price is directed.

Production of agricultural commodities (particularly maize) has stagnated over the past several cropping years with 1984/85 being an exception. The major cause of the stagnation was inadequate rainfall, with the lack of agricultural inputs being a secondary factor (agricultural spares, tires, chemicals). For the traditional emergent farm group, appropriate technology has been identified by the IBRD as the major factor limiting increased production. Real growth in agriculture was approximately 2.8% during the 1970-1978 period, but only 0.4% during 1980-1983. The commercial sector has shown more year-to-year variation than the traditional sector. The lack of foreign exchange for inputs and a greater sensitivity to changing economic conditions are contributing factors to this variability.

The agricultural policy changes have also affected production. NAMBoard fertilizer sales dropped from 225,000 MT in 1982/83 to 165,000 MT in 1983/84 and further to 140,000 MT in 1984/85. Two factors contributed to the drop: firstly, fertilizer prices were raised by 60% as the subsidy was reduced; and secondly, the drought made fertilizer applications uneconomical. Therefore, lower yields were a result of both weather and policy changes. The effect of the commodity price increases have been mitigated by the weather as lower yields have counteracted any increase in hectarage planted. An encouraging note is that maize marketings for 1983/84 exceeded the marketing for 1982/83 even though commercial farmers reduced the area planted to maize and overall yields were down. It appears that the increased prices for maize, combined with the availability of consumer goods in the rural areas, "pulled" more maize from the traditional sector into the official market channel. (This phenomenon is due in part to the increased supply of consumer items in the rural areas following price decontrol). The 1984/85 final projected maize production was a record 12.5 million bags (roughly 30 percent increase over 1983/84) with the increase coming from both area expansion and good rainfall. Marketings were projected to be 7.5 million bags. The precipitous change in the marketing procedures in 1985 caused a great deal of confusion in the system and the unofficial estimate of official marketings now is less than 6.5 million bags with a significant quantity of maize in the rural areas but not collected for safe storage. The lack of trucks, spare parts, tires, diesel fuel and very bad roads have been blamed.

Significant variation in production among commodities has developed. Wheat and rice production, although still small, has steadily increased. Maize production, after dropping sharply in 1978-80, has regained the level of earlier years. Millet, sorghum, cassava and potato production has been almost flat or declining for a decade, but the over 50% increase in their prices in the last two years may cause a resurgence in production. Increased production of traditional commodities will also be encouraged by the large increase in the price of mealie meal. Contradictory movements are evident in export/cash crops, where tobacco and peanut production has declined and cotton, soybeans, sunflower and sugar production has increased significantly. (The production of oil seeds has outstripped the domestic crushing capacity; hence, Zambia must increase its processing capacity for oil seeds.) Steady growth is also evident in the livestock sector.

The changes in production mentioned above largely reflect changes in the area under cultivation, which shows a dramatic decline in peanut (groundnut) area, offset only in part by increased area planted to other oilseed crops. Overall, the total area under cultivation seems to have declined since 1977/78, or at least stagnated. This can be attributed to pricing policies and the lack of appropriate equipment and spare parts to expand or maintain the area under cultivation.

The recent increase in marketed production was particularly important for maize, which accounts for at least 90% of the total volume marketed through official channels. Maize is the staple of the urban sector, and its availability is a sensitive political issue. Other crops--rice, groundnuts, sorghum, millet, cassava, etc.--account for only 5% of officially marketed outputs. The quantities of these crops marketed outside official channels are significant and play an important part of the diet in many parts of the country. Officially marketed production of these crops has also increased significantly on a percentage basis since 1979/80; however, the base point was quite low.

Policy Constraints

The GRZ instituted a pan-territorial and pan-temporal pricing system in 1972. The GRZ's reason for the administered price system was based on equity grounds--i.e., "fair return" to producers and "fair prices" to consumers. Also, the price policy is used as an income transfer mechanism, although it serves as an inefficient policy instrument for this purpose. Further, the desire to maintain relatively low consumer prices led the GRZ to "squeeze" the margins to such an extent that only subsidized marketing agencies could operate. Beginning in 1983, significant policy changes have been implemented. Specifically, all consumer prices were decontrolled with the exception of maize, wheat, and candles (wheat was totally freed in November 1984) The result was a renewed flow of consumer commodities to the rural areas

The GRZ still maintains the pan-territorial and pan-temporal pricing schemes for agricultural commodities and continues to set minimum producer prices. For all practical purposes, only the maize producer and consumer price controls are operative as virtually all other food commodities flow through the private (or parallel) marketing channels. Hence, NAMBoard has been relegated to a "buyer of last resort" on all food commodities except maize.

The policy continues to favor maize consumption over the substitutes sorghum, millet and cassava. The IBRD has estimated that transportation costs alone constitute approximately 40% of the consumer price of mealie meal. While part of the transportation costs are incurred by the millers, the bulk is incurred by NAMBoard. Consequently, the consumer price of mealie meal is substantially subsidized in terms of transportation alone. This has a depressing effect on the prices of the traditional substitutes, discouraging production by traditional farmers of those commodities in which they have a technical comparative advantage. Further, the maize subsidy retards the development of processing facilities for the traditional commodities (and the employment that could be generated) by depressing the demand for those commodities.

Producer prices have, in general, been set too low (particularly in relation to border price equivalents) imposing an implicit tax on those producers who sold through the official channels. Beginning in 1983, producer prices have increased in real terms. The 1985 prices approached or exceeded border price equivalents at the existing exchange rates; however, the recent depreciation of the kwacha due to the foreign exchange auction system has reduced the domestic price of maize to less than one half to one third of the border price equivalents. Producer response to this turn of events is difficult to assess, but unless the minimum producer price is raised (price increases are expected very shortly) or the system totally freed, a significant reduction in area planted can be expected. The same will largely be true of all commodities bought at the official prices.

On the input side, fertilizer has an equal status with maize; i.e. pan-territorial and pan-temporal pricing, single channel marketing and subsidized distribution. (Roughly estimated to be 40% of the selling price in 1984.) NAMBoard is the sole import distributor of fertilizer, generally selling to the Provincial Cooperative Unions (PCU) for further sale to local cooperatives and farmers. Nitrogen Chemicals of Zambia is the sole fertilizer manufacturer, producing ammonium nitrate for mixing with imported raw material to produce finished compound fertilizer. In 1983, fertilizer prices were raised by 60%; however, this did not eliminate the explicit fertilizer subsidy. The subsidy encourages the over-use of fertilizer, and because much of the fertilizer is used by commercial farmers the subsidy flows from the GRZ to the relatively well-off, not to the traditional producer. Also, because of the flat price structure, producers are encouraged to use fertilizer for maize in farming areas not well suited for maize, rather than produce traditional crops that require less fertilizer. At the new, auction-determined exchange rate the current fertilizer prices are also only a third or so of border price equivalents, and they will now have to be approximately tripled if subsidies are to be eliminated--a politically difficult ramification of the exchange rate reform.

The procedure in setting maize prices is a further complicating factor in the overall pricing system. Producer prices have been set on the basis of the estimated average production costs of the commercial farmer during the preceding year. The resulting prices have only an incidental relationship to the supply and demand conditions facing the country.

In summary, the result of the pricing policy for maize and fertilizer is an inefficient cropping pattern which disregards technical comparative advantages and encourages over-consumption of maize relative to other commodities, over-utilization of fertilizer and inefficient use of the transport sector.

The land tenure system and its "land without value" concept exacerbates the problems of subsidy removal. Land is held by individuals in leasehold at a uniform rental fee of 8 ngwee per hectare, which is an insignificant factor in production costs. While there are development costs involved in opening new land to cultivation, there is no mechanism to reflect the scarcity (or locational advantage) of land, specifically that along the line of rail or major transport arteries. Production costs under the present pan-territorial pricing system will be virtually the same for any given production system, in any area of the country. Hence, net profits will also be virtually the same. As the marketing system moves toward the freer multi-channel system proposed in the IBRD Agricultural Rehabilitation Project and to be supported by the ZAMCAM Project, producer prices will fall in those areas away from the consuming centers and at the same time production costs will rise, causing a double disincentive. If land were given an economic price, that land near the consumer centers would be "bid up," returns to the GRZ would increase (economic rent extracted from the leaseholder), production costs would increase and an equilibrium for net profits would be established between and among regions. This will not happen under the present land tenure system. Those farmers fortunate to have land near transport arteries or consumption centers will continue to accrue unearned profits due to location. At the same time the multi-channel marketing system is being implemented, the GRZ could establish a "regional land fee" policy to reflect the relatively scarcity of "line of rail" land.

An additional constraint to the development of the agricultural sector is the lack of an adequate data base and analytical capacity with which to develop a coherent development strategy and the policies to implement that strategy.

Recent Policy Changes

i) Increased Agricultural Prices

Much of the recent performance in agriculture (positive and negative) can be traced to the larger economic problems mentioned earlier (see Section III.A.), and to the major efforts made by the government to correct some of the more serious economic policy problems in agriculture. Producer prices in current terms have increased significantly since 1975. Using the implicit GDP price deflator, real maize prices have increased by roughly 45% since 1979/80 and those for soybeans by 12%. For almost all other commodities, real prices have also increased. In general, the government has made a major effort to sustain, and improve in a number of cases, the real incentive structure in agriculture. As mentioned before, the recent depreciation of the kwacha has placed the price incentive structure in grave danger.

However, without the devaluation/depreciation, the restructuring process on which the GRZ has embarked would largely, if not totally, be a futile effort.

The movement toward an open market determined exchange rate is the most important policy reform in Zambia and must be protected/supported to the fullest extent possible. One of the next most important policy reforms is the movement toward eliminating subsidies to maize and fertilizer and opening the marketing system to private trading in all commodities. This will negate the need for the GRZ to set producer prices on a regional basis. The GRZ will only need to establish the national minimum and the intervention prices as agreed to in the ZAMCAM Agreement. The agricultural sector has shown some improvement since 1979/80; but while several significant policy reforms have already been initiated, the additional policy reforms promised need to be implemented, as well.

In 1983, the explicit fertilizer subsidy to NAMBoard was reduced as prices for fertilizer rose from K14.9 per 50kg bag to K24.2, a 60 percent increase. This increase explains much of the decline in fertilizer usage by commercial farmers. The price of fertilizer was again raised to K28.60 for the 1984/85 crop year. Further price increases are due if the subsidy on fertilizer is to be reduced. To date it is not clear whether sufficient price increases have occurred to reduce the NAMBoard fertilizer subsidy by one third, as required by the ZAMCAM Agreement; however, an announcement regarding another, substantial price increase is expected very shortly.

For 1985/86 producer prices have been increased for all commodities. Maize prices have increased by 17%, groundnut prices by 15-20%, soybean prices by 28%, wheat prices by 37%, cotton prices by 25%, and rice by 13%. The three long-neglected commodities for which many Zambian farmers have a comparative advantage, millet, sorghum and cassava, have had significant price increases over the past two years. However, the rate of inflation over the past few weeks has been very high (roughly estimated to be 80%) so that prices in real terms have dropped considerably. The auction system depreciation of the kwacha and the large increase in production costs makes it increasingly problematic that production will be sustained without the large price increases previously mentioned.

ii) Non-Price Producer Incentives

The Government has introduced a number of non-price producer incentives, notably concessional tax rates for agricultural incomes; accelerated depreciation and customs duty exemptions for farm machinery; foreign exchange retention allowances for those marketing over, for example, 5,000 bags of maize, and 50% retention of foreign exchange earnings for those exporting non-traditional commodities. Tax rates on farming incomes were reduced from 80% to 25% in 1981 and to 15% in 1982, and farmers are now allowed to write off 100% of the capital cost of farm machinery and implements within two years. Although these incentives mostly benefit the medium and large scale farmers, they are needed in the short run to arrest the declining trend and to encourage increased supply of marketed production.

Future Prospects

While Zambia was a net exporter of maize during 1972-1976, it has become a net importer in recent years. Production of groundnuts and tobacco, the two traditional major export crops, declined during most of the 1970's at an annual rate of 20% and 17% respectively. Export earnings from agricultural crops in recent years amounted to K12 million, which is virtually the same nominal value as during 1964-66, indicating a considerable deterioration in real terms. The sector's contribution to diversification of the economy from mining remains much the same as at independence. The slight improvement that has taken place has been primarily due to relatively stagnant or declining growth rates in the other major sectors, rather than to an increase in real agricultural production. Agriculture must increase its contribution to export earnings if an economic recovery is to be initiated and sustained. This is the aim to which most of the policy changes have been directed; foreign exchange auction, market liberalization, freeing of import license procedures, subsidy reductions, economic pricing, etc.

C. Required Policy Changes

The GRZ has embarked on a comprehensive package of policy reforms in order to restructure the economy away from its reliance on declining copper exports, imported equipment and other inputs, and capital intensive modes of production--which have helped create and then exacerbated the current economic crisis. These reforms include the devaluation and continued flexibility of the exchange rate, recently continued by implementing an auction system for available foreign exchange, the increase of agricultural producer prices and an agreement to adopt a pricing methodology utilizing border price concepts, the raising and gradual decontrol of agricultural consumer prices, the phased elimination of consumer, farm input (namely fertilizer) and commodity subsidies, budgetary and wage restraint, and eliminating interest rate controls. In addition, the Government has agreed to allow private traders to enter the maize market and compete with the current NAMBoard/PCU parastatal monopoly, although this policy reform has not yet been implemented.

Most consumer price controls have been removed. While maize still has a uniform consumer price ceiling, retailers are now allowed to charge for transportation services beyond 25km. Despite the positive effect of removing price controls, many parastatals are reluctant to raise prices to full cost recovery due to social and political pressure. Producer prices for most agricultural commodities continue to be set by the GRZ, although the bulk of the food commodities, except maize, is traded at prices above the floor price. Under the current reform program, however, supported by both AID (the ZAMCAM Program) and the World Bank (the Agricultural Rehabilitation Support Project), the GRZ plans to allow these prices to serve as floor prices, with NAMBoard becoming the buyer of last resort. This is in fact already occurring in some commodities, primarily due to the relatively low producer prices set by the government.

With copper reserves running out and with the labor force continuing to grow at its current rate, Zambia has no choice but to restructure its economy to diversify its exports, to replace as many imports as it can efficiently produce domestically (particularly food imports), and to generate productive employment opportunities as fast as possible. Its only alternative is to experience a continuing decline in its ability to import and to provide jobs and a satisfactory level of income for its people.

This restructuring effort is vital to the economic health and security of Zambia and, in view of the social unrest that could eventually occur if present trends of declining incomes and growing unemployment continue, to political stability as well. Restructuring is an effort requiring urgent and continued attention at the highest levels of the Zambian political system, to ensure the timely implementation of the reform program already set forth, forestalling or neutralizing the opposition of adversely affected groups, and to keep public attention focused on the best interests of the Zambian nation as a whole. It is also an effort deserving strong support from the international donor community, including the United States.

The success of such a restructuring effort will depend heavily on changing the price signals 1) to encourage producers and potential investors to direct more productive resources toward the agricultural sector and toward more labor-intensive industrial activities and 2) to encourage consumers to switch their consumption habits as much as possible away from tradable commodities (both exports and imports) toward other commodities produced domestically. This is a necessary and vital first step.

The discussion above has noted the discrepancies between current relative prices and the true economic value of key commodities, imported inputs, and factors of production. Primary among these distorted relative values have been those created by the overvalued foreign exchange rate, which caused imported commodities and inputs to look cheaper than domestic substitutes of the same quality. The importation and use of sophisticated capital equipment looked cheaper than hiring more domestic labor to do the job with less expensive equipment. The profitability of export production was artificially reduced, lowering producer incentives to reinvest capital in maintaining or expanding output or to attempt new export production. Since the kwacha value of domestic commodities produced for export or import substitution was also artificially reduced, so was the resulting demand for domestic labor.

The overvalued exchange rate, therefore, not only reduced incentives to produce commodities that could earn or save foreign exchange, but it also lowered the effective demand for and value of the domestic resources (such as land and labor) used in the production process. Thus domestic employment and income has been reduced as well as the ability to import essential commodities. Appropriate exchange rate adjustments were essential if an export- and employment-oriented development program is to have any chance of real success in Zambia, which is why the success of the auction system just instituted is so important. The economic benefits of a devaluation derive primarily from its effect on relative prices--raising the domestic kwacha prices of tradable commodities relative to those of non-tradables. This will change the incentives to produce and consume in desired directions, and while the higher prices for certain tradable commodities (such as, in the case of Zambia today, maize) will be harder for some elements of the society to absorb than others, those same groups will generally be the ones to benefit more from the higher demand for domestic labor and locally produced goods that will ensue.

The devaluation of the kwacha exchange rate occurring through the auction system will increase the number of crops and manufacturing activities for which the country will have an effective comparative advantage, encouraging new exports and new production for import substitution. It will also enhance the profitability of those crops and activities for which Zambia already has such an advantage, thereby encouraging an expansion of their production, so long as pricing policies and marketing arrangements allow the increased kwacha value of tradable commodities to be passed on to the producers. This is expected to save or earn more foreign exchange for essential imports, increase productive employment, and increase domestic income.

Devaluation was necessary, but it is not sufficient by itself, however. To be successful, it must be accompanied by other measures to rationalize the entire trade regime, to promote exports, to encourage and facilitate new investment, and to restrain domestic demand (namely credit expansion, budgetary deficits, and negotiated wage increases), in order to keep domestic inflation from overtaking and cancelling the effects of the devaluation.

Wage restraint is important not only to reduce the growth of domestic demand, but, since wages represent the price of an important factor of production, it will also improve producer incentives to employ more labor versus more machines in the productive process. For an employment-oriented development strategy to be successfully implemented, it is essential to prevent administered or legal minimum wage levels from rising much above alternative sources of worker income. In the case of Zambia, where urban wages are already significantly higher than rural or informal sector incomes, wages should continue to be made to fall in real terms by not permitting them to rise as fast as inflation, until more of a balance is restored. Reducing rural/urban wage disparities would not only produce a more equitable distribution of income, but it would also help to reduce the rural-urban migration in search of higher wages and to keep more labor on the farms where it is needed to increase agricultural production. The main reason for reducing real, formal sector, urban wage rates, however, is to encourage more rapid employment generation. It is far better for the economic and social health of the nation for more (and a growing proportion of) workers to have jobs paying a living wage than for only a small (and declining) percentage to have jobs with higher wages.

The interest rate on capital loans is the other important factor price affecting producer incentives to employ more labor. It should be kept at sufficiently positive real levels to encourage more efficient rationing of capital equipment and other inputs among alternative uses and to raise the cost of more capital-intensive modes of production relative to those providing more employment. The GRZ recently eliminated all controls on the interest rate.

In addition to appropriate exchange rate and factor prices, domestic commodity prices must reflect the relative economic values of the different products. If administered prices result in serious distortions in the prices of key commodities, skewed investment incentives will result in overproduction of the more favorably priced items and underproduction of those with lower prices (in the case of controlled producer prices), and consumers will overconsume subsidized commodities instead of utilizing lower-cost substitutes (in the case of controlled consumer prices). In Zambia many commodity prices have been decontrolled during the last few years. The key remaining prices subject to administrative controls are those for maize (producer and consumer) and fertilizer, which result in a substantial subsidy burden on the government budget, in addition to the misallocation of investment resources. These are being addressed with a package of policy reforms supported by the ZAMCAM Program, to which PAAD the reader is referred for details (especially pages 27-30).

The maize producer price has differed from its true economic value in three major ways: 1) the use of a cost-plus pricing methodology; 2) the use of a "pan-territorial" price; 3) the use of a "pan-temporal" price. This has led to uneconomic production patterns, wasteful transportation and storage costs, and inadequate production incentives.

The administered price of fertilizer has been kept below actual economic costs by 1) the overvaluation of the kwacha exchange rate (resulting in the undervaluation, in kwacha, of the imported chemicals used in manufacturing the fertilizer compounds), 2) direct subsidies on production and 3) pan-territorial price controls which require NAMBoard, the sole distributor, to subsidize the costs of transport to the more remote regions. In addition to the fiscal burden of the subsidies, this has led to the general overuse of fertilizer by commercial farmers.

Finally, the consumer price of maize meal has been kept well below current production, processing and distribution costs, even as heavily subsidized as these already are, by an administered price that requires the government to subsidize NAMBoard. In addition to the obvious fiscal burden this imposes on the government, it has led to overconsumption and even wasteful uses of maize vis-a-vis substitutes, and therefore to larger import requirements. While a rise in the consumer price of maize adversely affects urban wage earners and those unemployed or in the low-income informal sector these same groups will benefit from the overall policy reform program, which is designed to stimulate a higher rate of both rural and urban employment generation, to make more foreign exchange available for the imports essential for higher capacity utilization of existing industrial facilities (sustaining more employment), and to concentrate public revenues on basic economic and social services, which will also stimulate employment and income generating activities. The reduction and eventual elimination of consumer subsidies are important elements of that program.

D. Effects of Proposed Reform Program on Major Groups

It is important to consider the effects of the reform program on the different groups of people in the country and to identify ways to ease the transition for those groups more adversely affected. Nevertheless, it must be remembered that the positive impact of the program for the whole country should far outweigh the adverse effects of individual reform elements on particular groups. If current trends are allowed to continue Zambia will continue to face growing unemployment and underemployment, high rates of urban migration in search of non-existent jobs, further reductions in its ability to import goods and services essential for the utilization of existing productive capacity and the creation of new capacity, sluggishness and inefficient use of resources in agricultural production, and a further decline in per capita income. The government's reform program is designed to rectify this situation. Each element of this program is an integral part of the total effort and cannot be justified or easily defended in isolation. The ultimate goal, however, is an employment-oriented development program designed to mobilize the rural population to better utilize the country's vast agricultural resources and to mobilize the urban population in support of agriculture with marketing, processing, production inputs and incentive consumer goods, as well as manufactured exports of their own.

Zambian agriculture faces difficult technical and physical constraints, in addition to the policy problems toward which this program is directed. The need for politically difficult policy reforms is often discounted in favor of getting on with the research required to improve productive technology or, more frequently, the physical infrastructure and government services needed to bring about and support increased agricultural production.

The lessons of historical experience, however, indicate that if the policy matrix is not right, investments in technical research, rural infrastructure and improved government services, such as extension programs, will not by themselves lead to successful agricultural development. Policies which make agricultural production profitable and which reward the individual efforts of farmers and farm workers, particularly marketing and pricing policies, are prerequisite to success, without which expenditures on the more costly and time-consuming agricultural development activities, no matter how wisely selected and designed, will be mostly wasted.

The following discussion of the effects of the GRZ reform program, including the major devaluation resulting from the auction system to be supported directly by ZAP Support, on the major groups affected--farmers and urban consumers--is presented with the above caveats in mind. For purposes of this discussion the farmers are divided into three groups--commercial farmers, "emerging" smallholder farmers, and subsistence farmers; and the urban consumers are divided into two groups--formal sector wage earners and informal sector workers, the latter including the unemployed (since they cannot be statistically separated).

The commercial farmers will face higher prices for both imported inputs (fertilizer, insecticides, tractors, spare parts, fuel, etc.) and outputs (for export crops and those replacing imports). Because the typical commercial maize farmer utilizes a large amount of imported inputs, the prices of which will increase by the same percentage as output prices (except for fertilizer, which will increase more rapidly when current subsidies are withdrawn), his profit margins might decline unless greater efficiency is achieved in the use of such inputs. Most of these farmers are located along the "line of rail," and they will retain their natural advantages of location and the lower associated transport costs. Eventually, many of these farmers may find that their comparative advantage lies in other crops requiring more sophisticated farming techniques and aimed more toward the export market, leaving more of the maize production to the smaller farmers.

The smallholder, "emerging" farmers will most likely receive higher prices for their outputs, but total input costs will rise less than for the commercial farmers, since fewer imported inputs are used. Maize producer prices in the more distant surplus regions will be reduced (from the border price equivalent) by the cost of transportation to the nearest deficit region or urban market. This should be more than made up, however, by the increase in producer prices resulting from a kwacha devaluation to a realistic exchange rate.* Furthermore, there seems to be considerable scope for greater efficiency in transportation activities, which should begin to be realized when private traders are permitted to enter the market, so that the magnitude of transport costs borne by surplus producers should be relatively less than those presently borne by NAMBoard.

Subsistence farmers, by definition, will not be directly affected by changing market arrangements and prices--unless they purchase fertilizer or other inputs with cash earned in other occupations, in which case they would be affected by the higher, unsubsidized price for fertilizer. It is likely, however, that more of them will be enticed to produce for the market (and thereby cease to be subsistence farmers) by the higher product prices and easier marketing arrangements expected to follow these reforms. They will certainly benefit from a greater government capacity (derived from the more efficient use of scarce managerial and financial resources resulting from this program) to implement development projects and provide economic and social services in remote areas; and their children will benefit from faster economic development and employment generation in urban areas.

Urban (formal sector) wage earners are one of the better off groups in

Zambian society, because urban wages are still considerably higher (although they have suffered a substantial real decline over the last several years) than rural incomes or the incomes of those households dependent on the urban informal sector for their livelihood. As the reform program is implemented, this group will initially suffer a still further reduction in real wages due to higher maize consumer prices, higher prices for imports, and continued wage restraint. This will eventually be mitigated, at least in part, by lower domestic marketing costs (which will bring maize prices back down somewhat) and a greater availability of consumer goods in general (from higher domestic production and an improved capacity to import). Depending upon the implementation of other reforms affecting manufacturing, mining, social services, etc., this group should benefit from enhanced job security as the whole economy begins to pick up and domestic demand increases, and as the greater availability of industrial inputs allows a higher rate of capacity utilization (and employment) in existing plant facilities. They will also benefit from the achievement of the ultimate goal of the reform program--to stop the steady decline of per capita income in Zambia and turn it back up again--which will eventually result in more rapid employment growth and rising wage rates.

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* In a country with such extensive agricultural resources as Zambia, an exchange rate could not be considered realistic unless it provided sufficient kwacha, at appropriate border price equivalents, to cover the necessary costs of production and transportation of most of the basic agricultural commodities needed to meet domestic demand. In a comparatively free market situation, supply and demand for foreign exchange would not be equated at a rate of exchange which would make imports of bulky, basic staple grains like maize cheaper than domestic costs of production (unless there was some higher value export commodity that could be produced instead), since excess import demand for foodgrain would bid up the equilibrium rate until most of it could be produced at home.

Urban informal sector workers and the unemployed, believed to be among the lower-income groups in Zambia, will also suffer declining real income initially due to higher maize prices and (of lesser importance to them) higher import costs. This will eventually be alleviated by more efficient marketing and somewhat lower prices, more job opportunities in the higher income formal sector, and higher incomes from more rapidly growing food processing and other production activities in the informal sector. To encourage this latter growth, the GRZ should consider ways to legitimize and facilitate informal sector activities, allowing them better access to imported inputs, credit, public training programs in business-related subjects like accounting, management, marketing, etc. The ZAP Support Fund will help speed the economic adjustment process and thereby alleviate the hardships imposed on this group a little sooner than otherwise.

It is clear that this will be the group most adversely affected in the short run by the reform program, since the cost of maize meal is thought to comprise a significant portion of their household budgets. The GRZ might want to consider a targetted food distribution or public employment program to provide some short-term relief for the hardest hit elements of this group. The GRZ is presently conducting a survey of such households and will be considering how this might be successfully done in the near future. USAID/Zambia is ready to propose PL 480 Food for Work Programs that might help.

If similar studies in neighboring countries can provide any insights, however, the "survival techniques" of such poor households usually involve extended family arrangements, including links to other relatives who are more remuneratively employed or are working on a family farm somewhere, and who can be relied upon for assistance when times get rough. If the GRZ reform program is successful in making agricultural activities more profitable, the bread-winners of many of these households can be expected to return to rural areas to seek employment or to resume farming themselves. Most of these households have migrated from rural areas to the cities during the last decade or so, precisely because the pricing and marketing system was biased against agriculture and it became increasingly difficult to make a decent living on the farms. The reform program will reduce the urban bias and increase incentives to return to the land.

IV. THE ROLE OF OTHER DONORS

A. World Bank

The World Bank recently approved the Zambia Agricultural Rehabilitation Project to support a program of policy reform for the agricultural sector described in the "Memorandum of Development Objectives and Policies," submitted to the Bank by the GRZ in January 1983, which affirmed the Government's commitment to:*

> "provide a system of incentives to producers of agricultural products, based on a sound price setting methodology, with a view to facilitating the establishment of economic prices and a rational allocation of resources according to the principle of comparative advantage among the various regions;
>
> "adopt a policy of economic pricing for parastatal enterprises, and streamline their operations; and
>
> "increase the efficiency of the marketing system, by allowing competition among the official marketing organizations, cooperatives, and private traders, eventually leading to a system in which official producer prices would become floor prices and NAMBoard would become the buyer and seller of last resort.

Total project cost was estimated at US$72.3 million, of which $39.9 million would be for farm machinery and implements, $11.4 million for spare parts, $19.4 million for agro-chemicals, $1.4 million for miscellaneous inputs, and $0.2 million for consultant services. The foreign exchange component was estimated at US$65.0 million, of which $25.0 million would be provided by the IDA credit and the rest co-financed by the African Development Bank ($23.4 million), Canada ($6.8 million), USAID ($5.0 million), and the Swiss ($4.8 million). Local currency costs of US$7.3 million would be financed by the local currency generations from the sale of the farm machinery and implements.

The IDA credit is to be made available in two tranches, the first SDR 10 million immediately upon credit effectiveness and the remaining SDR 14.7 million approximately 15 months later, subject to satisfactory progress toward implementing the policy reforms being supported.

Current progress on the project is as follows:

a) the first tranche of $10 million (supplemented by an additional $10 million in June 1985) has been released.

b) the major consultant study dealing with maize marketing, strategic reserves, etc., will be contracted for before the end of the calendar year. A preliminary report is expected by late March and the final report is due by late May.

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* World Bank, "Report and Recommendation of the President of the International Development Association to the Executive Directors on a Proposed Credit of SDR 24.7 Million to the Republic of Zambia for the Agricultural Rehabilitation Project," December 18, 1984, pp. 14-15.

c) no further significant study is to be done on fertilizer; rather the project will attempt to apply the findings of the ZATPID-funded fertilizer study.

d) all project funds will be released through the newly instituted auction. This has already caused some concern as the project had not been designed in that way. Project foreign exchange is tied to the procurement of agricultural or agro-industrial commodities, and in the initial auctions this category has not been drawn down to the extent expected.

Nevertheless, the implementation of the World Bank project, with which USAID's ZAMCAM project is closely associated, appears to be proceeding reasonably well.

Also in the recent past (June 1985), the World Bank approved the Industrial Reorientation Project for $75 million. The objective of this project is to raise capacity utilization and production levels of efficient industrial enterprises in Zambia in order to increase the supply of manufactured goods for both the domestic and export markets. The project supports policy and institutional reforms designed to increase the efficiency and productivity of industrial firms and to reorient the industrial sector towards greater use of domestic inputs and towards export markets. To accomplish its objective, the project provides financing for: a) imports of spare parts, raw materials, intermediate goods and other inputs, and b) technical assistance, equipment and training to help improve INDECO's capacity to evaluate investment projects and improve the operation of existing public enterprises, to enhance to BOZ's capacity to forecast and budget foreign exchange, to establish a tariff commission in the MOF and to set up an export promotion board in the Ministry of Commerce and Industry. Credit effectiveness depended on two major policy changes taking place: a) introduction of an auction system for foreign exchange, and b) elimination of the present system of import licensing. These policy changes took place on October 3, 1985. As this project was specifically designed to support the auction system there have apparently been no adverse effects in its early implementation.

B. IMF

The present IMF Standby Arrangement (of SDR 225 million for 21 months) became effective July 26, 1984. The arrangement supports Zambia's economic restructuring effort toward agriculture and has as its main objectives further reduction of domestic and external imbalance to sustainable levels.

Under the program, the GRZ undertook a number of measures aimed at further strengthening public sector finances and restraining domestic consumption. The overall budget deficit was to be reduced from 6.9% of GDP in 1983 to 4.5% in 1984 through a combination of measures to raise revenue and reduce real expenditures. Revenue and grants were programmed to increase by 15.5%, reflecting mainly higher excise and import duties, including a new minimum import duty rate of 10% and a shift in the basis for taxing imports from f.o.b. to c.i.f., to be effective August 1, 1984. In addition, the program included a number of administrative actions aimed at improving tax collection. Expenditure growth was to be limited to 7%, well below the projected level of price increases, including sharply reduced levels of real outlays for personnel emoluments and subsidies. As a percentage of GDP, total expenditure (excluding interest payments) was to be reduced to about 27% compared with 32% for 1983 and an average of 38% for the period 1980-82. Furthermore, the authorities undertook to establish a blocked account for government external debt service into which monthly payments were to be made in domestic currency, regardless of the availability of foreign exchange. Despite less recourse to domestic nonbank borrowing, banking system credit to the government was to be limited to K175 million, equivalent to 12% of the broad money stock at the beginning of the period. Total net domestic assets of the banking system were to increase by the equivalent of 23.9% of broad money, of which credit to the non-government sector, including parastatals and marketing agencies, was to account for nearly 50% compared with 41% in 1983. Broad money was projected to rise by 15% compared with the projected growth in nominal GDP of 25%. Interest rates were increased by an average of 2 percentage points, with the maximum lending rate raised to 15% since raised again to 17%.

On the supply side, the program included increases in agricultural producer prices ranging from 12% to 42%, greater price liberalization and higher retail prices in key areas of the economy (including significant increases for a number of key products such as maize meal, petroleum products fertilizer, and beer), and additional efforts to reduce costs and increase managerial efficiency in parastatal enterprises. These measures are to be buttressed with continued wage restraint and enhanced operating efficiency of the non-government sector. The program envisaged no increase in real GDP, reflecting the limited possibilities for increasing mineral exports, which are expected to account for 97% of total exports, and the limited prospects for increasing capacity utilization in the domestic manufacturing sector, in view of the acute shortage of foreign exchange resources.

Discussions on a new agreement between the IMF and the GRZ are scheduled to resume in November 1985. Major areas of concern, now that the foreign exchange auction system has been instituted, will include the size of the fiscal deficit, the allowable rate of money supply (and therefore domestic credit) growth, the need for continued wage restraint, and how to finance external debt service requirements. Until the discussions are completed little of a definitive nature about the new agreement can be said.

C. Other Donors

Great Britain. Britain is considering reprogramming a portion of its regular project aid for the current year to be in support of the auction system. This would mean that an additional L4 million would become available in the near future. This foreign exchange will be restricted to UK source procurement and will have to utilize the Crown agent procurement system. Discussions are proceeding regarding the possibility of providing a supplemental of up to L10 million which would be subject to the same restrictions.

Canada. Canada has indicated that it might be willing to reprogram its current project pipeline of C$12 million to be in support of the auction system if requested to do so by the GRZ. They also intend to provide their current year allocation (C$8 million) to support the auction system, but those funds will not become available until mid-1986. Canadian foreign exchange would similarly be restricted to procurement of Canadian goods and services.

The GRZ intends to solicit other donors, such as Sweden, which have sizeable project pipelines regarding the possibility of reprogramming such funds to support the auction system.

V. PROPOSED U.S. ASSISTANCE

A. Objectives

There is broad agreement that economic development in Zambia depends on a fundamental restructuring of its economy away from the present overwhelming dependence on copper exports to much greater use of Zambia's agricultural and labor resources, providing more productive employment opportunities for its workers. In the short run, realizing that objective requires substantial and continuing policy changes which will increase the profitability of more labor-intensive, export-oriented industrial and agricultural production, both of foodgrains and export crops such as coffee, tobacco and confectionary groundnuts. Several major steps have already been taken or are in process to bring about these changes, including the dramatic decision announced on October 3, 1985, to institute a free market auction system for foreign exchange. The ZAP Support Fund proposed in this PAAD is designed to support the exchange rate auction system directly. First and foremost, it will alleviate what is considered to be the most critical constraint to the success of the new system--insufficient foreign exchange to maintain a viable, regular auction and to build public confidence in the new procedures. Secondly, it will help reduce the fiscal deficit, itself temporarily puffed up by the higher kwacha value of GRZ purchases of foreign exchange (for both imports and debt service payments) until new revenue measures can be put into effect. And thirdly, by reducing public borrowing to finance the deficit, it will increase the availability of private sector credit to finance a) imported inputs through the auction system, b) operating capital required to maintain existing capacity, and c) new investments. Because of the auction system's importance to the success of the overall structural adjustment program, ZAP Support will be providing indirect, but nevertheless critical, support to the other elements of the program, as well.

In designing the program, the Mission reviewed the merits of a cash transfer versus a Commodity Import Program (CIP). The Mission concluded that the cash transfer mechanism consitutes the only appropriate means to achieve the desired support for the auction, for the following reasons: (a) provision of untied cash allows the auction to perform the function of allocating scarce foreign exchange more effectively, as use of a CIP would introduce source/origin requirements which could create pockets of slow moving currency (as is the experience with IBRD agricultural rehabilitation funds); (b) the requirement for foreign exchange to support the auction is immediate, and provision of a cash transfer is the quickest way to provide funds; and (c) with the imminent release of the first tranche of ZAMCAM ($7 million) tied to U.S. source/origin and transport sector, provision of additional CIP-type funds might create absorption difficulties.

ZAP Support is a logical continuation of the current AID assistance program in Zambia, as it has evolved over the last five years. Recognizing the importance of better policies, the Zambia FY 1982 CDSS (approved in 1980) identified the improvement of Zambia's institutional capacity to analyze development problems and the implications of alternative policy decisions as a key area of emphasis. The design and implementation of the Zambia Agricultural Training, Planning and Institutional Development (ZATPID) Project (currently underway) is consistent with this assistance strategy. It is fair to say that much of the recent progress in designing and implementing policy reform measures can be credited to the increased awareness of the implications of policy alternatives engendered by the research, training and analysis sponsored and supported under the ZATPID Project. The importance of better policies was re-emphasized in the FY 1985 CDSS deliberations and validated by a major evaluation of AID's assistance strategy for Zambia in 1983.* Subsequent CIP and PL 480 agreements have included progressively stronger covenants by which the GRZ committed itself to continued reforms in agricultural pricing and marketing policy.**

The recently (September 1985) obligated ZAMCAM Program, which at $25 million is so far the largest of the new Africa Economic Policy Reform Programs (AEPRP), continues this emphasis on agricultural policy reform, supporting three related policy reforms designed to improve the efficiency of the agricultural marketing system for maize and fertilizer, including 1) the establishment of a multi-channel marketing system for maize and fertilizer, allowing any producer, trader or processor to sell to any buyer, 2) permitting maize and fertilizer prices, based on appropriate border prices, to vary enough to cover the different transport, storage and handling costs incurred in different parts of the country and at different times of the year, and 3) the elimination of all subsidies to all governmental and quasi-governmental organizations involved in the food production and distribution system. The Macroeconomic Analysis section of the ZAMCAM PAAD emphasized the importance of a realistic exchange rate, which at that time clearly required a major devaluation, if the other reforms, particularly those relating to producer prices for both inputs and outputs, were to make any economic sense.

B. Policy Change to be Supported

On October 3, 1985, President Kaunda announced that, effective on that day, "a free exchange rate system will be adopted for the Kwacha and this exchange rate will be freely determined in the market place." The "auction system will be used both to determine the exchange rate and, except for the items exempted, to allocate foreign exchange to the users...All the foreign exchange will be auctioned except for the following purposes:

- o Use by the Party and its Government;
- o Use by the Bank of Zambia;
- o Debt payment;

* Aulakh, Ravi, C. Stuart Callison, Colette Claude, and Dirk Dijkerman, *Evaluation of AID's Assistance Strategy for Zambia*, U.S. Agency for International Development, Nairobi, June 1983.
** These are summarized in Annex A of the Zambia Multi-Channel Agricultural Marketing (ZAMCAM) Program PAAD, dated May 30, 1985.

- o Use by ZCCM under the retention scheme;
- o Purchase of crude oil;
- o Purchase of medical and educational supplies;
- o For meeting Zambia Airways IATA bill; and
- o For specific projects or specific companies.

"Foreign exchange for these purposes will allocated as at present. However, the ruling exchange rate (as determined in the auction) will apply."***

The President, in the same speech, summarized the unfavorable economic trends that have afflicted Zambia over the last decade, somewhat more eloquently than the discussion in Part III, above, and cited seven serious problems or weaknesses of the former, less market-oriented exchange rate system:

1) It "was not designed to deal with the structural problems facing the economy brought about by the long-term decline of the mining industry."
2) The "fixing of the rate was, in relation to the strength of the economy, unavoidably arbitrary with the consequence that the official rate was always behind the true exchange rate."
3) "With the exchange rate (the price of foreign exchange) not being adequate, the incentive to the potential exporter was similarly insufficient...If exports are to be..encouraged, it will be essential for Zambia not only to improve the competitiveness of her exports, but also to give the exporter a good return. This matter is especially urgent because of the rapid decline of the mining sector and the need to give added impetus to non-mineral exports."
4) "Owing to the scarcity of foreign exchange..it is important that the use of local raw materials should be intensified. For this to happen, the prices of local raw materials must be lower compared to those of imports...The exchange rate is the best instrument for changing the relative prices of imports. However, since the time for effecting these basic changes in the economy is short, the exchange rate policy must be employed in such a way that it induces positive action in as short a time as possible."
5) "While capital equipment has to be imported at great cost in foreign exchange, labour is available in the country...Owing to the comparatively low cost of foreign exchange, it has sadly been preferable to use capital equipment instead of the abundant and increasingly idle labour...The comparative cost of capital equipment, in relation to labour, must be changed in favour of labour. Again, the best instrument to achieve this is the exchange rate policy."

*** Full text of President Kaunda's remarks delivered to a news conference, "Why FOREX Will Be Auctioned," *Sunday Times of Zambia*, October 6, 1985, pp. 3 and 4. See Annex E for details on how the auction system is operating.

6) Because of (the persistent balance of payments deficits), Zambia's external debt by way of payments arrears has increased. If the deficits are not arrested, these debts will continue and grow even further. One way of dealing with the deficits is to discourage the use (and) consumption of foreign goods and services by making them less attractive. Again, the exchange rate is the best instrument for achieving this objective."
7) "The (then) present system of import licensing and manual allocation

of foreign exchange involves a considerable number of administrative decisions. There is no way these decisions can always be fair...Any individual..fortunate enough to get an import licence can become a monopolist and charge whatever price he pleases for his product...To minimise the incidence of inefficient allocations it is necessary to reexamine the system and to see in what way it can be made less subjective and less dependent on the human factor."

President Kaunda went on to recognize the hardships this new foreign exchange rate policy is likely to engender in the short run. He said,

"We in the Party and its Government have studied and analysed very carefully the economic problems that face us. We have also looked at the various options before us...The option we have chosen is one that we think best serves the interests of the country and our people...

"However, let me hasten to add that this measure alone without taking other collateral measures, will not bring about a sudden upswing in the economy. But taken together with other measures such as rigid control of Government spending, increasing agricultural production, labour productivity, creative management, continued political stability, peace and security, the day should not be far off when we should all feel the salutary effect of the action I have just announced.

"I call on peasants, workers and employers in all walks of life to respond to these measures with calmness, courage, determination, hope and realism. The challenge we face is to win the economic war. This is what the Economic Crusade 1985 is all about...

"I know the cost of living is already high. To most of our people, it is unbearable. If it were all in the power of the Party to turn silver into gold, no one would need to push us to use this magic power; for we are here to work for the interests of the people. But the Party does not have this magic power. It can only do what is possible for mortal people to do. And this is what we are doing.

"We are saying to our people that it is within their power to turn adversity into opportunity, despair into hope. This is not the time to mourn. It is not the time to lament our problems. None of these things will do us any good. It is time to act...We must take the bull by the horns. We must beat the cost of living by producing locally most of the things we consume..."

President Kaunda, by making such an eloquent statement to the public explaining the need for the exchange rate decision and appealing for forebearance and support, despite predictable hardships, and by throwing his immense personal prestige behind the entire reform process as in the best interests of the nation as a whole, has vastly improved the chances of its ultimate success without serious social and political unrest. Nevertheless, the adjustment process will be a difficult one, economically and politically, in the short run, and additional, equally unpopular decisions will soon have to be made in order to maintain the coherence of the entire economic policy matrix (i.e., maize and fertilizer prices will have to rise by substantial amounts in order to match border price equivalents, to continue the process of reducing subsidies, and to maintain sufficient production incentives in the face of the higher kwacha cost of imported inputs).

The first three weekly auctions have gone reasonably well. The vast majority of bids have been small, in the US$50-60,000 range, and from well known Zambian firms. There were no large bids of US$1 million or more; and there has been no evidence of unscrupulous practices by minority traders to corner a market in foreign exchange or to influence the outcome of the auction, as some had feared. Most bids have been for equipment, spare parts and other industrial or commercial inputs. The main disappointment has been the slow rate of drawdown of the World Bank Agricultural Rehabilitation Project funds, totalling US$25 million and initially made available for auction at the rate of $3.0 million per month. Winning bids at the first weekly auction included only $100,000 for agricultural equipment and supplies eligible for these credits. The second auction included about $500,000 and the third about $330,000 of eligible winning bids.

It is believed that agricultural equipment and supply importers, and those of their client farmers who produce maize (the bulk of them), are holding back or bidding low because maize producers prices are still controlled at pre-auction border price levels. Most of the winning agricultural bids so far have reportedly been for irrigation equipment, chemicals and spare parts that could be used mainly for uncontrolled crops. The slow drawdown of World Bank funds has required the Bank of Zambia to put up more of its own foreign exchange than planned, in order to maintain the US$5.0 million amount promised for auction, taking it away from other priority, and scheduled, uses (like debt service payments, pipeline reduction etc.). The GRZ is presently considering higher prices for maize and fertilizer, which are expected to be announced soon, and this should encourage more agricultural bids.

Zambia has thus become the first politically stable African country to free its foreign exchange rate and embark on such a complete overhaul of its economic policies to allow free market forces to prevail. The success of the foreign exchange auction system is crucial to the success of the entire structural adjustment process, including the agricultural policy reforms supported by the AID program these last several years. It therefore deserves the strong support of the U.S. Government and other foreign donors to the maximum extent possible. The Africa Bureau and USAID/Zambia are for these reasons proposing to make the entire FY 86 OYB for Zambia, $22.5 million, available on a cash grant basis, with as few strings and as expeditiously as possible, to support the foreign exchange auction program. This will help assure the success of the program (since one of its most critical constraints is the sheer lack of free foreign exchange to support the weekly auction), alleviate some of the economic hardship of the structural adjustment process (by allowing a higher level of imported inputs and incentive goods to increase capacity utilization and encourage new investment), and provide additional foreign exchange for the essential agricultural and industrial inputs required to get this economy going in the right direction.

C. Resources for the Program

1. Foreign exchange. This program proposes to grant the GRZ $22.5 million of foreign exchange which will be auctioned through the current auction program. Use of this AID-provided foreign exchange will not be tied to any source/origin requirements. All AID-provided funds must be disposed of through the auction program and cannot be reserved for other GRZ requirements for foreign exchange such as payment of debt arrearages, etc. (See page 25 above and Annex E for foreign exchange reservation categories). Discussions with GRZ and local IMF officials indicate that the GRZ is committed to auctioning off all foreign exchange not legally or absolutely required elsewhere. In this context, any additional foreign exchange from AID and other donors will automatically be additional to whatever level the GRZ can itself provide from its own sources.

The anticipated pattern of release of AID-provided foreign exchange is that $1.0 million will be released for each weekly auction for the first 10 weeks of the program and $500,000 each week thereafter until the funds are exhausted, though the flexibility should be retained to change the rate of disbursement if later circumstances indicate a different rate would more effectively support the success of the auction system. This pattern of disbursement was requested during PAAD preparation by GRZ officials, who wanted to balance the need for a stable, prolongued supply of foreign exchange with the need for a little more up front until other donor sources of supply, currently under discussion, can be realized.

2. Local currency. This program will generate a very significant

amount of local currency. The auction program (see details in Annex E) provides that bidders deposit local currency equivalent to their bid prior to the auction date. That local currency is immediately deposited if the bid is successful at the exchange rate set by that auction. As exchange rates can be expected to fluctuate during the life of this program, it is impossible to determine beforehand the exact amount of local currency that will be generated. Early indications would project from K120 million to K160 million.

Local currency resources of these dimensions cannot be responsibly and efficiently programmed by a USAID the size of USAID/Zambia, particularly when taken together with local currency resources already on hand and being generated by various PL480 and CIP programs (as well as ZAMCAM). Consequently, USAID/Zambia intends, on a one-time basis, to arrange with the Ministry of Finance for the ZAP Support-generated local currency to be utilized for general budgetary purposes.

The GRZ is expected to adopt a target rate of growth for the domestic money supply, related to the real growth of the economy, and this, if implemented, would automatically limit the rate of domestic credit expansion to an acceptable range. With the level of total domestic credit relatively fixed, the amount available to the private sectors of the economy is a residual determined by the size of the GRZ fiscal deficit financed by the domestic banking system. By utilizing the local currency generations for budgetary support, thereby reducing the fiscal deficit by an equivalent amount (assuming the availability of these local currency generations itself will not cause an increase in the level of expenditures), ZAP Support will indirectly increase the amount of credit available to the private sector in Zambia by that amount. Since 1982 the GRZ has exercised much tighter control over the budget than before, so that the level of expenditures authorized in 1986 is not expected to be affected by the availability of ZAP Support counterpart funds. (In the upcoming November 1985 negotiations between the GRZ and the IMF, the amount of local currency budgetary support expected from ZAP Support will be factored into the determination of a mutually agreeable fiscal deficit ceiling to be financed by the domestic banking system, and that ceiling will be lower than would otherwise be the case by the ZAP Support amount.)

VI. GRANT ADMINISTRATION AND COORDINATION

A. AID Administration

Administration of this program will place the minimum of management requirements of USAID/Zambia, which already has sufficient workload with its existing portfolio. Required activities associated with the releases of foreign exchange include periodic review of auction program implementation, confirmation cables to AID/W to release periodic tranches, and review of disbursement records to monitor the AID contribution. Required activities for release of counterpart involve verifying that deposits of kwacha are correct and arranging with the MOF to release such funds to be used in the general budget. The current USAID/Zambia staff has the skills to perform these tasks without any assistance from RFMC or REDSO/ESA; though these offices would be available, if needed.

B. GRZ Administration

The Implementing Agency on the part of the GRZ will be the Bank of Zambia as designated by the Ministry of Finance. The constituted manager of the auction program is the Foreign Exchange Management Committee (FEMC) which sets the conditions of each auction. (See Annex E for details). The FEMC will include in its weekly auction of foreign exchange those funds which are made available to it from AID on deposit in the BOZ's correspondent Bank in the U.S. (the Federal Reserve Bank of New York). The BOZ will advise USAID/Zambia of the amount of AID-provided foreign exchange it has used, to help USAID monitor the program. Regarding management of counterpart funds, the auction program provides for the prior generation of kwacha equivalent to the foreign exchange released. For releases of AID-provided foreign exchange the BOZ will immediately deposit the appropriate sum of kwacha in a special account and will release it only after USAID and MOF have arranged for such a release.

C. Implementation Procedures and Schedule

Subsequent to satisfaction of Conditions Precedent set forth in Section VI.D. below, USAID/Zambia will take steps to release the initial four-week tranche of foreign exchange for use in the auction program. USAID/Zambia will prepare a Financing Request for a Cash Transfer signed by both the Mission Director and a GRZ representative, which will cover the entire amount obligated in the grant agreement. Each four-weekly period, USAID/Zambia will cable SER/FM/PAD to confirm that the conditions for release of each four-weekly tranche have been met. FM/PAD will schedule payment through the Federal Reserve Electronic Funds Transfer System to the designated GRZ correspondent bank. These funds will be scheduled for release from the correspondent bank's special account on a weekly basis in the amount of $1,000,000 for the first ten weeks and $500,000 weekly thereafter. Such electronic transfers should be effected on the Monday prior to the Friday foreign exchange auction in question. The correspondent bank will provide USAID, by telex, a report of the actual cash disbursements from the special account on a four-weekly basis.

Generation of kwacha in payment for access to AID provided foreign exchange will be immediately deposited in a special account in the BOZ. The BOZ will advise USAID of the weekly deposits in this special account. USAID and the Ministry of Finance will agree, on a four-weekly basis, to provide the Kwacha from this special account to the Ministry of Finance's account to be used for general budget expenses. The Mission has developed procedures with the MOF for the utilization of local currency generated by PL480 programs by attributing funds to appropriate productive sectors of the GRZ budget. These existing procedures, which consist of an exchange of letters with an excerpt of the GRZ budget appended, appear to be entirely appropriate for use in attributing local currency to be generated by the cash transfer.

Implementation Schedule

TIMING (wks)	ACTION	AGENT
0 (expected o/a 14 Nov. 1985)	Signature of Grant Agreement	USAID/GRZ
1	Satisfaction of General CPs	GRZ
2	Transmission of FR	GRZ/USAID
3	Initial 4 weekly tranche released	FM/PAD
6	Confirmation for 2nd tranche	USAID
7	2nd 4-weekly tranche released	FM/PAD
7	1st tranche counterpart released	USAID/GRZ
10	Confirmation of 3rd tranche	USAID
11	3rd 4-weekly tranche released	FM/PAD
11	2nd tranche counterpart released	USAID/GRZ
	Tranche releases continue to exhaustion of foreign exchange and counterpart.	
30 Sep. 1986	PACD	USAID

D. Conditions Precedent and Covenants

Prior to any disbursement under the Grant, or to the issuance by AID of documentation pursuant to which disbursement will be made, the Grantee will, except as the Parties may otherwise agree in writing, furnish to AID, in form and substance satisfactory to AID:

1. A statement representing and warranting that the named person or persons have the authority to act as the representative or representatives of the Grantee, together with a specimen signature of each person certified as to its authenticity;
2. A statement designating the bank and the special account number into

which the foreign exchange disbursement is to be made.

3. Evidence that the GRZ has established a special account in the BOZ for deposit of kwacha generated by the AID-provided foreign exchange.

In addition to the above general conditions, USAID will provide confirmation to FM/PAD that the following conditions are fulfilled for release of each four-weekly tranche.

(a) that the auction program continues to operate in a manner consistent with the spirit of the guidelines published October 9, 1985 (reproduced as Annex E to this PAAD).

(b) that the GRZ has continued to adequately publicize the results of the auction.

The GRZ covenants the following:

1. The Grantee agrees to immediately deposit in the BOZ special account currency of Zambia (Kwacha) equivalent to the US dollar disbursement made at each auction at the highest rate of exchange which is not unlawful in Zambia on the date of the US dollar disbursement is made. (i.e. exchange rate established by that respective auction).
2. AID and the Grantee agree that the kwacha funds deposited in the BOZ special account shall be used by the Grantee for the productive sectors of the GRZ budget.
3. The GRZ covenants that it will provide reports on the utilization of counterpart fund proceeds on a six-monthly basis relating to budget attribution. This report is to be certified as correct by an appropriate official within the Ministry of Finance or other Grantee agency and will be submitted to A.I.D. within thirty (30) days after the close of each six-month period, except as A.I.D. may otherwise agree in writing.
4. Grantee agrees to provide such other reports on the disbursement and use of Special Account funds as A.I.D. may from time to time require.

The above conditions and covenants were discussed with appropriate GRZ officials during the process of PAAD development, and they indicated they could foresee no problem in obtaining official GRZ approval of them.

ANNEX A

GRZ request to be inserted.

ANNEX B

INITIAL ENVIRONMENTAL EXAMINATION

Country	Zambia
Program Title	Zambia Auction Program (ZAP) Support, 611-0757
Funding	$22.5 million
Period of Funding	FY 1986
Prepared by	James A. Graham, REDSO/ESA
Environmental Action Recommended	Categorical Exclusion - under AID Reg 16 Section 216.2 (C)(1)(i)
Concurrence	John A. Patterson, Director, USAID/Lusaka
Date	October 22, 1985

Bureau Environmental Officer's Decision:

Approved ______________

Disapproved ______________

Date ______________

Narrative:

Section 216.2 of AID Regulation 16 provides that certain classes of action do not require an Initial Environmental Examination. Among these classes are the following:

Section 216.2 (C)(1)(i) the action does not have an effect on the natural or physical environment.

This program is composed of a cash transfer grant to the Government of Zambia in support of the auction system. As such, the program will have no effect on the natural or physical environment. Section 216.2(C)(3) provides that the originator of a program determines in writing the extent to which a class of Categorical Exclusion applies to such a program. This written determination is to be concurred in by the Bureau Environmental Officer. This Annex constitutes the written determination by the Mission Director, USAID/Zambia, that the above quoted Categorical Exclusion applies to this program and an Initial Environmental Examination need not be made.
(Lusaka 5095)

ANNEX D

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable generally to FAA funds, and criteria applicable to individual fund sources: Development Assistance and Economic Support Fund.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FAA Sec. 481; FY 1985 Continuing Resolution Sec. 528. Has it been determined or certified to the Congress by the President that the government of the recipient country has failed to take adequate measures or steps to prevent narcotic and psychotropic drugs or other controlled substances (as listed in the schedules in section 202 of the Comprehensive Drug Abuse and Prevention Control Act of 1971) which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully? — No

2. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal

remedies and (b) the debt is not denied or contested by such government? No

3. FAA Sec. 620(e)(1). If assistance is to a government, has it (including government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities? No

4. FAA Sec. 620(a), 620(f), 620(D); FY 1985 Continuing Resolution Sec. 512 and 513. Is recipient country a Communist country? Will assistance be provided to Angola, Cambodia, Cuba, Laos, Vietnam, Syria, Libya, or South Yemen? Will assistance be provided to Afghanistan or Mozambique without a waiver? No

5. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, the damage or destruction by mob action of U.S. property? No

6. FAA Sec. 620(1). Has the country failed to enter into an agreement with OPIC? No

7. FAA Sec. 620(o); Fishermen's Protective Act of 1967, as amended, Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing activities in international waters? No
(b) If so, has any deduction required by the Fishermen's

Protective Act been made?

8. FAA Sec. 620(q); FY 1985 Continuing Resolution Sec. 518

(a) Has the government of the recipient country been in default for more than six months on interest or principal of any AID loan to the country? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the appropriation bill (or continuing resolution) appropriates funds?

(a) Zambia currently has a waiver for Sec. 620(q). Thus, it is not currently more than 6 months in default, it will be so on Jan 4, 1986. However, OAR/Zambia has brought this to GRZ's attention and arrangements will be made to correct/avert such default.

(b) No

9. FAA Sec. 620(s). If contemplated assistance is development loan or from Economic Support Fund, has the Administrator taken into account the amount of foreign exchange or other resources which the country has spent on military equipment? (Reference may be made to the annual "Taking into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB". This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

Yes, taken into account by the Administrator at time of approval of the FY 1986 Agency OYB.

10. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have they been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

No

11. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the AID Administrator in determining the current AID Operational Year Budget? (Reference may be made

Any such arrearages have been taken into consideration by the AID Administrator in determining the current OYB.

to the Taking into Consideration memo.)

12. FAA Sec. 620A; FY 1985 Continuing Resolution Sec. 521. Has the country aided or abetted, by granting sanctuary from prosecution to, any individual or group which has committed an act of international terrorism? Has the country aided or abetted, by granting sanctuary from prosecution to, any individual or group which has committed a war crime? — No

13. FAA Sec 666. Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA? — No

14. FAA Sec. 669, 670 Has the country, after August 3, 1977, delivered or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan). — No

15. ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. of Sept. 25 and 28, 1981, and failed to disassociate itself from the communique issued? If so, has the President taken it into account? Reference may be made to the Taking into — While Zambia was represented and failed to disassociate itself from the communique, this was taken into account at time of approval of FY 1986 Agency OYB.

Consideration memo.)

16. FY 1985 Continuing Resolution

If assistance is from the population functional account, does the country (or organization include as part of its population planning programs involuntary abortion? N/A

17. FY 84 Continuing Resolution. Has the recipient country been determined by the President to have engaged in a consistent pattern of opposition to the foreign policy of the United States. No

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1. Development Assistance

Country Criteria

FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy? N/A

2. Economic Support Fund

Country Criteria

FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the country made such significant improvements in its human rights record that furnishing such assistance is in the national interest? No

5C(2) NON-PROJECT ASSISTANCE PROJECT CHECKLIST

Listed below are statutory criteria applicable to projects. This section is divided into two parts. Part A. includes criteria applicable to all projects. Part B. applies to projects funded from specific sources only: B.1. applies to all projects funded

YD

with Development Assistance loans, and B.3. applies to projects funded from ESF.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED FOR THIS PROJECT?

Yes

Yes

A. GENERAL CRITERIA FOR PROJECT

1. FY 1985 Continuing Resolution Sec. 525; FAA Sec. 634A; Sec. 653(b).

(a) Describe how authorizing and appropriations committees of Senate and House have been or will be notified concerning the project; (b) is assistance within (Operational Year Budget) country or international organization allocation reported to Congress (or not more than $1 million over that amount)?

A Congressional notification will be sent as required.

2. FAA Sec. 611(a)(1). Prior to obligation in excess of $100,000, will there be (a) engineering, financial or other plans necessary to carry out the assistance and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?

Yes

3. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

None required

4. FAA Sec. 611(b); FY 1985 Continuing Resolution Sec. 501 If for water or water-related land resource construction, has project met the standards and criteria as set forth in the Principles and Standards for Planning Water and Related Land Resources, dated October 25, 1973, or the Water Resources Planning

Act (42 U.S.C. 1962, et seq.)? (See AID Handbook 3 for new guidelines.) N/A

5. FAA Sec. 611(e). If project is capital assistance (e.g., construction), and all U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistant Administrator taken into consideration the country's capability effectively to maintain and utilize the project? N/A

6. FAA Sec. 209. Is project susceptible to execution as part of regional or multilateral project? If so, why is project not so executed? Information and conclusion whether assistance will encourage regional development programs. No

7. FAA Sec. 601(a). Information and conclusions whether project will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; and (c) encourage development and use of cooperatives, and credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.

The provision of cash will stimulate the flow of international trade due to increased availability of foreign exchange.

8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

Availability of foreign exchange will encourage private U.S. sales to Zambia.

9. FAA Sec. 612(b), 636(h); FY 1985 Continuing Resolution Sec. 507. Describe steps taken to assure that, to the maximum extent possible, the country is contributing local

currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

N/A

10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?

N/A

11. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?

N/A

12. FY 1985 Continuing Resolution Sec. 522. If country to: (a) increase the flow of international trade; (b) foster private initiative and competition; and (c) encourage development and use of cooperatives, and credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.

The provision of cash will stimulate the flow of international trade due to increased availability of foreign eschange.

8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

Availability of foreign exchange will encourage private U.S. sales to Zambia.

9. FAA Sec. 612(b), 636(h); FY 1985 Continuing Resolution Sec. 507. Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

N/A

10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of

the country and, if so, what arrangements have been made for its release? No

11. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise? N/A

12. FY 1985 Continuing Resolution Sec. 522. If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity? No

13. FAA 118(c) and (d). Does the project comply with the environmental procedures set forth in AID Regulation 16? Does the project or program take into consideration the problem of the destruction of tropical forests? Yes

14. FAA 121(d). If a Sahel project, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of project funds (dollars or local currency generated therefrom)? N/A

15. FY 1985 Continuing Resolution. Sec. 536. Is disbursement of the assistance conditioned solely on the basis of the policies of any multilateral institution? No

B. FUNDING CRITERIA FOR PROJECT

1. Development Assistance Project Criteria

a. FAA Sec. 102(b), 111,

113, 281(a). Extent to which activity will (i) effectively involve the poor in development, by extending access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (ii) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life and otherwise encourage democratic private and local governmental institutions; (iii) support the self-help efforts of developing countries; (iv) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (v) utilize and encourage regional cooperation by developing countries? N/A - ESF Funds

b. FAA Sec. 103, 103A, 104, 105, 106. Does the project fit the criteria for the type of funds (functional account) being used? N/A

c. FAA Sec. 107. Is emphasis on use of appropriate technology (relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)? N/A

d. FAA Sec. 110(a). Will the recipient country provide at least 25% of the costs of the program, project, or activity with respect to which the assistance is to be furnished (or is the latter cost-sharing requirement being waived for a "relatively least developed" N/A country)?

e. <u>FAA Sec. 110(b).</u> Will grant capital assistance be disbursed for project over more than 3 years? If so, has justification satisfactory to Congress been made, and efforts for other financing, or is the recipient country "relatively least developed"? (M.O. 1232.1 defined a capital project as "the construction, expansion equipping or alteration of a physical facility or facilities financed by AID dollar assistance of not less than $100,000, including related advisory, managerial and training services, and not undertaken as part of a project of a predominantly technical assistance character." N/A

f. <u>FAA Sec. 122(b).</u> Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth? N/A

g. <u>FAA Sec. 281(b).</u> Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civil education and training in skills required for effective participation in government processes essential to self-government. N/A

2. <u>Development Assistance Project Criteria (Loans only)</u>

a. <u>FAA Sec. 122(b).</u> Information and conclusion on capacity of the country to repay the loan, at a reasonable rate of interest. N/A

b. FAA Sec. 620(d). If assistance is for any productive enterprise which will compete with U.S. enterprises, is there an agreement by the recipient country to prevent export to the U.S. of more than 20% of the enterprise's annual production during the life of the loan? N/A

Economic Support Fund

Project Criteria

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the extent possible, does it reflect the policy directions of FAA Section 102? Yes; N/A

b. FAA Sec. 531(c). Will assistance under this chapter be used for military, or paramilitary activities? No

c. FAA Sec. 534. Will ESF funds be used to finance the construction of the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such use of funds is indispensable to non-proliferation objectives? No

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? Yes

5C(c) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds. These items are arranged under the general headings of (A)

Procurement, (B) Construction, and (C) Other Restrictions.

A. Procurement

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed? N/A

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him? N/A

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company? N/A

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If offshore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.) N/A

5. FAA Sec. 604(g). Will construction or engineering services be procured from firms of countries otherwise eligible under Code 941, but which have attained a competitive capability in international markets in one of these areas? Do these countries permit United States firms to compete for construction or engineering services financed from assistance N/A

programs of these countries?

6. FAA Sec. 603. Is the shipping excluded from compliance with requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent that such vessels are available at fair and reasonable rates? N/A

7. FAA Sec. 621. If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? If the facilities of other Federal agencies will be utilized, are they particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs? N/A

8. International Air Transport. Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U. S. carriers be used to the extent such service is available? N/A

9. FY 1985 Continuing Resolution Sec. 504. If the U.S. Government is a party to a contract for procurement, will the contract contain a provision

authorizing termination of such contract for the convenience of the United States? N/A

B. Construction

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services to be used? N/A

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable? N/A

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP)? N/A

C. Other Restrictions

1. FAA Sec. 122(b). If development loan, is interest rate at least 2% per annum during grace period and at least 3% per annum thereafter? N/A

2. FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights? N/A

3. FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the communist-bloc countries? Yes

4. Will arrangements preclude use of financing:

a. FAA Sec. 104(f); FY 1985 Continuing Resolution Sec. 527: (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; (4) to lobby for abortion?

(1) Yes

(2) Yes

(3) Yes

(4) Yes

b. FAA Sec. 620(g). To compensate owners for expropriated nationalized property?

Yes

c. FAA Sec. 660. To provide training or advice or provide any financial support for police, prisons, or other law enforcement forces, except for narcotics programs?

Yes

d. FAA Sec. 662. For CIA activities?

Yes

e. FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained?

Yes

f. FY 1985 Continuing Resolution, Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for military personnel? Yes

g. FY 1985 Continuing Resolution, Sec. 505. To pay U.N. assessments, arrearages for dues? Yes

h. FY 1985 Continuing Resolution, Sec. 506. To carry out provisions of FAA section 209(d) (Transfer of FAA funds to multilateral organizations for lending)? Yes

i. FY 1985 Continuing Resolution, Sec. 510. To finance the export of nuclear equipment, fuel, or technology or to train foreign nationals in nuclear fields? Yes

j. FY 1985 Continuing Resolution, Sec. 511. Will assistance be provided for the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights? No

k. FY 1985 Continuing Resolution, Sec. 516. To be used for publicity or propaganda purposes within U.S. not authorized by Congress? Yes

AID GRANT No. 611-K-604
AID PROJECT No. 611-0757

GRANT AGREEMENT
ZAMBIA AUCTION PROGRAM SUPPORT
(ZAPS)
BETWEEN
THE REPUBLIC OF ZAMBIA

THE UNITED STATES OF AMERICA

DATED: NOVEMBER 1985

ZAMBIA AUCTION PROGRAM SUPPORT

GRANT AGREEMENT

Grant No: 611-K-604
Project No: 611-0757
Date: November 1985

Between
The REPUBLIC OF ZAMBIA ("Grantee")
And
The UNITED STATES OF AMERICA, acting through the AGENCY FOR INTERNATIONAL DEVELOPMENT ("AID")

ARTICLE 1:

The Grant

For the purposes of assisting the Grantee to meet immediate balance of payments requirements and to support its foreign exchange auction program, the United States, pursuant to the Foreign Assistance Act of 1961, as amended, agrees to grant to the Government of the Republic of Zambia under the terms of this Agreement, an amount not to exceed Twenty-two Million Five Hundred Thousand United States ("U.S.") Dollars ($22,500,000) (the "Grant").

ARTICLE 2:

Conditions Precedent to Disbursement

SECTION 2.1. Conditions Precedent to Initial Disbursement. Prior to any disbursement under the Grant, or to the issuance by AID of documentation pursuant to which disbursement will be made, the Grantee will, except as the Parties may otherwise agree in writing, furnish to AID, in form and substance satisfactory to AID:

A. A statement representing and warranting that the named person or persons have the authority to act as the representative or representatives of the Grantee pursuant to Section 7.2, together with a specimen signature of each person certified as to its authenticity;

B. A statement designating the bank and the special account number into which the foreign exchange disbursement is to be made.

C. Evidence that the GRZ has established a special account in the BOZ for deposit of kwacha generated by the AID-provided foreign exchange.

SECTION 2.2. Notification. When AID has determined that the conditions precedent specified above have been met, it will promptly notify the Grantee by Implementation Letter issued pursuant to Section 8.1 of this Agreement.

SECTION 2.6. Terminal Dates for Meeting Conditions Precedent. If the conditions specified in Section 2.1 have not been met within ninety (90) days from the date of this Agreement, or such later date as AID may specify in writing, AID, at its option, may terminate this Agreement by written notice to the Grantee.

ARTICLE 3:

Disbursement

SECTION 3.1. Disbursements. After satisfaction of the conditions specified in Section 2.1, the Greantee may request AID to disburse the Grant. After review and approval of the documentation submitted by the Grantee, AID will disburse the initial tranche of theGrant to the bank and account number designated by the Grantee. Release of subsequent tranches will depend on AID confirming that (a) the auction program continues, and (b) that the Grantee continues to adequately publicize auction results.

SECTION 3.2. Terminal Date for Requests for Disbursement Authorization. No letter of commitment or other disbursement authorization will be issued in response to a request received after twelve (12) months from the date of signing of this Agreement, except as AID may otherwise agree in writing.

SECTION 3.3. Terminal Date for Requests for Disbursement. No disbursement of Grant funds shall be made against documentation submitted after fourteen (14) months from the date of signing of this Agreement, except as AID may otherwise agree in writing.

SECTION 3.4. Date of Disbursement. Disbursements by AID will be deemed to occur on the date on which AID makes a disbursement to the Grantee or its designee, or to a bank, contractor or supplier pursuant to a letter of commitment or other form of disbursement authorization.

ARTICLE 4:

General Covenants

SECTION 4.1. Continuing Responsibilities. The Grantee and AID shall cooperate fully to assure that the purposes of the Grant will be accomplished. To this end, the Grantee and AID shall from time to time, at the request of either Party, exchange views through their representatives with regard to the Grantee's economic development and its progress in achieving the objectives of its economic stabilization program, including the level of current expenditures and its foreign exchange position, the performance by the Grantee of its obligations under this Agreement, and other matters relating to this Agreement.

SECTION 4.2. Reports and Records. The Grantee will:

(a) furnish AID on an annual basis beginning one year from the date of this agreement a report concerning the performance of the Grantee's obligations under this Agreement, and such other reports and information as AID may reasonably request from time to time;

(b) maintain or cause to be maintained, in accordance with generally accepted accounting principles and practices consistently applied, such books and records relating to this Grant as may be prescribed in Implementation Letters. Such books and records may be inspected by AID or any of its authorized representatives at all times as AID may reasonably require, and shall be maintained for three years after the date of last disbursement by AID under this Grant;

SECTION 4.3. Completeness of Information. The Grantee confirms:

(a) that the facts and circumstances of which it has informed AID or caused AID to be informed, in the course of reaching agreement with AID on the Grant, are accurate and complete, and include all facts and circumstances that might materially affect the Grant and the discharge of responsibilities under this Agreement; and

(b) that it will inform AID in a timely fashion of any subsequent facts and circumstances that might materially affect or that it is reasonable to believe might so affect, the discharge of responsibilities under this Agreement.

SECTION 4.4. Use of Local Currency.

(a) Grantee will establish and maintain a Special Account in the Bank of Zambia and deposit therein currency of the Government of the Republic of Zambia in amounts equal to proceeds accruing to the Grantee. Funds in the Special Account may be used for such purposes as are mutually agreed upon by AID and Grantee, including the purposes set forth in Annex 1 to this Agreement, and as otherwise specified pursuant to this Agreement.

(c) Except as AID may otherwise agree in writing, deposits to the Special Account shall become due and payable at the time request is made for issuance of Letters of Credit or Direct Letters of Commitment. Grantee shall make all deposits at the highest rate of exchange prevailing and declared for foreign exchange currency by the competent authorities of the Government of the Republic of Zambia.

(d) The Grantee shall provide AID with a quarterly detailed accounting of the use of such local currency. The format for such reports will be specified in an Implementation Letter.

(e) Any unencumbered balance of funds which remain in the Special Account upon termination of assistance hereunder shall be disbursed for such purposes as may, subject to applicable law, be agreed to between Grantee and AID.

ARTICLE 5:

Special Covenants

SECTION 5.1. The Grantee covenants that, except as AID may otherwise agree in writing, it will:

(a) The Grantee agrees to immediately deposit in the BOZ special account currency of Zambia (Kwachà) equivalent to the US dollar disbursement made at each auction at the highest rate of exchange which is not unlawful in Zambia on the date of the US dollar disbursement is made. (i.e. exchange rate established by that respective auction).

(b) The Grantee agree that the kwacha funds deposited in the BOZ special account shall be used by the Grantee for the productive sectors of the GRZ budget.

(c) The GRZ covenants that it will provide reports on the utilization of counterpart fund proceeds on a six-monthly basis relating to budget attribution. This report is to be certified as correct by an appropriate official within the Ministry of Finance or other Grantee agency, will be submitted to A.I.D. within thirty (30) days after the close of each six-month period, except as A.I.D. may otherwise agree in writing.

(d) Grantee agrees to provide such other reports on the disbursement and use of Special Account funds as A.I.D. may from time to time require.

ARTICLE 6:

Termination: Remedies

SECTION 6.1. Termination. This Agreement may be terminated by mutual agreement of the Parties at any time. Either Party may terminate this Agreement by giving the other Party thirty (30) days written notice.

SECTION 6.2. Refunds.

(a) If AID determines that any disbursement is not supported by valid documentation in accordance with this Agreement, or is in violation of United States law, or is not made or used in accordance with the terms of this Agreement, AID may require the Grantee to refund the amount of such disbursement in U.S. dollars to AID within sixty (60) days after receipt of request therefor. Refunds paid by the Grantee to AID resulting from violations of the terms of this Agreement shall be considered as a reduction in the amount of AID's obligation under the Agreement and shall be available for reuse under the Agreement if authorized by AID in writing.

(b) The right to require such a refund of a disbursement will continue, notwithstanding any other provision of this Agreement, for three (3) years from the date of the last disbursement under this Agreement.

(c) Any interest or other earnings on Grant funds disbursed by AID to the Grantee under this Agreement prior to the authorized use of such funds for the Grant will be returned to AID in U.S. dollars by the Grantee,

SECTION 6.3. Nonwaiver of Remedies. No delay in exercising or omitting to exercise any right, power, or remedy accruing to AID under this Agreement will be construed as a waiver of such rights, powers, or remedies.

ARTICLE 7:

Miscellaneous

SECTION 7.1. Implementation Letters. From time to time, for the information and guidance of both Parties, AID will issue Implementation Letters describing the procedures applicable to the implementation of this Agreement. Except as permitted by particular provisions of this Agreement, Implementation Letters will not be used to amend or modify the text of this Agreement.

SECTION 7.2. Representatives. For all purposes relevant to this Agreement, the Grantee will be represented by the individual holding or acting in the Office of the Minister of Finance and AID will be presented by the individual holding or acting in the position of AID Mission Director, Lusaka, Zambia, each of whom, by written notice, may designate additional representatives. The names of the representatives of the Grantee, with specimen signatures, will be provided to AID which may accept as duly authorized any instrument signed by such representatives in implementation of this Agreement, until receipt of written notice of revocation of their authority.

SECTION 7.3. Communications. Any notice, request, document or other communication submitted by either Party to the other under this Agreement will be in writing or by telegram or cable, and will be deemed duly given or sent when delivered to such Party at the following address:

To the Grantee:

Mail Address:	Permanent Secretary Ministry of Finance P.O. Box 50062 LUSAKA, Zambia
Alternative address for cables:	Finance Lusaka

To AID:

Mail address:	AID Mission Director P.O. Box 32481 LUSAKA, Zambia
Alternative address for cables:	ZA 40810 AID Mission Director

With copy for Director, REDSO/ESA

Mail address:	Director, REDSO/ESA P.O. Box 30261

NAIROBI, Kenya

All such communications will be in English unless the Parties otherwise agree in writing. Other addresses may be substituted for the above upon giving of notice.

SECTION 7.4. Information and Marking. The Grantee will give the appropriate publicity to the Grant as a program to which the United States has contributed.

IN WITNESS WHEREOF, the Grantee and the United States of America, each acting through its duly authorized representatives have caused this Agreement to be signed, in duplicate originals, in their names and delivered as of the day and year first above written.

REPUBLIC OF ZAMBIA
BY:

KEBBY MUSOKOTWANE
ACTING MINISTER OF FINANCE

UNITED STATES OF AMERICA
BY:

PAUL J. HARE
AMBASSADOR
BY:

JOHN A. PATTERSON
AID MISSION DIRECTOR

ANNEX A

I. Program Description:

This program proposes to grant the GRZ $22.5 million of foreign exchange which will be auctioned through the current auction program. Use of this AID-provided foreign exchange will not be tied to any source/origin requirements. All AID-provided funds must be disposed of through the auction program and cannot be reserved for other GRZ requirements for foreign exchange such as payment of debt arrearages, etc. The AID-provided foreign exchange is expected to be "additional" to that pool of foreign exchange which is drawn from the IBRD projects and the resources of the GRZ. The anticipated pattern of release of AID-provided foreign exchange is that $1.0 million will be released for each weekly auction for the first 10 weeks of the program and $500,000 each week thereafter until the funds are exhausted, though the flexibility should be retained to change the rate of disbursement if later circumstances indicate a different rate would more effectively support the success of the auction system.

This program will generate a very significant amount of local currency. The auction program provides that bidders deposit local currency equivalent to their bid prior to the auction date. That local currency is immediately deposited if the bid is successful at the exchange rate set by that auction. As exchange rates can be expected to fluctuate during the life of this program, it is impossible to determine beforehand the exact amount of local currency that will be generated. Early indications would project from K120 million to K160 million.

Local currency resources of these dimensions cannot be responsibly and efficiently programmed by a USAID the size of USAID/Zambia, particularly when taken together with local currency resources already on hand and being generated by various PL480 and CIP programs (as well as ZAMCAM). Consequently, USAID/Zambia intends, on a one-time basis, to arrange with the Ministry of Finance for the ZAPS-generated local currency to be utilized for general budgetary purposes.

II. Implementation procedures:

Subsequent to satisfaction of Conditions Precedent, USAID/Zambia will take steps to release the initial four-week tranche of foreign exchange for use in the auction program. USAID/Zambia will prepare a Financing Request for a Cash Transfer signed by both the Mission Director and a GRZ representative which will cover the entire amount obligated in the grant agreement. Each four-weekly period, USAID/Zambia will cable SER/FM/PAD to confirm that the conditions for release of each four-weekly tranche have been met. FM/PAD will schedule payment through the Federal Reserve Electronic Funds Transfer System to the designated GRZ correspondent bank. These funds will be scheduled for release from the correspondent bank's special account on a weekly basis in the amount of $1,000,000 for the first ten weeks and $500,000 weekly thereafter. Such electronic transfers should be effected on the Monday prior to the Friday foreign exchange auction in question. The correspondent bank will provide USAID, by telex, a report of the actual cash disbursements from the special account on a four-weekly basis.

Generation of kwacha in payment for access to AID provided foreign exchange will be immediately deposited in a special account in the BOZ. The BOZ will advise USAID of the weekly deposits in this special account. USAID and the Ministry of Finance will agree, on a four-weekly basis, to provide the Kwacha from this special account to the Ministry of Finance's account to be used for general budget expenses.

IMPLEMENTATION SCHEDULE

TIMING (wks)	ACTION	AGENT
0 (expected o/a 14 Nov. 1985)	Signature of Grant Agreement	USAID/GRZ
1	Satisfaction of General CPs	GRZ
2	Transmission of FR	GRZ/USAID
3	Initial 4 weekly tranche released	FM/PAD
6	Confirmation for 2nd tranche	USAID
7	2nd 4-weekly tranche released	FM/PAD
7	1st tranche counterpart released	USAID/GRZ
10	Confirmation of 3rd tranche	USAID
11	3rd 4-weekly tranche released	FM/PAD
11	2nd tranche counterpart released	USAID/GRZ
	Tranche releases continue to exhaustion of foreign exchange and counterpart.	
30 Sep. 1986	PACD	USAID

ANNEX E

BANK OF ZAMBIA

MODIFICATION TO FOREIGN EXCHANGE ARRANGEMENTS

GUIDELINES TO PARTIES INVOLVED IN THE BUYING AND SELLING OF FOREIGN EXCHANGE

I. OBJECTIVES:

With effect from October 4, 1985, new procedures governing the determination of the exchange rate of the Kwacha and the allocation of foreign exchange will be introduced. The new arrangements centre on the auctioning of foreign exchange which will provide the mechanism for determining the exchange rate of the Kwacha and allocating foreign exchange for imports and other payments not

specifically excluded from the auction. The objectives are to:
(i) ensure that the exchange rate is fully responsive to changes in the demand for and supply of foreign exchange;
(ii) provide foreign exchange in timely manner;
(iii) attract into the banking system foreign exchange which is currently held outside the banks;
(iv) reduce reliance on administrative mechanisms in the allocation of foreign exchange; and
(v) promote the production of a higher volume and broader range of exports.

II. DESCRIPTION OF NEW FOREIGN EXCHANGE ARRANGEMENTS:

1. Without prejudice to the foreign exchange retention privileges enjoyed by ZCCM and exporters of eligible non-traditional products, foreign exchange proceeds from exports of goods and services as well as external cash loans and grants will surrendered to authorized dealers at the exchange rate determined in the auction.
2. Predetermined amounts of foreign exchange arising from exports proceeds and disbursements of cash loans and grants will be made available for auction at fortnightly or weekly intervals.
3. Access to the cash loans and grants passing through the auction will, unless untied, be restricted to eligible imports as determine in accordance with the agreements covering such loans and grants.
4. The exchange rate of the Kwacha will vary from auction to auction depending upon the demand for and supply of foreign exchange at each auction.
5. Predetermined amounts of foreign exchange will be allocated outside the auction system for the following items:
   - Party and government imports and other payments;
   - Bank of Zambia;
   - ZCCM's exports earnings retention quota;
   - Non-traditional exporters' retention quota;
   - Crude oil imports and related port charges; and
   - IATA payments by Zambia Airways;
   - Debt payment;
   - Medical and Educational supplies
   - Specific projects and companies
6. All foreign exchange transactions will be valued at the prevailing auction rate.
7. The US dollar will remain the intervention currency for the Kwacha.

III. GUIDELINES FOR OPERATIONS:

1. A Foreign Exchange Management Committee chaired by the General Manager, Bank of Zambia, will administer the new foreign exchange arrangements, subject to an approved foreign exchange budget. The Committee will conduct the fortnightly/weekly foreign exchange auction as well as make direct allocations to Government, ZCCM, ZIMOIL, Zambia Airways and TAZAMA.
2. Access to the foreign exchange available for auction will be restricted to users for whom direct allocations have not been made in the foreign exchange budget.
3. Participation in the auction will be confined to commercial banks acting on behalf of their customers. Applications for the foreign exchange to be auctioned will take the form of bids. These bids will be submitted through the commercial banks which may also bid for their own foreign exchange requirements.
4. Bidders must state in US dollars the total amount of foreign exchange wanted, the precise amount of Kwacha they are willing to pay per US dollar and the purpose for which the foreign exchange is required.

5. At the time of placing bids customers must pay the commercial banks full Kwacha value of their foreign exchange application.
6. Each commercial bank will consolidate its customers' foreign exchange requests and tender bids on its customers' behalf. The banks will provide information regarding the identity of their customers, their offer prices, and the value and type of transaction involved. The banks will ensure that their customer's bids are supported by documentary evidence such as proforma invoices, import licences and/or Exchange Control approval by the Bank of Zambia.
7. Bids will be lodged by the commercial banks with the Secretariat of the FEMC on a prescribed form not later than 0900 hours on Thursday. If Thursday is a public holiday, submission of bids will be made on Wednesday.
8. The commercial banks will hold the consolidated amounts of total bids for the auction in designated accounts with the Bank of Zambia.
9. The FEMC Secretariat will sort, classify and consolidate all the bids received from the commercial banks.
10. The FEMC will meet at 15.00 hours on Friday or the first following working day if Friday is a public holiday to price the available foreign exchange.
11. The marginal bid will be the lowest bid which fully exhausts the amount of foreign exchange available for the auction. The price of foreign exchange at each auction will be determined by the marginal bid which will be the ruling rate until the next auction.
12. If an applicant's bid price exceeds the marginal bid, he will be allotted the amount of foreign exchange requested at the price struck at the auction. Where an applicant's bid price is equal to the marginal bid, the applicant will receive a pro-rated amount of foreign exchange requested if there are more than one such applicants.
13. The FEMC will shortly after each auction announce through the information media the total number of bids received, the number of successful bids and the US dollar/kwacha exchange rate struck at the auction.
14. The Bank of Zambia will advise the commercial banks of the names of successful bidders and provide foreign exchange against successful bids within three business days of the close of each auction.
15. The foreign exchange so provided by the Bank of Zambia will be held by the commercial banks against the successful bidder's external payments obligations in earmarked accounts until these are fully settled. The interest earned by the commercial banks on these foreign currency balances will accrue to the Bank of Zambia.
16. The Bank of Zambia will, within five business days, refund to the commercial banks the deposits of unsuccessful bidders and the balance of deposits due to successfully bidders whose bids are above the marginal bids.
17. Upon allocation of foreign exchange to successful bidders, the commercial banks will sell foreign exchange within the spread approved by the Bank of Zambia.
18. The commercial banks will not hold foreign exchange in excess of their normal working balances. The level of working balances will be subject to the approval of the Bank of Zambia. The operation of the retention quota for non-traditional exports will not be affected by this paragraph.
19. The Bank of Zambia reserves the right to reject any bid without assigning reasons.

IV. <u>FOREIGN EXCHANGE ALLOCATION TO GOVERNMENT:</u>

1. Predetermined amount of foreign exchange will be allocated to Government at the prevailing exchange rate determined at the auction.

2. Government Ministries will channel their requests for foreign exchange through the Director of Budget, Ministry of Finance.

V. FOREIGN EXCHANGE ALLOCATION TO ZCCM:

A predetermined per centage of metal export receipts will be allocated to ZCCM at the prevailing exchange rate.

VI. FOREIGN EXCHANGE ALLOCATION FOR CRUDE OIL IMPORTS AND PORT CHARGES:

A predetermined amount of foreign exchange will be allocated for the import of crude oil and the payment of related port charges.

VII. IMPORT LICENSING:

1. A new import licence applicable to all categories of imports will be issued without restriction. There will no longer be a separate category of "Import Licence not involving payment in Foreign Exchange."

2. All commercial importers must register with the Ministry of Commerce and Industry and must possess a trading or manufacturing licence.

3. A flat, non-refundable import licence fee will be charged by the Ministry of Commerce and Industry.

4. The Ministry of Commerce and Industry may validate and/or vary unused old import licenses for the purposes of bidding at the auction. The Ministry will be under no obligation to refund fees previously paid in respect of import licences so validated and/or varied.

5. There will be no time limit on the use of old import licences.

6. Imports will no longer be prohibited for protective purposes.

VII. SUPPLIERS CREDIT:

1. Suppliers credit may be used for the importation of machinery, equipment, spare parts and intermediate inputs.

2. The use of suppliers credit for the importation of finished consumer goods will not be permitted.

3. Users of suppliers credit will provide to the Bank of Zambia satisfactory evidence of the eligibility of the goods to be purchased under the suppliers credit.

4. The terms and conditions of suppliers credit arrangements entered into must be registered with the Bank of Zambia.

5. Except as provided for in a suppliers credit agreement between Government and a foreign supplier or suppliers, there will be no Government guarantee or Bank of Zambia currency undertaking in respect of suppliers credit.

IX. EXCHANGE CONTROL:

A. Payments for Imports and Related Services:

1. Letters of credit in respect of imports to be financed out of the foreign exchange available for auction may not be established prior to securing foreign exchange through bidding at the auction.

2. Notwithstanding the provisions of paragraph (1) above, the commercial banks may establish letters of credit against line of credit provided by their principals and correspondent banks; Customers for whom such letters of credit have been established will subsequently bid for foreign exchange in order to settle their foreign currency obligations to the banks.

3. Physical receipt of the goods against which

foreign exchange has been provided must be within a period of six months.

4. Satisfactory evidence of customs clearance of the goods must be produced through the commercial banks to the Bank of Zambia, failing which an applicant's future bids will not be considered.

5. There will be no restrictions on payments for imports of goods and related services out of foreign currency held abroad by residents and non-residents; Exchange Control approval will not be required and there will be no obligation to declare the source of the funds.

6. Importers must ensure that all the requirements of the Controller of Customs and Excise are met.

7. Outstanding letters of credit in the accounts of commercial banks will be dealt with in an orderly manner, Bank of Zambia will service these regularly.

B. Foreign Exchange Transfers:

1. Residents and non-residents may remit into Zambia, or sell to the authorised dealers in Zambia without restriction, foreign currency held abroad/by them.

2. There will be no obligation to declare the source of the funds so remitted.

C. Travel Allowances:

(a) Holiday Travel Allowance

1. Application for holiday travel allowances will be approved by the commercial banks without prior Exchange Control approval by the Bank of Zambia.

2. Approvals must be within the limits established by the Bank of Zambia.

3. Holiday travel will be paid out of the commercial bank's working balances.

4. The amount of foreign exchange approved for holiday travel will be endorsed in the traveller's passport.

(b) Business Travel Allowance

1. Applications for business travel allowances must be submitted through the commercial banks to the Bank of Zambia for prior Exchange Control Approval.

2. Business travel allowances will be paid out of the commercial banks' working balances, subject to the limits established by the Bank of Zambia.

3. The amount of foreign exchange approved for business travel will be endorsed in the traveller's passport.

4. Cabinet Office authority will no longer be required for travel abroad on parastatal business; instead, officials of ZIMCO group companies will require head office approval.

5. Foreign travel by officials of statutory bodies will require approval by the supervising ministry.

(c) Party and Government Travel Allowance

1. Officials travelling abroad on Party and Government business will be paid travel allowance out of the government travel vote provided for in the foreign exchange budget.

2. Freedom House/Cabinet office authority is required for travel abroad on Party/Government business.

D. Payments for Airline Tickets

1. Payments for airline tickets in respect of routes covered entirely by airlines operating to and from Zambia (on line travel) may be made in Kwacha without prior Exchange Control approval by the Bank of Zambia; travellers will not be required to complete AT forms in respect of such journeys.

2. Payments for airline tickets in Kwacha in respect of routes, a portion of which is not served by airlines

operating to and from Zambia (off-line travel) will require prior Exchange Control approval by the Bank of Zambia; applicants must complete AT forms.

3. All applications for outward PTA's will require prior approval by Bank of Zambia.

4. Foreign airlines operating in Zambia will obtain foreign exchange for their remittance from the auction market.

E. Expatriate Remittances

1. Between 4th October, 1985 and December 31, 1985, expatriate remittances will continue on the present basis but at the rate of exchange prevailing ruling 3rd October, 1985.

2. With effect from January 1, 1986, expatriate contracts will be modified to have the following components:

(a) An inducement allowance which may be denominated in US dollars and remittable monthly with a maximum limit to be stipulated from time to time by the Bank of Zambia.

(b) An end of contract gratuity with a maximum limit of 25 per cent of the inducement allowance earned during the life of contract.

(c) A non-remittable salary payable locally in Kwacha.

3. After the transitional period expatriate remittances will be governed by the following conditions and procedures:

(i) The remittances of expatriates in the private and parastatal sectors will be made out of the commercial banks' working balances, without the need for the employee or the employer to bid for the foreign exchange.

The Remittances of expatriates employed by the Government will be paid out of the foreign exchange allocated to Government.

(ii) The remittances will be effected at the prevailing auction-determined exchange rate.

(iii) The inducement allowance and the gratuity will be remitted through the employer's commercial bank.

(iv) All eligible remittances will be charged to the account of the employer.

(v) The remittances of expatriates employed by Government will be administered by the Ministry of Finance.

4. Detailed rules and regulations governing the above will be issued by the Bank of Zambia.

F. Remittance of Profits and Dividends

Profits and dividends declared after 31st October 1985, may be remitted through bidding at the auction, subject to the limits established by the Bank of Zambia.

G. Payments for Education Abroad

1. Payments for education abroad will be made out of the commercial banks' working balances.

2. Applications must be supported by the necessary documentary evidence and Exchange Control approval.

3. For socio-cultural reasons Exchange Control approval will no longer be granted for primary education abroad. Students already studying abroad and the children of contract expatriate employees will not be affected by this paragraph.

H. Payments for Medical Treatment Abroad

1. Payments for medical treatment abroad in respect of Government-sponsored patients will be made out of foreign exchange allocated to Government.

A. All other payments for medical treatment abroad will be made out of the commercial bank's working balances.

3. Applications must be supported by an appropriate certificate or recommendation from the Ministry of Health.

X. COMMERCIAL PAYMENTS ARREARS

1. A group of consultants appointed by the Bank of Zambia is preparing a mutually acceptable, multi-option scheme for eliminating the outstanding commercial payments arrears in an orderly manner.

2. The elimination of commercial payment arrears will be based on the principle that pipeline creditors are not treated less favourably than other creditors.

3. Claims in the pipeline will be guaranteed at the exchange rate prevailing on 3rd October, 1985. The resulting exchange losses will be borne by the Government of the Republic of Zambia within the framework of the Revaluation Reserve Account of the Bank of Zambia.

4. Foreign currency loans made by the Development Bank of Zambia will be covered by the exchange rate guarantee referred to above.

5. However, until the details of the scheme for eliminating the arrears have been worked out and agreed payments in respect of principal, interest etc. will be frozen.

6. Notwithstanding the above, the exporters will continue to be allowed to use their share of foreign exchange under the Export Retention Scheme for dismantling the pipeline claims at a discount.

7. Further, funds in the commercial payments pipeline cannot be withdrawn from the purposes of bidding at the auction. Similarly, letters of credit established prior to the start of the auction cannot be retired through bidding at the auction.

8. Notwithstanding the above provisions, Bank of Zambia will use its best endeavours to progressively reduce the arrears relating to personal remittances.

XI. MISCELLANEOUS RULES AND PROCEDURES:

1. Commercial banks will bid as agents of their customers and the law governing principal and agent will govern their relationship.

2. Bids once submitted to the FEMC shall not be withdrawn. However, the Committee may in exceptional cases (such as fraud) permit the withdrawal of bids before the auction takes place.

3. Where the successful bidder fails to take the bid within such a time as the Committee may prescribe from time to time, then:

(a) Where the Kwacha appreciates in value, the loss will be borne by the customer.

(b) Where the Kwacha depreciates in value, the gain in local currency will be transferred to the Bank of Zambia by the bank within a period not exceeding 5 working days.

4. In addition to the penalties prescribed in paragraph 3 above, where a customer fails to take a successful bid for reasons which the Committee considers to amount to a blatant abuse of the new foreign exchange arrangements, the customer will suffer a penalty not exceeding 10 per cent of the amount of the bid. The Bank of Zambia will debit the bank's account with the Bank with the amount of the penalty and the Bank will in turn reimburse itself from that customer.

5. Where a bidder persistently abuses the new foreign exchange auction arrangements, the Committee may put him on a black list for a maximum of 12 months. No bid will be accepted from such person as long as that person's name remains on the black list.

6. All questions and issues relating to foreign exchange auction will be referred to the FEMC whose advice/decisions

on the matter will be final
XII MONITORING AND REVIEW:

The Bank of Zambia will monitor and review the operation of the new foreign exchange arrangements and will, in consultation with the Minister of Finance and National Commission for Development Planning, make modification as necessary to ensure the smooth working of the new arrangements.

M.D. MWAPE
GENERAL MANAGER

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