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MEETING:	Zambia: Concepts Paper/PAIP for FY1988 Non-Project Assistance

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TIME:	2:00 - 4:00 pm	TIME:	10:30 - 12:30 pm
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1. Introduction

The Government of the Republic of Zambia (GRZ) may be moving away from the May 1 announced heavily statist policies back in the direction of more economically efficient policies. Economic performance targets for the New Economic Recovery Program (NERP) have apparently been accepted by the IBRD and are under discussion with the IMF and within the GRZ political leadership. As before May 1, Zambia's severe balance of payments and debt situations will greatly constrain achievement of structural adjustment measures.

While there are many unknowns surrounding the GRZ's NERP Action Plan, the direction (if not the pace and magnitude of reforms) appears to be such that we recommend in this PAIP that we position ourselves to initially provide $8 million program aid to support these policies. In keeping with our approved strategy, we propose funding a Commodity Import Program (CIP) to support private suppliers and private farmers with badly needed foreign exchange for agricultural equipment, spare parts and inputs. We propose producing a PAAD by July, 1988 after we have had time to judge the new measures and their implementation.

There may be a special opportunity to move faster, and with a different USAID program mode, in order to leverage significant levels of additional assistance from other donors and higher GRZ debt servicing. Exploiting this opportunity may give a higher potential that the GRZ's policy adjustments and economic restructuring will succeed. Under this option USAID (and the World Bank) would attempt to negotiate a GRZ contribution of approximately $28 million to combine with approximately $52 million tentatively available from the Nordic and Scandanavian countries to clear the GRZ arrears to the IBRD. In turn, this would allow the IBRD to resume disbursements from its current projects and extend new assistance under their Special Program for debt-distressed, low-income countries. Such assistance is hoped to be of a magnitude, along with bilateral assistance, to finance the structural adjustment package. It is also expected that the adjustment program will be sufficient to justify a formal debt rescheduling under the auspices of the Paris Club. This option has the advantage of bringing about Zambian solutions to its development and debt problems within, rather than outside of, the Western financial institutions. At the same time, this option carries a high risk that the reform effort may not be sustained.

AID/W approval to proceed with a PAAD, and guidance on the preferred action is urgently solicited. If the second option is to be explored, approval to proceed with a cash transfer PAAD would be needed no later than January 8, 1988, in order to produce the PAAD in time to make the funds available to meet the needs of this option.

2. GRZ Economic Policy Reform -- Past, Present and Future

As has been well documented previously (e.g., USAID/Zambia FY 1989 CDSS Update, main body and Annex 1), the Government of the Republic of Zambia (GRZ) began its efforts towards economic policy reform to restructure the economy in the early 1980's. Beginning in mid-1985, however, the pace and substance of these reforms and restructuring efforts increased with the introduction of a major macroeconomic reform package which was supported by the IMF, the IBRD and all western donors.

Due to continuing economic pressures and mounting political pressures, on May 1, 1987 the GRZ announced that it was abandoning the IMF program and would instead develop its own economic recovery and restructuring program. The foreign exchange auctioning system was eliminated and the exchange rate was fixed at K8/US$ where it has remained. The GRZ also announced that it would limit debt service payments to ten percent of net export earnings (effectively five percent of gross export earnings). In addition, price controls were reintroduced and nominal interest rates were reduced by ten percentage points.

In August 1987 the GRZ released its New Economic Recovery Program and Interim National Development Plan (INDP). These documents formed little more than a statement of objectives for the new program. The objectives of the NERP/INDP were laudable in and of themselves and corresponded to the general goals and objectives of the USAID/Zambia CDSS and the previous reform program. The problem with these documents was that they contained no statements of how the objectives were to be achieved. To remedy this situation, the GRZ announced that implementation plans were to be developed. While no one in the donor community has actually seen these implementation plans, GRZ/IBRD AND GRZ/IMF discussions have reported that the GRZ intends to adopt a number of macroeconomic policies which will represent a reversal of a number of the May 1 "control" policies.

Based upon discussions with the recent IBRD and IMF teams, it appears that the GRZ will announce a number of macroeconomic policy measures in the January 29, 1988 budget speech which could mark the beginning of a movement back toward a less-statist economic policy environment. These measures are reported to include the following:

A. A fifty percent devaluation of the kwacha. It is unknown whether this means a move from the current K8/US$ TO K12/US$ which would reflect the typical GRZ way of thinking of a devaluation, or to K16/US$ which would represent the normal definition of a devaluation.

B. A restrained monetary policy, with an approximate target of 30 percent money supply growth compared to the estimated 60 percent money supply growth in 1986 and 1987.

C. Reduction of price controls from the current list of 21 items to a list of 4 items (fertilizer, maize meal, candles and kerosene) with a further reduction to 2 items over the course of 1988.

D. A reduction of the budget deficit to a level consistent with the proposed money supply growth. The figures reported to be under discussion are a deficit in the range of 5 percent to 6 percent of GDP, or a deficit of approximately K1.5 billion which would entail expenditure reductions and/or revenue increases of about K1.0 billion based upon preliminary projections of the 1988 budget deficit based upon the NERP.

E. An agreement not to limit debt service payments to a fixed percentage of either net or gross export earnings.

While the above five items are not as comprehensive as the pre-May 1 reform program, if adopted they would represent a significant step back from the heavily statist policy orientation which appeared in the May 1, 1987 announcements. In addition, if the above measures are adopted and implemented, they could represent a significant first step towards the reforms that will be necessary if Zambia is to effectively and efficiently restructure the economy.

Whether or not the GRZ will continue onward with the reform effort after the above steps is largely an unknown. The most likely scenario is that we will continue to see ups and downs in the reform efforts (the "roller coaster effect") which have dominated Zambia's recent political and economic history. Despite the likelihood of continued vacillation, USAID/Zambia believes (as argued in the FY1989 CDSS Update) that we must be ready to support those elements of the GRZ which recognize the need for and importance of a more market-oriented set of economic policies.

While Zambia has benefitted from the significantly higher price of copper during 1987, the country's balance of payments is expected to show an ex ante overall deficit of $719 million, excluding the payment of approximately $553 million in debt arrears. If Zambia were to pay the full $930 million of current debt service (includes the IMF) due in 1987, it would require the payment of 110% of total export earnings. Adding payments necessary to clear debt arrears to all creditors at the end of 1986 would increase the 1987 ex ante debt service ratio to over 175%. Given the GRZ's 10 percent of net exports limit on debt service, however, actual debt service payments in 1987 have been limited to approximately $43 million or 5% of total export earnings. As a result, debt arrears are expected to total approximately $1.4 billion at the end of 1987.

Even with generally optimistic assumptions concerning the performance of Zambia's economy in 1988, the balance of payments is expected to remain a severe constraint for the implementation of any adjustment program. We estimate that the 1988 ex ante overall deficit (with optimistic performance assumptions, but without arrears payments, rescheduling or exceptional financing) would be approximately $664 million with a debt service ratio of almost 102%. Including the payment of arrears, the overall deficit and debt service ratio would jump to over $2.1 billion and almost 260%, respectively.

Hence, we are once again proposing that the USG position itself to provide program assistance in the range of $8-$13 million in FY1988 if the GRZ adopts and implements the policies outlined above. While our inputs are very small as compared to Zambia's need and debt, our inputs could provide that margin necessary to leverage a broad debt-FX solution.

3. CIP Options

Program Objectives: Over nine years from 1977-85 the U.S. provided nine CIPs (7 loan, 2 grant) to Zambia totalling $160 million. Recent CIP's had two closely inter-related purposes. First, to provide short-term balance of payments relief in the form of urgently needed foreign exchange to support accelerating agricultural development and economic diversification objectives. Second, to generate local currency for programming by the GRZ and USAID into agricultural and rural development and diversification, and to support policy changes designed to increase agricultural production, small farmer and rural incomes in order to try to stem the rural to urban movement of the population which is driving urban demand for goods and services the GRZ cannot afford to provide.

Program Proposal: It is proposed that we provide an initial FY88 grant of $8 million to the GRZ to finance the cost of commercial importation of commodities if the GRZ adopts significant reforms, and increase the level of FY88 funding to $13 million if the GRZ effectively implements those reforms.

A. Alternative 1 - Import Requirement:

Eligible commodities would include but not be strictly limited to agricultural spares, tires and/or implements and other equipment to support private sector equipment dealers and farmers. This could possibly include some small scale implements from Code 941 countries, such as ox-drawn plows or fertilizer raw materials.

Rationale: The present GRZ strategy is to encourage commercial farmers to produce import substitution and export oriented commodities (wheat, soybeans, cotton, tobacco, fruits and vegetables, etc.) and to encourage the small holder to produce commodities for direct local consumption (maize, sunflower, millet, sorghum, groundnuts, etc.) The commodity mix proposed will directly support this strategy by providing the mechanized machinery and related spare parts for commercial farmers and animal traction implements for small holders. This commodity list continues to support the long-standing USAID/Zambia goals and strategy of increased agricultural production and increased rural incomes. The increased availability of these commodities would have a substantial impact on agricultural production as interviews with private sector equipment dealers (in conjunction with a recent favorable CIP Evaluation) and with the local banking community have indicated a strong demand for agricultural equipment and spares. These discussions have also indicated that the current regime of foreign exchange allocation is not providing sufficient funds to meet the demand for these commodities. Certain problems in sourcing from the U.S. could develop due mainly to the U.S. industry preference for manufacturing certain smaller size ranges of equipment (especially tractors) outside the U.S. However, we believe sufficient demand exists to absorb $8-$13 million in U.S. commodities over a 1-1/2 to 2 year period. In past CIPs, spares and equipment have been imported into Zambia by authorized dealers of U.S. manufacturers and quickly sold, primarily to private sector farmers.

Probability of Success under Current Economic Scenario: The foreign exchange under this type of import assistance will probably be disbursed over two years. Although the demand for U.S. made equipment appears to be as strong as in the past when similar programs were successfully implemented, private sector CIPs tend to serve multiple business interests which apply for allocations in relatively small increments. To be competitive, private businesses purchase only what can be sold during a fairly short time period so their cash is not tied-up in an overstocked inventory. While consistent with both GRZ and USAID agricultural development goals, this alternative will most likely not achieve one of Zambia's immedate balance of payments objectives, i.e., the payment of World Bank arrears in February 1988.

B. Alternate 2 - Import Requirement:

Up to $8 million for Code 899 petroleum, oil and lubricants (POL).

Rationale: The FY1985 CIP included POL products as a fallback in the event that agricultural commodities did not move. The PAAD made specific references to averting disastrous disruptions in the local economy similar to those which had recently been experienced. Although POL is only indirectly complementary to the Mission's agricultural development strategy, we recognize the absolute necessity of POL to the agricultural sector. A timely purchase of one shipment of a blend of kerosene, naptha, diesel fuel and heavy fuel oil could fill a gap in financing and avoid tremendous losses resulting from general economic disruption. An allocation of $8 million to the local oil refinery, ZIMOIL, would procure approximately two-thirds of a regular shipment of the aforementioned blend of refinery feedstock and provide approximately a 30 day supply of petroleum to Zambia.

Probability of Success under Current Economic Scenario: USAID experience with nine import programs confirms that this alternative is the quickest disbursing CIP. However, it will not achieve the immediate Zambian objective of timely balance of payments support in February relative to clearing IBRD arrears. Even under the most optimistic scenario, we believe that program funds could not be obligated prior to February 15, 1988. It has been our experience under the FY1985 CIP and AEPRP (ZAMCAM) that the minimum timeframe for an AID financed competitive POL procurement, even where advertising has been waived, is 50 days from distribution of an RFQ to disbursement of funds to the supplier. In analyzing the utility of a CIP this timeframe must be viewed with respect to the ZIMOIL purchase schedule with vessel loading dates of February 18, 1988 and April 1, 1988.

Given a February 15, 1988 program obligation, the AID procurement process would definitely miss the scheduled February shipment and probably be too slow to finance the April 1 loading date. Thus, AID could only finance a mid-May 1988 shipment with any certainty. This scenario would push disbursement back to late May and be of little assistance to Zambia in alleviating the anticipated acute foreign exchange shortage early in CY1988. We do not recommend this alternative.

4. Cash Transfer Option

Up to $8 million as a cash transfer (for the financing of POL.)

Rationale: This is the quickest form of balance of payments support and the only type of aid program assistance which provides a reasonable opportunity of providing timely assistance to leverage the additional resources and reforms discussed below in Section 5. Under a cash transfer funds would be available almost immediately for disbursement upon program obligation in mid-February.

In the case of ZIMOIL, the funds would be available to the Bank of Zambia to finance the scheduled February 18 shipment under the existing POL contract. Under this current contract, not eligible for AID CIP financing, the bank of Zambia would have sufficient time to pay for the shipment using cash transfer funds. In addition to providing timely balance of payments support, a cash transfer would offer a cost-savings by allowing ZIMOIL to take advantage of lower prices in effect when their current contract was negotiated. To illustrate, ZIMOIL advised that a regular 90,000 ton shipment would cost around $11.5 million under its existing contract, whereas an AID approved tender under a CIP would elicit offers at about $13.5 million given current spot market prices.

Probability of Success under Current Economic Scenario: If funds can be obligated by February 15, 1988, this is the only form of program assistance which AID can offer in response to the immediate (February) Zambian foreign exchange requirements.

5. Why A Cash Transfer? - LEVERAGE !

The reason for exploring an immediate Cash Transfer Option is to lay out the program basis for moving to exploit a special opportunity which may be presenting itself to leverage additional resources and additional reforms, all in the context of U.S. foreign aid and foreign policy objectives.

The GRZ will be $80 million in arrears to the IBRD in February, 1988. IBRD disbursements stopped in May, 1987 when the GRZ stopped servicing IBRD debt. If we could provide our program aid in an appropriate form, a timely manner and a negotiated framework, we can: (a) leverage the GRZ to pay a significant portion of the IBRD arrears, (and incidentally USAID arrears); (b) bring in additional bilateral donor assistance, debt relief, and IBRD resources; and (c) support the new reform package which cannot be implemented without significant outside support. The bottom line is that the GRZ reforms will undoubtedly flounder without the resources which might be brought in through this use of our program aid.

The IBRD cannot disburse funds until an estimated $80 million (by February 1988) in GRZ arrears on past IBRD/IDA loans are paid. A group of bilateral (Nordic and Scandinavian) countries may contribute $52 million:

Sweden	$20,000,000
Norway	$10,000,000
Netherlands	$12,000,000
Finland	$10,000,000
	$52,000,000

but these contributions for the payment of the arrears to the World Bank are currently short by $28 million.

While there are important unanswered questions about the quality of the reforms, as well as the timing and firmness of the $52 million, as an alternative to the latter, "stand-alone" CIP (above) it is proposed that the U.S. and IBRD position themselves to negotiate a GRZ contribution of the $28 million needed to complete the payment of the GRZ's arrears to the World Bank. By so doing, the U.S. could leverage IBRD disbursements from its current projects and develop new IBRD and other donor program assistance for Zambia. It could leverage GRZ debt servicing of $28 million to the IBRD and $1 million to the U.S. (to keep Zambia out of Brooke sanctions through March 1988). It could convert the $52 million pledged from the above donors for the payment of the IBRD arrears into a complete pay-off package. In addition, it is probable that a Consultative Group Meeting for Zambia could be called, and some form of debt relief organized through the Paris Club process. Finally, this scenario would support the GRZ in its tentative step forward in reversing, at least for the moment, the policy directions established on May 1, 1987.

If it is possible for the U.S. to make program decisions and move fast enough to bring in other donor and GRZ funds to complete the financing of the GRZ's arrears payment to the World Bank, the only feasible program mode option for doing so is to provide a cash transfer (see above). The timing of scheduled oil shipments and A.I.D.'s documentation and procurement requirements would prohibit the use of a Commodity Import Program to provide the foreign exchange necessary to successfully bring the above results to fruition in February, as required. (IBRD arrears quickly mount to an estimated $110 million by July; the magnitude of arrears after February puts this solution out of the range of GRZ and other donor action after February.)

6. Program Aid Analysis: Issues and Questions

At this stage of consideration we have more questions than answers, but in keeping with PAIP guidelines, we raise them for urgent consideration and guidance.

A. The substance and quality of the GRZ proposed NERP Implementation Plans and Performance Targets (they do not want them called economic "reforms") are an open question. The macro-economic measures summarized in Section 2 have been gleaned from oral presentations. The GRZ is unwilling to share their forward planning with us as it violates Zambian law to divulge anything before the budget and policies are presented to Parliament on January 29, 1988. The IBRD and IMF teams, in respect of this law, also refuse to share the details of the proposed measures with us.

We are, therefore, unable either to provide more than hearsay evidence or comment on the quality of the reforms. The GRZ has expressed surprise that we might need to know the details of the reforms; they interpret their meetings with AID officials in Washington last October as implying that U.S. acceptance of the reforms is possible if the IBRD accepts them. GRZ officials have also commented that the Nordics and Scandinavians have no need to see the substance of the package before committing themselves. The earliest we will be able to assess the quality of the reforms is January 29, 1988. In the meantime, it is recommended that AID/W review its position with the IBRD and IMF in Washington to supplement our own understanding of the policy package with data from the IBRD and IMF. Action: Early comments on the substance and quality of the reforms is solicited.

An important collateral question (raised in Lusaka 05274 for comment) is U.S. willingness to support these reforms, if (a) only agreed to by IBRD; (b) tacitly concurred to by IMF, or (c) only after reaching a formal agreement with IMF. This is an important decision both in terms of our possible leverage to the efforts to finance the GRZ's payment of debt arrears to the World Bank and our willingness to reschedule bilateral U.S. debt under any of these three scenarios. It is less relevant should we decide to do a straight CIP.

B. Timing of any possible U.S. support is another issue. It is obvious from our lack of substantive understanding of the reforms that we should be adopting a wait-and-see posture. We believe it would be sound to wait beyond the January 29, 1988 budget speech and late March budget adoption in order to judge the GRZ's implementation of the package after 3-4 months before providing program assistance. That is the timeframe for the CIP option. Only one factor is driving a faster timeframe: payment of the IBRD debt arrears must be accomplished by February or the magnitude of those arrears will climb to a size impossible for the GRZ and bilateral donors to meet. In the continuing absence of debt rescheduling or a writeoff mechanism for IBRD debt, Zambia qualifying for the new IBRD/IMF assistance programs for debt-distressed, low-income countries becomes an urgent matter.

The option of a February timing is driving us into early program choices. One of the most frustrating aspects of these choices is a lack of urgency on the GRZ's part. The GRZ attitude is that the payment of IBRD debt arrears is an IBRD problem, not a Zambian problem. "If the IBRD can arrange financing, fine. If not, that is their problem, not Zambia's." Also, the GRZ has been unwilling to pay more than some proportion (unstated) of the 10% net FX formula from its own funds to the IBRD arrears; therefore, the IBRD and we are proposing to explore the possibility of the U.S. donating $8 million towards a February oil shipment to leverage the GRZ to pay $28 million in February to the IBRD. This could be accomplished with a cash transfer, but will be impossible to implement as a CIP because of lead time and procedures of a CIP.

For the U.S. to obligate funds in February will require the GRZ to pay U.S. debt arrears of approximately $1 million in January--a most difficult move for them. However, the Minister of Finance and Permanent Secretary said in two separate conversations as late as December 30, they are proposing January debt servicing of the U.S. FAA debt. In this situation we have the unique opportunity to provide economic assistance to Zambia that will result in a direct net outflow of funds for the country, i.e., the payment of $1 million on U.S. arrears plus the payment of an additional $8 million to the Workd Bank, in exchange for $8 million of U.S. program assistance. We will put ourselves in an unfortunate political position if the GRZ services the U.S. debt in January in anticipation of a February obligation which cannot be assured until Washington gives its clearance, Congressional Notification approval is obtained, and local negotiations are complete which will be well into February.

C. Commitment. We must never forget that at best Zambia is a mixed economy with the balance in this mix constantly shifting as the President balances off competing demands and tries to strike that elusive and dynamic middle ground between economic controls and free markets, and between socialism and some mild form of private enterprise. This lack of decisive commitment to market reforms is compounded by his constant shift of economic managers (five P.S.'s of Finance and five P.S.'s of Development Planning in 18 months). The acute lack of effective economic leadership in Zambia continues to undermine commitment to reforms. There are probably far more immediate "losers" in a real economic reform and thus far more resisters than reformers. The President concluded the National Council Meeting last week with a call for the party faithful to give up "poisonous, exploitive capitalism for socialist goals." This was yet another indicator of non-commitment to real market-policy reforms in many parts of the political structure. Therefore, any of us who think this is the first step toward Zambian capitalism will be acutely disappointed and frustrated. (We urge decision-makers to re-read at least the summary of the Political Annex to our CDSS, written only six months ago, where we concluded that it is in U.S. interests to support the reformers whenever we can.)

The bright side of the commitment question is the way which the GRZ is approaching the current implementation plans. Last time around the reforms were explained by the political leadership as imposed on Zambia as the price of getting donor foreign exchange. This time the reforms are Zambia's and will be explained as such in order to elicit popular acceptance. This implies a higher degree of political commitment than existed prior to May and is to be supported. However, it also poses a greater risk for the GRZ if popular acceptance of the reforms is not forthcoming.

D. The GRZ's ability to implement the reforms is another issue. There is no more managerial ability than before May 1; in fact, the repeated change in civil servants has undoubtedly undermined experienced, confident management in the ministries and organizations which will be responsible for the program's implementation. Also, the GRZ has continued to accept far more technical assistance than they can effectively absorb, further diluting their own management ability. There has been no renewed interest in making use of HIRD and IBRD financial management help in the Ministry of Finance, Bank of Zambia or National Commission of Development Planning. Lack of managerial ability and policy coordination was a factor contributing to the earlier reform failure; we are skeptical that things will go better this time, especially in a national election year.

E. The probable impact of the new reforms are impossible to analyze without knowing the specifics of the new measures. If we understand correctly, the per capita GDP growth after all the measures are implemented is a realistic (and possibly optimistic) 'zero'. We have long said that the best Zambia will do for some time is to slow the rate of economic decline--not start positive growth. Hard financial and economic decisions will need time to work before real growth is possible. Yet the political pain and economic hardship inherent in the proposed reforms may be more than can be tolerated 6-10 months before national elections. This is the dilemma: the reforms will be seen as too slow to satisfy the reformers and too fast to satisfy those concerned with the social impacts of the reforms.

If the proposed policy package is not sufficient to result in real growth or at least lay a firm basis for future growth, should we support it? Western support will be seen by some as trying to hold Zambia in Western financial shackles, and by others as relieving the pressure to face up to the harder economic measures needed to generate growth.

The current approach of some donors, not the GRZ, paying the World Bank arrears does not directly move Zambia away from the 10 percent of net foreign exchange debt service formula which sets a bad precedent for Western creditor nations. While we must see Zambia service the U.S. debt for us to obligate funds, it does not reinforce the principle that the GRZ is responsible for servicing its external obligations unless we can leverage a higher debt servicing by the GRZ. Rather, it perpetuates the GRZ's belief that Zambia's debt is a donor problem, not their own, which should be solved by our converting old loans into grants while providing additional assistance.

There are some positive impacts. The proposal does envision Zambia adopting some sound (as yet unevaluated) economic measures; it represents some move away from the May 1 state controls even if it does not abandon these; it does propose a financial plan (as yet unknown and unevaluated) which could keep Zambia within the Western financial institutions; it could lead to debt rescheduling, the only option for U.S. debt management. It does call for Zambia to service the U.S. economic assistance debt to get out of Brooke--even if only for a short period.

F. We suggest that we support this move because it leverages economic reforms. This is a dangerous and false sense of U.S. importance in Zambia's economy. We are number seven among bilateral donors, behind countries with smaller economies, but larger per capita aid levels. More importantly, when it comes to its politics and economy, Zambia will do what it wants, not what the U.S. or West wants. The package of reforms the GRZ intends to implement in 1988 has already been drafted by reformer technocrats and will be accepted or amended by the political leadership without reference to U.S. positions or support. They will adopt and implement the reforms or not with or without us. This is absolutely necessary if they are to succeed.

Others argue that we should extend program aid to provide real debt relief. They do not understand Zambia's position that debt servicing will continue within the 10 percent of net foreign exchange limit, and any consequences beyond that of IBRD or U.S. aid cutoffs for debt default are our problems--not Zambia's. Zambia cannot understand why a rich country like the U.S. does not forgive debt. We gain no leverage over debt management through this program, unless we, the IBRD or the IMF can get Zambia to abandon the 10% formula, and time does not allow such conditioning of our aid.

Leveraging in other resources is another reason given for our participation. There is some justification for this when our $8 million could be the margin of difference between triggering the IBRD financing plan and other donor flows versus Zambia going it alone with its own resources. We are not in possession of the facts to measure the amount of additional resources which might result from the proposed approach. It is very important that we remember that large aid flows to Zambia have and will continue with or without the reforms. (The Italian commitment of $212 million last week underscores this fact.)

Because of IBRD "informal" discussions with the GRZ and other donors, we must be very skillful to avoid being branded the "villian" if the whole plan collapses because we do not or cannot participate in a scheme which would have resulted in GRZ debt arrears paid to the World Bank if we had participated. Up to last week the Zambians were absolutely uninvolved and non-commital on whether U.S. aid should be used in any way which could result in IBRD arrears being paid or as program or project aid. The GRZ posture began to change this week (December 28-31) with clearer signals from Finance that they would like the U.S. to consider program aid which would result in the Bank arrears being settled by them and donors. As time gets short and other sources cannot be found, the U.S. will be seen as the donor of last resort, whose participation will make or break the reforms. This is a most unfortunate position, but cannot dictate our policy.

G. We must decide if this is the best use of our limited resources. But before that, we need to reconsider our level of FY1988 resources in Zambia. The OYB was cut by one-third from $15 to $10 million to indicate our reduced support following the May 1 policy reversals. Recent AID budget decisions signal that the cut will remain regardless of Zambian reforms. Not only is that inconsistent with our own criteria for determining OYB levels, but sends just the opposite signal than we intend, i.e., with or without reforms U.S. support will remain at the same reduced level.

If we use the balance of our assigned OYB ($8 million) to help leverage the payment of the World Bank arrears, we will have nothing left to support the reforms or own strategy objectives in agriculture; Zambia will believe we repaid ourselves with no net direct gain to them (actually at a net loss to them). When we are perceived as being unable to help implement the reforms with financial, as opposed to technical resources, the negative impression may be just as damaging than the perception that we are unwilling to help leverage IBRD arrears.

A collateral issue is how Congress will react to the second (cash transfer) alternative in this proposal. It is most important that immediate consultations be held with the Hill to sound this out.

H. Consistent Support for Reforms. Our CDSS anticipated that there would be ups and downs, forwards and backward movement on restructuring the Zambian economy. We concluded that we must keep our eye on the long term objective and not be dissuaded by temporary setbacks. AID has not done this very well since May. We also concluded that we should support those Zambian reformers when they try to reform Zambia's economic policies. This is where we are now. They and we have helped swing the pendulum back in the right direction--though the pace and magnitude may be lacking. They have been able to do this in seven short months when others said nothing could change until after the elections. As long as we do not again fall prey to the temptation and expectation that Zambia has decided on an "ever upward" capitalist track and will not deviate from that policy, we should support the reformers.

The consequences of not supporting these reformers at this time mayl be a long delay before the reformers can overcome the stigma of starting reforms which the West could not or would not support. It will be several years (not just after elections) before they would try again.

It must also be recognized, however, that the up-down, backwards-forwards see-saw on economic reforms can be expected to continue. Due to this, we cannot know except over longer time if there will be an underlying trend of an improving policy environment and economy around which the political cycle will oscillate. Thus, to a very large extent we are and will be engaged in a risk-prone venture which could easily prove to be a failure.

I. Conclusion. The proposed U.S. move to reinstate program assistance in a way which leverages GRZ payment of arrears to the World Bank is probably premature and has only a small chance of generating a continuing policy movement towards a more market-oriented economy. Our strong preference has been and is that other donors bail out the IBRD. We should get involved only if:

(a) all the rest of the $52 million is assured;
(b) the IBRD endorsed reforms might collapse without our help;
(c) There is a reasonable chance the GRZ will perceive our move as helpful instead of undue interference;
(d) the quality of reforms warrant our support (a fact which we cannot know until the end of January 1988);
(e) the timing, required documentation, and actual transfer of money will really work in a way which results in renewed reforms and renewed debt servicing and higher overall disbursements;

(f) the $5 million cut in Zambia's OYB would be restored if after June we see the reform package is working;
(g) the package will result in increased aid flows from other donors; and
(h) rescheduling of debt can take place.

This is a lot of "ifs". The GRZ already (from ZAMCAM, PL 480, Self-Help and CIP Conditions Precedent negotiations) feels the U.S. conditions its assistance more than any other bilateral donor and does not want to encumber this plan with U.S. conditioned aid. We, too, feel that we are better off not participating than to tie our aid to conditions that doom the whole package to failure.

Unless the foregoing nine conditions can be quickly met, we would much prefer, as we will again argue in our May 1988 Action Plan, that we return to our historical focus and strength - concentrating on the agricultural sector, and leave the macro-economic leadership to the IMF/IBRD. There is much that must be and can be done at the agricultural sector level while the macro-policies are being sorted out. Strong staff development, institution building, policy analysis, data research, systems and procedural changes, and physical infrastructure improvements make incremental change in the agriculture sector the effective option to wholistic national macro reforms which repeatedly fail without strong sectoral underpinnings. This does not mean we do not recognize the constraints imposed by improper macro-policies. It does recognize that Zambia is not able to move on wholistic macro-reforms, and where movement is possible it is politically desirable to leave this to the more neutral IFI's while we contribute where we have been more effective - in agriculture.

J. If it is decided to proceed with U.S. program aid which might result in the GRZ paying its arrears to the World Bank, everyone must be very clear about why we are doing it. From our perspective, and lacking data for analysis, the main reason would be to keep Zambia in the Western financial institutional framework as it solves its debt, development and restructuring problems. We must accept that there again will be back-tracking and we cannot be dissuaded from sectoral developments, as we have been this time, by macro disappointments.

7. Action Request and Timing

A. AID/W comments by January 8 on options of:
(a) July Agriculture Sector CIP, or,
(b) February Cash Transfer
(c) Possibility of restoring the Zambian OYB level.

B. If the February Cash Transfer option is recommended by AID/W, USAID would need to:

1. Prepare cash transfer PAAD - by January 28
2. Negotiate GRZ payment of U.S. arrears to clear Brooke - by January 28
3. Negotiate with IBRD and other donors GRZ payment of IBRD arrears - by January 28
4. Confirm reforms in Budget speech - by January 29
5. GRZ pay U.S. arrears - by January 29
6. AID/W review of cash transfer PAAD - by February 4
7. Congressional Notification - on February 5
8. Informal negotiation of cash transfer Agreement - by February 19
9. Sign cash transfer agreement - on February 19
10. GRZ pays IBRD arrears - by February 22
11. U.S. transfers $8 million for Balance of Payments Support - by February 22

C. If the July Agriculture - Private Enterprise CIP option is recommended by AID/W:

1. Review quality of reforms announced in January 29 Budget speech to see if they warrant program aid - by February 15
2. AID/W authorizes preparation of Agriculture CIP - by March 1
3. USAID and REDSO arrange for CIP PAAD design team - by April 1
4. Design of CIP-PAAD - by June 8
5. AID/W review and approval - by July 25
6. GRZ services U.S./FAA debt arrears - by August 1
7. Obligation of CIP - by August 31

E. Action: Please cable AID/W comments on the options presented in this paper NLT January 8. In addition, provide guidance on the depth and breadth to be required in the Cash Transfer PAAD if the Cash Transfer Option is approved.