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MEMORANDUM

DATE: April 30, 1993

TO: Keith Brown, Director, AFR/SA
Lucretia Taylor, Deputy Director, AFR/SA

COPY: Fred Winch, Director, USAID/Zambia

FROM: Richard Harber, Supervisory Country Development Officer, AFR/SA/MBZ

SUBJECT: Trip Report — Joint Evaluation Mission to Examine the Foreign Exchange System, Procurement Practices, Attempts to Harmonize Donor Balance of Payments Practices, and Other Miscellaneous Topics

I travelled to Lusaka, Zambia from April 16 through April 26, 1993. The purpose of the trip was to be the U.S. representative on the World Bank led, multi-donor Joint Evaluation Mission (JEM) to Zambia. The task of the JEM was to review Zambia's current foreign exchange regime (pricing and allocation mechanisms and processes) and proposed changes to that system, as well as general issues and practices dealing with the management of balance of payments support. Originally, the JEM was scheduled from April 18-23, 1993, but was extended at the Paris Consultative Group on Zambia to run from April 18-29, 1993. Since I was unable to participate for the full length of the JEM, I do not yet have a copy of JEM's the final *Aide Memoir*. This memorandum describes the general discussion and direction of the JEM and what I believe will be the JEM's general conclusions/recommendations.

GENERAL COMMENTS ON THE JEM MECHANISM/CONCEPT

The basic concept behind the JEM is designed to improve donor coordination and cooperation in examining key questions and issues in specific countries. Special attention is placed on the variety of issues and policies which have been developed under the Special Program of Assistance (SPA). The basic idea of the JEM mechanism is good; however, the execution tends to leave something to be desired. In the Zambia case, there was a very specific (but broad) issue to be examined. Out of a total team of fifteen outsiders, perhaps five or six had previous experience or knowledge about Zambia, and three or four had background experience in dealing with the main question of the JEM. With the exception of two or three of the people on the JEM, everyone else was participating on at least one other Mission over the same time period.

One-half of the bilateral donor contingent (ODA, NORAD), spent their time pushing their own agenda's which were not necessarily consistent with the SPA goal of promoting open, transparent market-based foreign exchange systems. NORAD's goal seemed to be to make the foreign exchange system and procurement procedures adhere to the system and procedures used by Norway, despite their relatively small level of balance of payments support. ODA (along with the EEC), on the other hand, was pushing to set up a solely retroactive financing or reimbursement system so that they could easily and clearly satisfy their auditors. They did not care that the initial seed money to establish such as system was not available. They went so far as to push for Zambia setting up a short-term line of credit (thus violating the IMF program) to enable such a system to be established.

ADMINISTRATIVE/ORGANIZATIONAL INFORMATION

The JEM Mission was composed of representatives from the following institutions/donors (members on the team): World Bank (Team Leader, 1 resident staff person, 3 Washington staff), USAID (1), ODA (2, split timing, plus two consultants from Price/Waterhouse), AFDB (1), NORAD (1), KFW (Germany, 1), IMF (1), EEC (1, consultant). Resident representatives from the EEC, Japan, UNDP, and Citibank also participated in many of the meetings and deliberations, but were not part of the JEM. In addition, representatives from the Bank of Zambia, Ministry of Finance, and the National Commission for Development Planning (NCDP) also worked with the Mission. While the Mission per se involved all these individuals, the basic work, analysis, and preparation of the aide memoir was done by about seven people, three from the World Bank, the EEC consultant, the ODA consultants, and myself. To be able to address the full range of issues which had been identified in the JEM's terms of reference (Attachment A), the Mission divided into five Working Groups (A-E) in order to examine the following topics:

A — Foreign Exchange System and Determination of the Exchange Rate;
B — OGL Organization/Administration (Procurement & Disbursement);
C — Standardizing Donor Requirements;
D — CounterValue Funds (GRZ Accounting Practices); and
E — Pre-Shipment Inspection.

At the request of the Team Leader, and with the concurrence of USAID/Zambia's Director, I devoted the entirety of my time to Working Group A (WG-A). While this working group formally had thirteen members, three people formed the core of the group — two of whom (EEC/USAID) wrote the Working Group's report, while the third (the IMF Resident Representative) functioned as chauffeur, expediter and opened meetings.

WORKING GROUP A

WG-A examined the questions and issues surrounding the immediate future structure of Zambia's foreign exchange system and the mechanism for determining the exchange rate. The WG-A report summarizes the current system and its perceived problems, analyzes the validity of the perceived problems, summarizes the Zambian Government's (GRZ's) proposed solution to the perceived problems, examines two options for the immediate future of the system, and makes a recommendation concerning these options.

The Current System: Zambia's current foreign exchange system is composed of three components — the Open General Licensing System (OGL), the Bureaux de Change/Retention Market, and GRZ foreign exchange non-market allocations for debt service, Zambia Consolidated Copper Mines (ZCCM) imports, petroleum imports, and other GRZ requirements. The unified exchange rate which applies throughout these three systems (since December 7, 1992) is a market-based rate determined by the Bureaux de Change/Retention market, i.e., the weighted average of the rates at the different Bureaux. The annual volume of foreign exchange through these channels are approximately $150 million for the Bureaux de Change/Retention market, $300 million for the OGL, and $1,000 million for the GRZ allocation system.

Due to the rapid inflation which has afflicted Zambia over the past year (over 200% per annum), the Bureaux rate has undergone a rapid devaluation in line with inflation.

Perceived Problems of the Current System: The rapid devaluation of the kwacha has raised the concern of the GRZ. The official casting of the problem is that the Bureaux rate is "inappropriate" for use as determining the exchange rate for commodities since the Bureaux can sell foreign exchange for the payment of services, as well as the importation of commodities. Further, there is a feeling that the Bureaux are being used to acquire foreign exchange to facilitate capital flight. In addition, the combined Bureaux/Retention market is highly concentrated with the largest institution accounting for somewhere between 50 and 60 percent of the market, and the three largest Bureaux accounting for approximately 80 percent of the market. As a result, the GRZ view is that the Bureaux determined exchange rate is undervaluing the kwacha, i.e., has devalued to too great a degree, for purposes of the pricing of commodities. Yet another dimension of the perceived problem is that it is felt that donor balance of payments funds should be "discounted" in some way since they generally carry some form of restrictions on their use; however, the GRZ has no sound basis to use for determining the degree of discount to apply.

GRZ Proposed System: To address these problems, the GRZ had prepared a proposal to introduce a tender (auction) system to price and allocate foreign exchange.[1] The JEM was requested due to a variety of donor questions and concerns regarding the proposed system. In very brief summary, the proposal was that the Bank of Zambia (BOZ) would hold a daily auction of funds. Commercial banks would bid, on behalf of their customers, for the funds which would have any donor restrictions identified prior to the submission of bids. Commercial banks would not be allowed to hold open positions in foreign exchange. Through the auction process, the ruling exchange rate and the allocation of donor funds would be determined. Thus, the appropriate discount on donor funds would be market determined and not set via GRZ fiat. The proposed system also delegated authority for initial review of documentation to the commercial banks, rather than by the BOZ.

JEM/WG-A Findings and Recommendation: The task of WG-A was to examine the current and proposed systems, make recommendations for improving each, and making a global recommendation on what system should be adopted. In the course of the review,

[1] *Due to the GRZ's negative experience with the foreign exchange auction from 1985 through 1987, the government explicitly decide to call the proposed system a tender system rather than an auction system.*

WG-A was also to examine the specific questions and concerns that had been raised by various donors.

The general report of WG-A is composed of the following nine sections:[2]

I. Introduction
II. General Macroeconomic Program, Environment and Implications for Any Foreign Exchange System
III. Medium-Term Issues in Developing the Foreign Exchange System
IV. Basic Foreign Exchange Data for Zambia
V. The Current OGL System and Possible Modifications
VI. The Tender System
VII. Comparison of Systems
VIII. Recommendations on General Issues Independent of Foreign Exchange Regime
IX. Overall Recommendation

A major part of the analysis was the examination of the GRZ's concerns about the current system. The key question was whether or not the exchange rate determined in the Bureaux market can be considered a representative rate for trade transactions. Examination of the time paths of the various market determined rates in Zambia over the last several years indicated that the Bureaux/retention market rate was simply a continuation of that time path, i.e., is determined by the macroeconomic fundamentals. Thus, no evidence of a capital flight premium was evident. This conclusion was bolstered by the fact that a minimum of 80 percent of the funds moving through the Bureaux/retention market are going for commodities, and not services. The suspected heading for capital flight is travel allowances and not commodities.

Given this conclusion, the "KIS"/"IIABDFI" principles, and donor concerns about the Bank of Zambia's capabilities to institute and satisfactorily (from the donors' viewpoint) manage a new system, the report (based on a straw pole of the entire JEM Mission) recommends that the current OGL system be maintained.[3] An option allowing the introduction of an exchange rate discount for OGL funds, relative to the Bureaux/retention exchange rate, was offered as a way to sooth concerns about possible undervaluation of the kwacha in the Bureaux/retention market.

In addition to the above major recommendation, a number of recommendations concerning modifications of the proposed tender system were included in case the GRZ decides to proceed with the tender system.

[2] *The summary and full versions of the WG-A report are attached (Attachments B and C).*

[3] *"KIS" — Keep It Simple; "IIABDFI" — If It Ain't Broke, Don't Fix It.*

Reactions: These basic conclusions were presented at a meeting with selected representatives of the Bank of Zambia (Special Advisor to the Governor, the HIID team member assigned to the BOZ, plus representatives from the foreign exchange and research divisions) and various donor representatives. The donor representatives were more or less content with the findings (less problems for them since there would be no need to adapt to a new system), although the EEC/ODA drum beat for moving to a full reimbursement/retroactive financing scheme continued. The reaction from the BOZ representatives was less than enthusiastic, but not specific. Reading between the lines of the comments and specific reactions, I got the following reactions:

1. There was a definite view that the Government had already established and announced a statement of future policy, namely that they were moving to a tender system.
2. There was a real concern over the introduction of an administratively determined "discount factor" between the Bureaux/retention market rate and the rate to be applied to other transactions. The undercurrents indicated that the existence of such an administrative lever would be too tempting a target for GRZ interference in the system.
3. Any aspects of the proposed tender system which trouble the donors can be modified.

OTHER WORKING GROUPS

At the time I departed, the only other working group which had produced any recommendations was Working Group B, dealing with procurement and disbursement issues. While this group uncovered some interesting matters, e.g., the Swiss based company SGS which provides pre-shipment inspection services has a sweetheart contract which is entirely one-sided, their recommendations are directed towards making the procurement process more realistic and less burdensome vis-a-vis paperwork and general procedures. It also had specific recommendations for strengthening the operations of various divisions of the Bank of Zambia.

Working Group C, dealing with the harmonization of donor policies, seemed to be heading towards a recommendation that donors should harmonize their balance of payments policies (surprise!). The key question will be whether or not there is a recommendation that the "least common denominator (LCD)" not be used. The LCD approach can be expected to result in the worst of all possible worlds (Italian and Canadian restrictions, in the Zambia case) for the provision of balance of payments support.

Working Group D, countervalue funds, had a single meeting to try to see if the GRZ is following the proper accounting procedures for countervalue funds, and to what extent donors are messing up the system. The proposed recommendation is that donors should take care and not mess up the system by requiring specific uses for the countervalue funds.

Working Group E, pre-shipment inspection, was merged under Working Group B.

OTHER COMMENTS/OBSERVATIONS

The Bank of Zambia continues to suffer from organizational and management problems. One of the biggest problems is simple lack of physical facilities, space, file cabinets, desks, computers, etc. Other problems revolve around the fact that the BOZ staff are not fully trained. One example of these problems come from the continuing difficulty in getting documentation for donors to support OGL transactions. In this case, the biggest difficulty is the lack of space and facilities to actually file the documentation that is received. As a result, when donors want to retrieve the documentation, it can't be easily found.

Another example comes from the poor state of basic accounting. Trying to track what is happening to base money and the money supply has been a continuing problem and difficulty for the BOZ. This is typically reflected in the fact that the "Other Items Net" category of the monetary accounts carries a major portion of the changes in the Zambian money supply. Two recent examples highlight the difficulties. First, the private auditing firm reviewing the 1990/1991 BOZ accounts finally had to give up on the audit due to the fact that it was impossible to track and verify the accounting. The latest crisis revolved around the fact that a $24 million equivalent discrepancy in the monetary base was discovered. As it turns out, this corresponded to the unpaid countervalue funds from ZimOil's purchase of foreign exchange for petroleum imports.

A final example comes from the sad state of data management and processing. In the course of preparing the Working Group A report, we requested data concerning the transaction volumes and exchange rates in the Bureau/retention market. In response, the BOZ Research Division provided us with three floppy disks of spreadsheet files. The basic data consisted of the buying and selling rates for the U.S. dollar, pound sterling and South African rand in each Bureaux for each business day. These data were organized in separate spreadsheet files for each day rather than in a data base which would allow comparative cross-section and time series analysis. The truly scary part of the story comes from the fact that we later found out that when we were given those three floppy disks, we were in possession of the only copy of all the country's computerized data concerning the Bureaux de Change! No spare or back-up copies, on floppy or hard disks, were maintained.

This litany of continuing difficulties makes one wonder what the series of IMF advisors to each of the main BOZ departments have been doing, as well as the string of HIID and other advisors which have been provided by other donors.

Attachments:

A — JEM Terms of Reference
B — Summary Working Group A Report
C — Full Working Group A Report

ATTACHMENT A:

JEM TERMS OF REFERENCE

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ZAMBIA

Joint Evaluation Mission

Terms of Reference

1. A Joint Evaluation Mission will visit Zambia from April 19-29, 1993. The purpose of the mission is to review Bank of Zambia and donors' procedures and policies concerning import support programs. (Paragraph 10 below gives more details of the specific areas to be examined.) It is hoped that the recommendations from this mission, both for government and for the donors, will increase the efficiency and accountability of the use of balance of payments assistance and thereby enhance the contribution of these resources to achieving sustainable economic growth in Zambia.

Background

2. Following the collapse of the auction system in May 1987, the official exchange rate was administratively determined, and the allocations were done through a Foreign Exchange Management Committee (FEMAC). Export proceeds gained through the export retention scheme had also to be surrendered to the Bank of Zambia and FEMAC approval granted for their use.

3. In February 1990, the current foreign exchange liberalization process was begun with the initiation of a two-tier exchange rate system operating through two windows. The first window continued much like the previous system with the rate set by government and the forex (mostly from ZCCM) allocated by government. The second window rate was also set by government but at a level (at least initially) thought to be close to a market equilibrium. This market worked on an Open General License system and was funded primarily from non-traditional export and donor proceeds. Initially the OGL list included only a small number of goods, mostly industrial imports, but the list was gradually expanded through late 1991 by which time it covered about 90 percent of base period imports. The official and second window rates were merged in April 1991. The coverage was shifted to a negative list basis in September 1992.

4. Through most of 1992, the private sector had two potential markets for foreign exchange. They could buy forex at the export retention market or at the OGL. The retention market had a higher price but had less restrictions on the goods to be purchased and had no donor-related requirements. In September, a Bureaux de Change system was established which provided an organized market for all other sources of foreign exchange and which for small amounts created an essentially free market for the purchase of nearly all goods and services.

5. In December 1992, government decided to let the Bureaux de Change rate be the OGL rate as well. At the same time government decided to adopt two further changes. First, the OGL transactions would be handled directly by commercial banks under rules set by the Central Bank. Second, an auction would be established to set the price for the donor

funds going into the OGL. In the event, the decentralization is going forward whereas rules and procedures for the auction are still being discussed.

Current Issues

6. One set of issues concerns the operation of the OGL itself and existed even before the recent changes. Donors are concerned to know how efficiently their funds are being used. The four major areas of concern were summarized in the SPA Guidelines for Donor Import Support.

- **Foreign Exchange Market Efficiency:** A market based exchange rate that allocates forex fairly and efficiently on the basis of price;

- **Enterprise Efficiency:** Reasonable efficiency of importing enterprises;

- **Procurement and Payment Practices:** By purchasers that are consistent with normal commercial practice;

- **Transparency and Accountability:** Administrative procedures that effectively guard against over invoicing (for capital flight), under-invoicing (to avoid duty) or mis-invoicing (to import prohibited items) and audit and reporting systems that follow up on the above and permit reasonably accurate and up-to-date reporting on donor funds.

7. In Zambia's case, there has been particular concern about the last area. The mission will also be interested in how the devolution of responsibility to selected commercial banks for the day to day operation of this system will affect the issues listed above, and how the Bank of Zambia will ensure that the objectives of value for money and accountability are being met.

8. The government is concerned about the need to liberalize and standardize donor requirements. These involve procurement, negative lists, country of origin, and record keeping requirements. The OGL system would be much easier to administer and more attractive to importers if these requirements could be made more liberal and more uniform. This will involve some compromise on the part of donors, but it will also require better information and assurances from government. This is an ongoing process. Donor requirements have been considerably liberalized in the past few years. More can be expected if government can show that donor concerns will still be met. The mission will explore ways in which donor requirements can be simplified and what donors will require in order to justify these changes.

9. The auction feature of the proposed system is intended to achieve a market clearing equilibrium rate. It is being considered as a replacement for using the Bureaux de Change rate for two reasons. First, the Bureaux is a small market and may not reflect the broader demand and supply forces. Second, the Bureaux rate cannot reflect any special disadvantages to buying donor funds as opposed to buying cash. The mission will examine the issues involved in setting up such a system and will make recommendations, but the primary focus will be on how the new procedures will affect the achievement of the SPA

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guideline objectives, namely enterprise efficiency, foreign exchange market efficiency, value for money, and transparency and accountability. The auction proposal is a complicating factor, but the primary concerns of OGL administration and donor rules simplification pre-date that proposal, and they will be the major areas on which this mission will focus.

Mission Objectives

10. There are many questions that could be usefully addressed by a Joint Evaluation Mission to Zambia. To be effective, the mission will need to concentrate its attention on a manageable number of issues that can be dealt with, given the resources available. The following are the key questions to be addressed in each area:

Foreign Exchange Market

(a) What are the various foreign exchange "markets" in Zambia (OGL, retention, Bureaux, government direct, other), and what are the sizes, the rates, the differential rules for access, and the macro economic effects? Does this collection of mechanisms constitute a reasonably efficient market? What are the objectives for future development of the system? How can the planning for these markets, including the estimation of likely levels of sources and uses, be improved? What are the options for channelling donor finance into the proposed new system? What might be the macro-economic effects of adopting the new system? How might a donor reimbursement mechanism operate, and how could the liquidity problems be overcome?

Enterprise Efficiency

(b) Are there serious distortions that affect the efficiency of foreign exchange use by importers, and what are the best ways to address these distortions?

Procurement/Payment

(c) Are public sector procurement procedure and practices sufficient to secure value-for-money? How should these be improved, and by what timetable?

(d) Are normal commercial procurement practices in the private sector adequate to achieve value-for-money? What safeguards are needed?

Transparency and Accountability

(e) To what extent do foreign exchange and taxation systems create incentives and opportunities for capital flight, tax evasion, or commercial corruption, and what is being done to reduce those incentives and to police those practices? What contributions does pre-shipment inspection make?

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(f) What safeguards exist to prevent and detect abuses at all stages of an import transaction and to ensure that an adequate documentary trail exists for audit?

(g) What systems exist in the Bank of Zambia and elsewhere to ensure compliance with donor accountability requirements? What changes are needed (in rules, procedures, practices, and administrative capabilities) in order to improve performance?

Donor Requirements

(h) What donor requirements and differences in donor requirements complicate the administration of import support? How can these be liberalized and standardized without compromising the efficiency of import support programs. What modifications would be needed in the reporting procedures used by commercial banks in the new system to allow it to be a common reporting format for all donors?

<u>Organization</u>

11. There is already a working group in Lusaka looking into many of these issues. That group should be encouraged to gather information, clarify issues, and prepare proposals in the areas above, to the extent possible. Where necessary, external resources should be used to do necessary research and compilation. These draft terms of reference where discussed and agreed at a meeting with the government and donors in Paris on April 5, 1993. The core mission time will be April 19-29, but not all members of the mission will be able to be in Lusaka for the entire time. In order to make that time effective, government has agreed to make available background information on the questions raised above in advance of the JEM. The mission leader will be in Lusaka from April 12 through April 29. The wrap-up meeting will be held April 28 or 29. An aide-memoire will be completed at the end of the mission that will record the agreements reached, the next steps to be taken by all of the parties, the person or organization responsible for pursuing each action, and an agenda for addressing any unresolved issues.

ATTACHMENT B:

SUMMARY REPORT OF WORKING GROUP A

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THE FOREIGN EXCHANGE SYSTEM STRUCTURE

I. INTRODUCTION

This section constitutes the report of Working Group A of the World Bank led Joint Evaluation Mission to Zambia. The task of Working Group A was to consider the broad questions of what systems should be used to determine Zambia's exchange rate and allocate scarce foreign exchange. This report examines Zambia's current Open General Licensing (OGL) system and the proposed Tender System, makes recommendations for modifying each of these systems, presents a comparative analysis of the two systems, and finally presents a general recommendation concerning which system should be adopted.

At the outset, it should be emphasised that no matter what system is adopted, a significant devaluation of the Kwacha can be expected unless stabilization measures are consistently and effectively implemented. Failure to achieve adequate stabilization represents the biggest threat to the smooth operation of either of the allocation and pricing systems.

II. MEDIUM-TERM ISSUES IN DEVELOPING THE FOREIGN EXCHANGE SYSTEM

The Government is committed to a unified, privately-operated, market determined, exchange and payment system, which is sufficiently flexible to acommodate donor concerns on accountability and "value-for-money" requirements. The basic model for such a system is the interbank market model to be found in Ghana and currently under consideration in Uganda. Under such a system exchange rate determination and foreign exchange allocation will be market-determined although, by dint of the structural characteristics of the Zambian economy and the debt/public finance structure of government, BOZ will remain a major player in the market. In considering the evolution of such a system a series of medium-term issues require to be addressed.

1. A fully unified system will require the elimination of capital controls. In the medium term, once sustainable macroeconomic balance has been achieved, the abolition of capital controls will add to the efficiency of the exchange rate system. In the short-run, however, consideration needs to be given to the possible adverse consequences that removing capital controls will have on the real demand for Kwacha and hence for domestic inflation.

2. An interbank market requires that the players (the commercial banks) take open positions, thereby severing the direct retail link between the supply of foreign exchange and the import financed. This is possible only if the supply of forex to the market is "untied", and the development of an interbank market therefore requires that donor support programmes are compatible with the requirements of an interbank market and that current non-market foreign exchange sources and uses be intermediated through the market system. Consideration must be given to whether components of the so-called "preferential" foreign exchange allocation can be allocated within the proposed interbank market system.

3. A wholesale interbank market would alter the role of authorized foreign exchange dealers from being agents of the importers to strategic players in the market. Given the current

concentration in the bureau-cum-retention market problems of market domination and issues of the competition policy must therefore be addressed.

4. Zambia is prone to sharp periodic external shocks affecting the supply of foreign exchange from terms of trade changes and from discontinuities/lumpiness in aid flows. Moreover in the short-run, the shallowness of the economy means that short-term (i.e., daily or weekly) fluctuations in supply and demand are prevalent. Efficient markets require sufficient depth so that the size of individual flows is small relative to overall market turnover, and therefore in moving to a full interbank market, consideration must be paid to:(i) whether macroeconomic conditions consistent with the development of necessary market depth; (ii) the level of reserve coverage required by the BOZ to allow for effective short-run intervention in the interbank market; (iii) requirements in the area of prudential regulation and banking supervison as authorized foreign exchange dealers switch from being brokers to market makers.

5. Notwithstanding other macroeconomic concerns, the issues mentioned above mean that creation of an interbank system cannot occur immediately. A broad-based retail tender system is the most logical transitional system for foreign exchange allocation. In contrast to the administrative OGL system, such a system provides a mechanism through which resource pricing is market determined, and where the true value of scarce foreign exchange is determined by revealed preference rather than assumed through an administrative queueing mechanism. However, in the short term the introduction of a tender system may place a heavier burden on the administrative capacity of the BOZ. A trade off may therefore be necessary between the resource allocation inefficiencies and administrative capacity.

III. THE CURRENT OGL SYSTEM AND POSSIBLE MODIFICATIONS

The current OGL system has been in operation since January 1990 when it was introduced under the dual-window exchange rate system. Progressive liberalization of the OGL, through the expansion of the positive list and the streamlining of the documentary process continued in 1992, and eventually in September 1992 the OGL moved from a positive to a negative list. The OGL now covers approximately 95% of all imports. These liberalization measures have been accompanied by a significant deepening of the market from $94 million in 1991 [$58m OGL + $36.5m retro-financing] to $285m in 1992 and to an anticipated level of $322 million in 1993. Allocations of foreign exchange are made by the Receipts and Payments division of BOZ, with applications for which funds were not currently available are queued according to a strict first-in-first-out [FIFO] basis. Over the past two years delays in allocating exchange through the OGL have averaged 3 - 4 weeks, reaching a maximum of 8 weeks on a few occasions.

In October 1992 the government introduced a Bureaux de change market, principally to finance small denomination personal foreign exchange transactions. While there are no limits on sales of foreign exchange for imports through the Bureaux market, there are limits of

$2000 for service payments and for foreign exchange. Since the introduction of the Bureaux market, the retention market has, *de facto*, been fully integrated with the Bureaux market. The turnover of the combined retention-cum-Bureaux market totalled approximately $30 million in the first four months of operation, compared to the $80 million turnover in the OGL market. By December and January, turnover in the market was approximately $10 million per month, equivalent to approximately 50% of the OGL market turnover. Extrapolating from 1992 retention volumes, we estimate that the retentions market comprises at least 75 to 80 percent of the total turnover. The remainder of the market is accounted for by service and travel allowance purchases.

In December 1992, the official and retention/Bureaux rates were unified so that all foreign exchange is valued at a market rate, even though the bulk of transactions (OGL, ZCCM, Zimoil, Government direct transactions and debt service) are allocated outside the market. Strictly, unification was not absolute since the December unification proposal envisaged a two-tier system:

i) the buying and selling rates for all transactions excluding OGL transactions would be set equal to a weighted average of the Bureaux rates.

ii) OGL transactions would be valued at the same rate less a discount. It was anticipated that the discount would be set by the Bank of Zambia at a level of 15%.

The unification proposal thus meant that while foreign exchange allocation was still done by administrative fiat, the pricing was market determined.

Decentralization of the OGL system

Finally, on 13 January 1993 the OGL system was abolished and replaced by a decentralized OGL system, in which the former OGL market functions were handled by authorized dealers. Specifically, the de-centralization has involved:

(i) the relaxation of the requirement by BOZ that the importer provides 100% Kwacha cover on application. The Kwacha cover now need only be provided once the LC is opened. In practice, however, most of the commercial banks still require full Kwacha cover from the importer prior to submission of application.

(ii) upfront foreign exchange allocation: if the import is to be financed by BOZ own resources or through a retro-active financing arrangement with the donors, then BoZ will release the foreign exchange to the Zambian commercial bank which can then confirm the LC in its own name. This contrasts with the previous provision that forex is released to the accepting bank only on opening of the LC.

There is a perception that the OGL system as of January 1993 has worked relatively efficiently. Non-market-allocated funds have been valued at the Bureaux market rate, as have all OGL transactions. Much of this perceived efficiency is due to the fact that OGL imports has been funded exclusively by BOZ own resources (ie metal export earnings) and retro-active financing The domestic banking system has therefore been handling the LC business, has received the upfront forex allocation and has been primarily responsible for the preliminary handling of documentary evidence.

In assessing the viaibility of the modified OGL system, we concentrated on four issues: whether the bureaux rate was sufficiently representative of goods market condition to serves as a reference rate for the OGL; whether the bureaux rate carries apremium over the "true" goods market rate which needs to be discounted for other transactions; whether the administrative allocation process for foreign exchange under the OGL is justifiable; and whether the system can be made more accountable.

Is the Bureaux rate representative? A fundamental concern about the modified OGL is that the Bureaux market is prone to collusive behaviour, is subject to large daily variations in volumes and rates, and is dominated by illegal or quasi-capital account transactions. Our analysis, however, indicates that concerns about excessive devaluation of the market due to capital flight are probably unfounded, and, moreover, since the Bureaux market rate of exchange is set on the basis of the combined retention-cum-Bureaux market, whose turnover is lmost 50% of the OGL itself, we conclude that the Bureaux rate is broadly representative of the rate of exchange for non-market current account transactions.

Should there be a discount on OGL Funds? There are three possible reasons for a discount. First, it represents a method of offsetting the additional transactions costs of importing through the OGL using donor funds as opposed to BOZ own resources. Second, the discount serves to adjust the reference rate to account for the excess devaluation premium of the Bureaux due to the presence of capital-flight pressures. Third, the discount can be justified as a mechanism for official short-term intervention to buffer the OGL from excessive movements in the reference rate which reflect factors unrelated to the determination of the current account exchange rate.

Introducing a discount factor necessarily moves the system away from strict exchange rate unification, and back towards a dual-window system, albeit one which is market-driven. Moreover, given that demand can flow between the OGL and retention-cum-Bureaux markets the discount factor cannot affect the prevailing exchange rate beyond the short-run (without continuing to increase the discount rate). Unification is thus maintained in the medium-term.

While we have noted that the Bureaux-cum-retention rate is a valid reference rate for foreign exchange pricing, we did acknowledge that the market has certain deficiencies and may be vulnerable to erratic short-term movements, even though none have yet occurred. Given these circumstances, the use of a discount as a buffering instrument against short-run volatility may be appropriate.

In addition, if significant differences in the perceived transactions costs of using OGL funds emerge, it may be possible to use the discount factor to transfer demand from the retention-cum-Bureaux back to the OGL market. This would be particularly important in the case where disbursement of donor funds is being curtail because of low demand on the OGL and no mechanism to disburse through the retention market.

The most controversial implication of this proposal is that this move may raise of concern about the extent of official intervention in the market, and hence the credibility of the system with such an adjustable discount factor. The introduction of such a mechanism will require the establishment of a clear set of guidelines on the use of the discount factor.

The level of the discount rate. If the discount is introduced simply to offset the additional "transactions cost" associated with using OGL funds, then its appropriate level becomes an empirical issue of what the market "requires". The required level of discount will be determined principally by the price elasticity of demand in the OGL market, and also by the extent to which demand for foreign exchange can be transferred between the OGL and Bureaux markets.

The appropriate level for the discount when used to offset adverse capital-flight effects or short-term deviations cannot so readily be determined. To the extent that it is felt that the Bureaux market is appropriate, there is no need for a positive discount rate at present.

Finally, the efficient functioning of the market requires a single discount rate. Moreover, if a broad base rationale is considered, the discount should apply to all non market funds, including non-donor OGL funds.

Is the allocation process robust? Although the pricing mechanism under the modified OGL would be market determined, the allocation process will remain an administrative function. As a consequence, the major difference between this approach and the tender is that allocation is based on a queue rather than on the basis of an allocation which reveal the importers' true valuation of the foreign exchange. Since the Modified OGL system cannot allocate funds on a valuation basis, its the success success depends on transparency and accountability.Since funds are released against approved applications subject to availability of foreign exchange, a queuing process become inevitable. At present the BOZ operates a First-in-First-Out (FIFO) procedure.

To ensure continued transparency in the operation of this procedure, clear guidelines for the criteria under which applications are rejected (during January to April an average of 17% of all applications by value were rejected). In addition, applicants, or their representative banks should be able to find out the status of an application in the queue.

OPTIONS AND RECOMMENDATIONS ON THE MODIFIED OGL

Aside from issues of documentary management and accountability, which will be covered in the Group B papers, the operation of modified OGL system depends solely on the question of the role of the discount factor designed to offset any excess premium on the reference exchange rate. The two options are:

Option A Retain the system without a discount factor so that the Bureaux-cum-retention rate will serve as the reference rate for all transactions in the economy. The Bureaux rate will *de facto* be the official exchange rate. This option has the advantage that it denies the athorities access to any direct price intervention in the market and thereby achieves full exchange rate unification. Any interventions on the part of the authorities in the foreign exchange market must be achieved by altering the quantity of foreign exchange supplied to the OGL and/or retention-cum-Bureaux market.

Option B Retain the system as is including the discount rate. This option has the advantage that while the official exchange rate will be market determined, there is the facility to buffer the exchange rate from excess short-term varaitions in the Bureaux rate which may be unrelated to the goods market price but which, if not buffered would be immediately transmitted to all non-Bureaux transactions.

If this second option is pursued a number of recommendations are required concerning the setting of the discount factor.

(i) There should be a single discount factor, the level of which will compensate for excess "transactions costs" asociated with using donor OGL funds, and the capital-flight premium on the Bureaux marketfunds, but which can be altered from time to time by the Bank of Zambia to offset adverse short-term fluctuations in the Bureaux exchange rate.

(ii) All official foreign exchange transactions not directly priced in the Bureaux-cum-retention market should be valued at the Bureaux rate less the discount rate.

(iii) The rate of discount should initially be set at a low level, between 2 and 5 percent, and be subject to periodic review. In the normal course of events the discount rate should not be changed frequently.

(iv) guidelines should be prepared on the procedures on the setting of the discount rate to offset the transactions cost element of donor funds, and on the rules for altering the discount rate to offset excess short-term deviations in the Bureaux rate.

Other Recommendations

1. On the institutional level, the use of the Byureaux-cum-retention rate will require that continued efforts are made to address the question of competition policy and market

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regulation to ensure that the high level of market concentration does not lead to excess profit to the financial sector.

2. To ensure transparency in the operation of the FIFO system for foreign exchange managment, it is recommended that:

> (i) Guideline be published describing the OGL queuing system and specifying the criteria for rejection of application;
>
> (ii) Procedures are established to ensure that importers or their representative of their bank are able to track the progress of unfunded applications through the OGL system.

IV. TENDER SYSTEM

Concerns about the modified OGL, in particular suspicions that the Bureaux de Change rate may not be appropriate for establishing the general exchange rate, combined with a desire to move rapidly to a market-based allocation as well as pricing mechanism for OGL funds, has led GRZ to consider introducing a foreign exchange tender process for the OGL. The proposed system is described fully in the "Report of the Technical Committee on the New Foreign Exchange Allocation System for OGL Imports" (February 26 1993). The principal issues associated with the design and operation of the tender system are discussed in the Report on the Foreign Exchange System Structure, attached to this Aide Memorie. The main issues and recommendations are as follows:

1. The Extent of Market Participation

The current proposal is that the tender system be primarily donor funded, with the GRZ providing funds only if a shortage of donor funds were to arise. Some donors have raised the question of why the GRZ is not committing its own resources to the proposed system.

The GRZ's foreign exchange resources, are the export earnings of ZCCM while the required uses are the financing of debt service, financing of ZCCM foreign exchange requirements, the financing of petroleum imports of ZimOil, and the financing of other GRZ foreign exchange requirements. In 1991, ZCCM import requirements amounted to 36 percent of ZCCM earnings, while the same figure for 1992 was 40 percent. For 1993, the expected percentage is 51 percent. The financing of ZimOil's imports currently must be funded (unless donor funds are explicitly provided) directly from ZCCM earnings since copper shipments have been used as direct collateral for a commercial line of credit for financing these imports.

GRZ's resources were significantly over-subscribed in 1991 and 1992 (deficits of $124.4 million and $190.2 million, respectively), and are expected to again be in a deficit in 1993

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by approximately $171 million. Significant donor support therefore was and is required simply to meet these areas of GRZ foreign exchange requirements. Even greater levels of support would be required in these areas if the GRZ were required to make a fixed commitment to funding the proposed tender system with its own resources.

In the same vein, the question is raised as to why the tender system should be restricted to the private sector and not include a greater portion of the parastatal sector, especially ZimOil.

With the exception of ZCCM and ZimOil, all parastatals are currently required to acquire foreign exchange either through the OGL/tender systems or from the Bureaux de Change market. The explanation for exclusion of ZimOil was presented above and is based on the fact that copper earnings are being used as direct collateral for securing a revolving line of commercial credit for financing petroleum purchases.

Another participation question is whether or not the Bureaux de Change should be allowed to also offer tenders in the system. From the point of view of market efficiency and integration, there is a strong basis for having the Bureaux participation in the tender system. There may be some concerns on the capacity of the smaller (non-bank) bureaux to meet the proposed documentation requirements. In addition, to the extent that the tender system is tied to the use of LCs, this might be problematical for the Bureaux.

2. Existence of a Reserve Price and Exchange Rate Volatility

This is a pressing issue given the fact that proposing a daily tender as opposed to a weekly tender since a daily auction would be expected to be a thinner market. Thus, it would be possible that if on a given day there are a limited number of bids, some of which are very low, there could be extreme revaluations of the exchange rate. Such an occurrence could then prompt an overreaction in the opposite direction which could generate unnecessary volatility in the exchange rate.

In order to avoid this phenomenon, a floor price could be introduced. An alternative would be to allow a revaluation of the exchange rate from day to day. In this case if there were a shortage of qualifying bids, the exchange rate would fall to the reserve price and the full amount of foreign exchange offered for tender that day would not be sold that day. The reserve price could either be based on the prevailing exchange rate (the weighted average of the successful bids) or on the minimum successful bid.

An alternative to establishing a reserve price would be to hold the auctions less frequently, e.g. twice a week with the possibility of moving to a daily auction at a later date. This would thicken the market, thereby reducing the likelihood of a collapse of bids, and would also provide a time period for all parties to test administrative procedures for the tender system.

3.Should Specific Monies or General Monies be Tendered?

The current proposed tender system would offer monies from a specific source each day, for example funds from a given donor or given donors. Such a system could give rise to differential discounts applied to different sources of money, a situation no acceptable to some donors, and may introduce unnecessary exchange rate volatility.

An alternative approach would be for the Bank of Zambia to make allocations from specific sources once a tender is approved, as currently used in the Ugandan system, allowing BOZ to manage the use of monies with greater restrictions without introducing donor specific discounts and without producing unnecessary exchange rate fluctuations. This approach assumes that it will be possible to maintain a sufficient pot of differentiated monies so that successful tender bids for non-restrictive imports can be consistently met. It also assumes that BOZ can function efficiently enough under this system.

4. Limits on a Single Bank's Purchases in a Single Tender

The current proposal sets a limit of 50 percent of the funds in a given day's tender to go to any single bank. Some donors have expressed a desire to see this maximum level reduced to 30 percent to 40 percent. From an efficiency point of view, there should be no limits on a single bank's purchases in a single tender: those willing and able to pay the most should gain access to the funds. The justification for setting these limits, however, is based on the desire to maintain equity in access to the tender funds, while not wanting to place an unnecessary burden on possible large tender requests. If the suggestion to shift the tender system to a twice weekly rather than daily basis is accepted, the problem of low funds availability will not exist and the 50 percent limit will not be necessary.

5. Rejection of Tenders, Publictation of Tender Results and Monitoring and Management Responsibilities.

The current proposal states that the Bank of Zambia has the right to reject any tender without the obligation to reveal why. In the interest of transparency, guidelines/rules for the tender process should be established and published. In addition, full disclosure of the full range of tenders and their associated information, quantity requested and bid price. The publication of the full bid information would provide increased transparency, could reduce bid spreads, market differentials in exchange rates, and promote the efficiency of the market by eliminating uncertainty. An argument could also be made that the full publication of information could provide a check on possible collusion in bidding practices.

Finally, the current proposal delegates the responsibility for collecting all required information and documentation to each participating commercial bank. The Bank of Zambia would then be responsible for reviewing this information and providing required reports and documentation to the donors providing the funds for the tender system. This is in contrast to

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the current system where the Bank of Zambia is responsible for assembling all required information and documentation, as well as reporting to donors.

An alternative proposal has been put forward that a group of commercial banks be designated official intermediaries in this system. The intermediary banks would be responsible for assembling and reviewing the documentation to make sure that it is complete before that documentation is forwarded to the Bank of Zambia. This alternative proposal would provide an additional level of verification and checking of documentation, but would require the shifting of normal banking relationships between commercial and correspondent banks.

RECOMMENDATIONS ON TENDER SYSTEM

The following points are the recommendations concerning the issues raised concerning the proposed tender system:

1. Extent of Participation

Given the general non-availability of GRZ-owned foreign exchange currently and for the foreseeable future, the proposal that the GRZ would only supply resources as a supplement to donor funds in the tender system is proper.

Given the existence of the commercial revolving line of credit for the financing of ZimOil's imports and the fact that this is directly secured with copper shipments, ZimOil and it's related foreign exchange allocation should not be moved into the tender system.

Allowing the Bureaux de Change to participate in the tender system is desirable from an efficiency and market integration viewpoint; it should be allowed provided that the Bureaux can satisfy the documentation requirements established for the system in general.

2.Exchange Rate Determination

To help eliminate possible unnecessary exchange rate fluctuations:

(i) tenders should be held twice a week rather than on a daily basis; and

(ii) a reserve price of 10 percent of the previous days minimum successful bid should be included in the tender system. This policy should be announced or included in the published rules of the tender system.

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3. Should Specific Monies or General Monies be Tendered

The current tender proposal be modified not to have specific monies "for sale" on a given day, and that this system be replaced with a funds selection system managed by the Bank of Zambia a la the Bank of Uganda system.

If the previous recommendation is accepted, the Bank of Zambia staff responsible for implementing the system should visit Uganda in order to get pointers on how to most effectively implement the revised system.

4. Limits on a Single Bank's Purchases in a Single Tender

In order to promote efficiency, the 50 percent limit on a single bank's purchases in a given tender should be eliminated.

5. Rejection of Tenders, Publication of Results and Management

To promote system transparency, the current tender system proposal should be modified to state that tenders will only be rejected in accordance with established and public rules and that an explanation for any rejected tender will be provided. A general explanation of the rejection should be provided publicly, with details available to the commercial bank which submitted the tender.In the interests of system transparency and full information, the Bank of Zambia should post in a public place not only the summary information for each tender, as currently proposed, but also the listing of successful, unsuccessful, and rejected (with reason for rejection) tender offers.

V. Comparison of Systems

The following two page chart compares the to proposed alternative systems in terms of their performance/characteristics vis-a-vis ten objectives.

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COMPARISON OF ALTERNATIVE SYSTEMS

OBJECTIVES	MODIFIED CURRENT SYSTEM	MODIFIED TENDER SYSTEM
Minimize Short-Term Exchange Rate Volatility	» Dominated by Macroeconomic Conditions. » Use of a Weighted Average smooths. » Can use a General "Discount Factor".	» Dominated by Macroeconomic Conditions. » Use of a Weighted Average smooths. » Inclusion of Reserve Price Protects Against Specious Bids. » Possible Announcement Effect.
Encourage Movement Towards Long-Term Foreign Exchange System Liberalizaiton	» Equivalent, Compatible with Long-Term Goal » Reliance on Market Forces for Exchange Rate Determination (Discount Factor Interventions Possible) and Use of Queuing for Foreign Exchange Allocation.	» Equivalent, Compatible with Long-Term Goal » Reliance on Market Forces for Both Exchange Rate Determination and Foreign Exchange Allocation.
Reduce Vulnerability to Fiscal and Monetary Policy Regime Variability	Equivalent, But Highly Vulnerable, i.e., Lack of Fiscal or Monetary Restraint Will Result in Exchange Rate Devaluation	Equivalent, But Highly Vulnerable, i.e., Lack of Fiscal or Monetary Restraint Will Result in Exchange Rate Devaluation
Promote Ability to Cope with Donor Funds' Lumpiness & Their In-Out Nature	» Equivalent » Excess Demand Presents Lower Public Profile since Evidenced in Queues & in Bureaux Market Rate	» Equivalent » Excess Demand Presents Higher Public Profile since Evidenced Solely in Tender System Rate
Promote Transparency to Minimize Risk of Abuse	» No Public Access to Verify First-In, First-Out Processing & Possible Queue Jumping » Uncertainty re Discount Factor Rules.	Perhaps Slight Advantage, since able to easily check allocation process (price).

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COMPARISON OF ALTERNATIVE SYSTEMS
(CONTINUED)

OBJECTIVES	MODIFIED CURRENT SYSTEM	MODIFIED TENDER SYSTEM
Maximize Degree to Which System Determines Exchange Rate and Rational Allocation	Equivalent	Equivalent, Possible Slight Advantage in Terms of Rational Allocation
Minimize Potential Collusion Problems	» Bureaux Market is Imperfect (Concentration) » Need for Competition Policy and Market Regulation	Collusion Possible, but can make information public for monitoring
Encourage Value for Money	Equivalent	Equivalent
Improve System Accountability and Auditiability	» Current Implementation System is Inadequate, i.e., Not Timely in the Collection & Processing of Documentation.	» Could Use Slight Modification of Current Implementation System. » Delegation of Authorities to Commercial Banks Would Necessitate the Strengthening of BOZ Supervisory Capacity. » More Difficult to Strengthen Supervisory Capacity than to Improve on Current Implementation System.
Other Considerations	» KIS (Keep It Simple), i.e., the current system is in place. » Current System is Not Suffering From Major Problems.	» Establishing new system, i.e., not simple. » If fails again, major problems. » Officials have essentially announced it already.

VI. RECOMMENDATIONS ON GENERAL ISSUES INDEPENDENT OF FOREIGN EXCHANGE REGIME

Finally, we consider four issues or questions which arise no matter which foreign exchange regime or structure is selected.

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1. Feasibility of Full Reimbursement/Retroactive System

The major aspect of this question is whether or not sufficient funds could be found to allow the start up of the system. Based on an average use of $25 million per month and setting up for a seven month stock (based on roughly six month turnaround for all documentation), plus a month's protection, an initial stock of funds of $175 million would be required. Since there are funds and (presumably) documentation for retroactive financing, reduce this by two month's worth so that the question is the mobilization of $125 million.

Does the GRZ Have the Money? The GRZ's resources were significantly over-subscribed in 1991 and 1992 (deficits of $124 million and $190 million, respectively), and are expected to again be in a deficit in 1993 by approximately $171 million. Significant donor support was and is required simply to meet these areas of GRZ foreign exchange requirements (debt service, petroleum, ZCCM imports, other GRZ), and thus even greater levels of support would be required in these areas if the GRZ were required to make a fixed commitment to funding the proposed tender system with its own resources.

Is Borrowing or Donor Support Feasible? Current GRZ commercial credit is secured by copper exports: further use of copper to secure a line of credit is not feasible. As an alternative to the use of copper as collateral, it might be possible to use donor commitments to reimburse upon the presentation of appropriate documentation to secure insurance of such a loan. If the GRZ were to secure such a line of credit without copper collateral, the annual cost of what would need to be a revolving line of credit would be approximately $6-7 million (interest costs plus fees), which again the GRZ does not have. In addition, this would put the GRZ in violation of IMF short-term credit ceilings.

Donors with funds in place for retroactive financing of imports could be used to generate free funds to initiate a partial reimbursement/retroactive financing system. The key problem constraining the use of such an approach is the accumulation and presentation of adequate documentation to allow the release of the funds. Under such circumstances, a partial reimbursement scheme may be feasible given the availability of donor funding for retroactive financing of imports with the provision of adequate import documentation.

2. Foreign Exchange Release: Up Front or Upon Presentation of LCs

To a large extent, this is a question of who earns the interest on the foreign exchange being held. One view/approach could be that it should be up front since the commercial banks are having to bear the opportunity costs of the kwacha cover. Alternatively, if the foreign exchange is not released until the LC is presented, the Bank of Zambia could earn the interest and thereby augment the supply of foreign exchange available.

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Recommendation

The system should be made as close to a commercial system as possible. Thus, a system of immediate release of the foreign exchange and collection of the kwacha cover from the commercial banks is endorsed, i.e.,

(i) In order to assure that funds are available for an LC (i.e., the sale of money rather than IOUs), the foreign exchange should be released to the commercial banks up front;

(ii) Commercial banks' accounts for the kwacha cover should be debited at the time of the foreign exchange transfer;

(iii) Commercial banks may collect the kwacha cover from their customers when the foreign exchange is requested or when an LC is opened; and

(iv) Fixed margins on commercial banks' re-sale of foreign exchange should be removed.

3. The "Minimum Condition" Option

The efficient functioning of any system of allocation (either the amended OGL or the Tender) requires that the product allocated through the market should be as homogeneous as possible so that a single price prevails. This is not possible given the diversity of donor conditions, and raises the question of whether there is a sufficient volume of relatively homogeneous, untied OGL funds which will allow the OGL to be fully funded. If this can be achieved, many of the discount/discrimination issues will disappear.

In such a case other more conditional funds require to be allocated to other forms of funding (for example, direct financing of external debt), until the point at which the conditions under which they can be allocated to finance OGL imports meet the minimum conditions.

In the case of 1993 Budget the World Bank and EEC balance of payments support is projected to be $314 million, 62% of total anticipated BoP support and 97.5% of anticipated OGL requirements ($322 million). In 1992 these two istitutions provided $230 million in BoP support, equivalent to 47% of total BoP support and 81% of OGL requirements.

Thus, a "minimum conditions" system which is acceptable to these two multilaterals would be expected to almost fully fund the OGL. There are a sufficient number of other donors whose requirements are consistent with those of the World Bank and EC to allow a "minimum conditions" criterion to be established.

4. Monitoring and Management Responsibilities

No matter what structure is selected, the Bank of Zambia is the entity responsible for the management, accountability, and auditability of funds. These functions can be handled by

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the Bank of Zambia itself, as is currently the case, or they can be delegated to commercial banks as in the tender system proposal.

The current system suffers from the inefficiency of the Bank of Zambia in the timely accumulation and tracking of documentation required by donors for the accountability and auditability of funds

It is the opinion of the Joint Evaluation Mission that in order to improve the accountability of funds it would be easier to strengthen the current systems of documentation accumulation and tracking, than to provide the necessary strengthening of the Bank of Zambia's supervisory capabilities. The following recommendations are offered:

(i) A system of intermediary banks for the collection, checking and processing of the documentation from commercial banks should be established. The fee for this service (LC confirmation and reporting) should be established through a tendering process with the use of the lowest fee offered at which at least two banks will provide these services, but allowing all four of the commercial banks with correspondence relationships function as intermediary banks, at the tender determined fee, if they so desire.

(ii) The bank supervisory capacity of the Bank of Zambia would need to be strengthened as quickly as possible.

VII. Overall Recommendation

We have examined two alternative systems for the allocation and valuation of foreign exchange not currently allocated through the bureau-cum-retention market. Both systems are feasible and are consistent with the medium-term objective of government to move towards a unified, market-determined foreign exchange system based around an interbank market. It is clear, however, that the tender system is a more market-oriented pricing and allocation system for allocating donor OGL funds (although both systems, in their current guise involve extensive non-market allocations of foreign exchange for priority use, albeit with reference to a market determined price.

While we agree that the tender system is probably preferable as a transitional mechanism towards an interbank market, we believe that given institutional constraints in the Bank of Zambia and in view of continuing macroeconomic imbalances, we believe that the current OGL-based system as described in this paper should be maintained at the present moment (subject to recommendations contained in Sections V and VIII above).

Five factors have shaped our recommendation:

1. We believe that the modified OGL system places a lower administrative burden on the Bank of Zambia. The system is simpler to manage given current

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resource and capacity constraints, and the accountability and audit requirements of the donors (see also Group B).

2. We believe that the modified OGL system is marginally more robust to short-run volatility elsewhere in the macroeconomic system, particularly if the OGL discount factor is used to buffer the system from adverse short-run movements in the bureau-cum-retention market.

3. In the face of short-term interuptions in the supply of foreign exchange the modified OGL system adjusts in the short-run through increases in the queue rather than through increasing the exchange rate (or even temporary cancellation of the tender), as may occur in the tender. While the economy and expectations remain sensitive to short-term movements in the exchange rates, this form of short-term adjustment, will have a lower "profile" and therefore less effect elsewhere in the economy.

4. Both systems necessarily carry risks of failure. However, given recent history in Zambia we feel that the political implications of the failure of the Tender system for the economic recovery programme may be severe.

5. Finally, we feel that since the current system is functioning reasonably efficiently it should be continued with slight modification as an interim step towards introducing the tender. The efficiency gain to using the tender system is likely to be greatest when macroeconomic stabilization has been achieved, and inflation reduced to a low, stable, level (at which point price signals will be less distorted). Since the tender system is, in itself, not instrumental in promoting stabilization, the marginal gain in allocative efficiency in introducing the system immediately probably does not outweigh the adverse effect on achieving stabilization which its failure may engender.

We therefore envisage a three-stage evolution towards the medium-term goal of an interbank market. First, while stabilization is being sought, the modified OGL system is retained while preparations are made for the development of a tender system (particularly on the issue of documentary management). This stage may last for 12 - 18 months. Second, having achieved stabilization and, having established a stronger documentary tracking and audit capacity for OGL funds, the tender system may be introduced for OGL funds. During this stage the government can, in conjunction with the donors, establish the regulatory environment and develop institutional capacity required to sustain an efficient interbank market in foreign exchange. Running parallel to this would be negotiations with donors to establish the basis for using donor balance of payments support in an "open positions" wholesale market.

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ATTACHMENT C:

FULL REPORT OF WORKING GROUP A

REPORT ON FOREIGN EXCHANGE SYSTEM STRUCTURE

I. INTRODUCTION

This paper constitutes the report of Working Group A of the World Bank led Joint Evaluation Mission to Zambia. The task of Working Group A was to consider the broad questions of what systems should be used to determine Zambia's exchange rate and allocate scarce foreign exchange. This report examines Zambia's current Open General Licensing (OGL) system and the proposed Tender System, makes recommendations for modifying each of these systems, presents a comparative analysis of the two systems, and finally presents a general recommendation concerning which system should be adopted.

Sections II through IV present basic background information and examines their implications concerning the selection of a foreign exchange pricing and allocation mechanism. Section II presents a very brief overview of the Zambian Government's (GRZ's) general macroeconomic program and environment, while section III examines the GRZ's long-term goals concerning the country's foreign exchange system. Section IV presents a very brief summary of the sources and uses of foreign exchange in Zambia in 1991, 1992 and preliminary projections for 1993.

Sections V and VI examine the OGL and Tender System, respectively, describing, analyzing and making recommendations for their modification. Section VII presents a summary comparison of the two systems vis-a-vis a set of general objectives for a foreign exchange system. Section VIII presents recommendations on a number of general issues which are independent of the foreign exchange system (OGL or Tender) selected. Finally, Section IX presents an overall recommendation concerning the choice of foreign exchange system.

II. GENERAL MACROECONOMIC PROGRAM, ENVIRONMENT, AND IMPLICATIONS FOR ANY FOREIGN EXCHANGE SYSTEM

To be provided by John Hill.....

- One major conclusion which will require emphasis is that no matter what system is adopted, a significant devaluation of the Kwacha can be expected unless stabilization measures are consistently and effectively implemented.

III. MEDIUM-TERM ISSUES IN DEVELOPING THE FOREIGN EXCHANGE SYSTEM

The Government is committed to a "unified, privately-operated, market determined, exchange and payment system, while taking into account overall key donor limitations, accountability and "value-for-money" requirements." Any new system must, therefore, satisfy the requirements of allocative efficiency and accountability."[1]

[1] *Statement by Minister Mung'omba to Informal Meeting of CG for Zambia, Dec 1992, para 18.*

The basic model for such a system is the interbank market model to be found in Ghana and currently under consideration in Uganda. Under such a system exchange rate determination and foreign exchange allocation will be market determined although, by dint of the structural characteristics of the Zambian economy and the debt/public finance structure of government, BOZ will remain a major player in the market.

A. Issues to be addressed when considering the medium term evolution of the market?

1. Multiple exchange rates will continue to exist as long as: (i) capital controls remain in place so that a parallel market will exist for the allocation of capital balances; and (ii) different transaction costs apply in the use of different sources of supply. A fully unified system will require the elimination of capital controls. In the medium term, once sustainable macroeconomic balance has been achieved, the abolition of capital controls will add to the efficiency of the exchange rate system. In the short-run, however, consideration needs to be given to the possible adverse consequences that removing capital controls will have on the real demand for Kwacha and hence for domestic inflation.

2. Government envisages the exchange rate being set through some form of interbank market, out of which will eventually develop a forward Kwacha market. An interbank market requires that the players (the commercial banks) take open positions, thereby severing the direct retail link between the supply of foreign exchange and the import financed. This is possible only if the supply of foreign exchange to the market is "untied". BOZ own resources (i.e., metal sector earnings) fulfil this requirement, most donor BoP support does not. In the case of Zambia, where in global terms there is a deficit in terms of own resources after ZCCM, debt service and ZimOil payments are met, the development of an interbank market therefore requires either: (i) that donor support programs be made compatible with the requirements of an interbank market; or (ii) that current non-market foreign exchange sources and uses be intermediated through the market system.

The former question is dealt elsewhere. A number of subsidiary issues concerning the re-allocation of own resources arise. First, even in a unified single allocation system, foreign sovereign debt service requirements should still be allocated preemptively (even if valued at a market determined rate). Second, given the large values of individual transactions relative to the size of the market as a whole, should Zimoil, ZCCM, the other parastatals, and government non-statutory foreign exchange uses be valued and allocated through a competitive market rather than preempting the market allocation? Third is the issue of whether an interbank market could function efficiently where the principal suppliers of foreign exchange are also the principal demanders?

3. A wholesale interbank market would alter the role of authorized foreign exchange dealers from being agents of the importers to strategic players in the market. Given the current concentration in the bureau-cum-retention market problems of market domination and issues of the competition policy must therefore be addressed.

4. Zambia is prone to sharp periodic external shocks affecting the supply of foreign exchange from terms of trade changes and from discontinuities/lumpiness in aid flows. Moreover in the short-run, the shallowness of the economy means that short-term (i.e., daily or weekly) fluctuations in supply and demand are prevalent. Efficient markets require sufficient depth so that the size of individual flows is small relative to overall market turnover. Moreover, efficient market are diverse so that risk perceptions and demand and supply forces are not subject to high covariance. Thus, in moving to a full interbank market, a number of issues need to be addressed. First, are foreseeable macroeconomic conditions consistent with the development of necessary market depth? Second, what level of reserves would be required by the BOZ to allow for effective short-run intervention in the interbank market? Third, as authorized dealers switch from being brokers to market-makers, what changes in prudential regulation and banking supervision is required?

5. Notwithstanding other macroeconomic concerns, the issues mentioned above mean that creation of an interbank system cannot occur immediately. As shall be discussed in more detail in later sections, a broad-based retail tender system is the most logical transitional system for foreign exchange allocation. In contrast to the administrative OGL system, such a system provides a mechanism through which resource pricing is market determined, and where the true value of scarce foreign exchange is determined by revealed preference rather than assumed through an administrative queuing mechanism. However, in the short term the introduction of a tender system may place a heavier burden on the administrative capacity of the BOZ. A trade off may therefore be necessary between the resource allocation inefficiencies and administrative capacity.

IV. Basic Foreign Exchange Data for Zambia

Table 1 presents a basic breakdown of the GRZ's principal sources and uses of foreign exchange for the period 1991-1993(incomplete estimates); however, this is not a full presentation of Zambia's balance of payments. Commodity exports provide roughly 60 percent of Zambia's foreign exchange, 95 percent of which is from the mineral sector. Donor financing provides another 25-30 percent of available foreign exchange, with the balance coming from services, private transfers, and short-term borrowing.

Table 1: Sources and Uses of Foreign Exchange, (US$ Millions)

Item	1991	1992	1993	1991	1992	1993
SOURCES	**1,823**	**1,785**	**1,397**	**100%**	**100%**	**100%**
Exports	1,127	1,089	877	62%	61%	63%
Metals	*1,043*	*1,058*	*877*	*57%*	*59%*	*63%*
Non-Traditional	*84*	*31*	*0*	*5%*	*2%*	*0%*
Services & Inward Exchange	83	28	0	5%	2%	0%
Short-Term Borrowing	166	191	34	9%	11%	2%
Donor Financing	438	491	506	24%	28%	36%
Change in Reserves	8	(14)	(20)	0%	-1%	-1%
USES	**1,786**	**1,801**	**1,551**	**100%**	**100%**	**100%**
Imports	968	1,170	1,026	54%	65%	66%
ZCCM	*380*	*427*	*450*	*21%*	*24%*	*29%*
ZimOil	*178*	*240*	*111*	*10%*	*13%*	*7%*
Other GRZ	*72*	*172*	*132*	*4%*	*10%*	*8%*
OGL	*251*	*285*	*322*	*14%*	*16%*	*21%*
Retention Financed	*82*	*44*	*11*	*5%*	*2%*	*1%*
Suppliers Credits	*5*	*2*	*0*	*0%*	*0%*	*0%*
Services	818	631	524	46%	35%	34%
Non-Debt Service	*252*	*182*	*85*	*14%*	*10%*	*5%*
Debt Service	*566*	*450*	*439*	*32%*	*25%*	*28%*
Multilateral	515	287	305	29%	16%	20%
Bilateral	12	11	110	1%	1%	7%
Financial Institutions	2	1	0	0%	0%	0%
Short Term	38	151	24	2%	8%	2%
SURPLUS/(DEFICIT)	**37**	**(16)**	**(153)**			

SOURCE: Bank of Zambia, Foreign Exchange Budgets. 1993 data are incomplete estimates.

Table 2: Availability of GRZ Public Sector Foreign Exchange Resources, 1991-1993

Item	Year	Qtr 1	Qtr 2	Qtr 3	Qtr 4
1991 ZCCM Earnings	1,042.7	312.3	229.1	254.8	246.5
less Debt Service Payments	566.2	475.6	46.2	23.6	20.8
Available Resources	*476.5*	*(163.3)*	*182.9*	*231.2*	*225.7*
less ZCCM Imports	380.4	97.3	80.7	105.0	97.4
Available Resources	*96.1*	*(260.6)*	*102.2*	*126.2*	*128.3*
less ZimOil Requirements	177.8	24.7	75.7	53.0	24.4
Other GRZ Requirements	42.7	8.9	12.4	11.5	9.9
Remaining Available Resources	***(124.4)***	***(294.2)***	***14.1***	***61.7***	***94.0***
1992 ZCCM Earnings	1,057.8	243.6	281.8	294.6	237.8
less Debt Service Payments	449.7	200.3	88.2	92.1	69.2
Available Resources	*608.0*	*43.3*	*193.6*	*202.5*	*168.6*
less ZCCM Imports	426.6	101.6	113.7	109.7	101.6
Available Resources	*181.4*	*(58.3)*	*79.9*	*92.8*	*67.0*
less ZimOil Requirements	239.9	61.6	53.4	75.7	49.2
Other GRZ Requirements	131.7	15.2	48.7	48.8	19.0
Remaining Available Resources	***(190.2)***	***(135.1)***	***(22.2)***	***(31.7)***	***(1.2)***
1993 ZCCM Earnings	876.7	259.3	205.8	205.8	205.8
less Debt Service Payments	439.4	95.8	139.5	90.4	113.7
Available Resources	*437.3*	*163.5*	*66.3*	*115.4*	*92.1*
less ZCCM Imports	450.0	105.5	113.1	112.5	118.9
Available Resources	*(12.7)*	*58.0*	*(46.8)*	*2.9*	*(26.8)*
less ZimOil Requirements	110.8	14.8	38.0	31.0	27.0
Other GRZ Requirements	47.4	10.6	16.0	10.9	9.9
Remaining Available Resources	***(170.9)***	***32.6***	***(100.8)***	***(39.0)***	***(63.7)***

Imports make up 55-65 percent of foreign exchange uses, with an additional 25-30 percent going for debt service. The bulk of debt service payments are to multilateral creditors. Two parastatals, ZCCM and ZimOil, account for about 57 percent of total imports. Imports through the OGL and the retention market account for about 31 percent of total imports.

Table 2 presents a breakdown of the public sector portion of these foreign exchange sources and uses. The point that is clearly evident from these figures is that the GRZ faces a continuing in the financing of its external payments. For 1991 this deficit amounted to $124 million, and $190 million in 1992. The estimated public sector deficit for 1993 is approximately $170 million. These deficits point up the fact that donors need to finance not only imports for the productive sectors, but also imports and debt service for the public sector.

V. The Current OGL System and Possible Modifications

The current foreign exchange market operations consist of three main elements; the OGL system, the Bureaux-cum-retention market rate, and non-market priority allocations of foreign exchange (principally debt service, ZCCM import requirements, Zimoil imports and fertilizer).[2] Part A provides a background on OGL and Retention-cum-Bureaux market, Part B provides some analysis on the issues on the feasibility of using the Modified OGL, and Part C concludes with options and recommendations.

A. The OGL: Background and Operating Procedures

The current OGL system has been in operation since January 1990 when it was introduced under the dual-window exchange rate system. OGL imports were purchased through the second window and funded from donor BoP support and export retentions. . Progressive liberalization of the OGL, through the expansion of the positive list and the streamlining of the documentary process continued in 1992, and eventually in September 1992 the OGL moved from a positive to a negative list (see Annex 1) The OGL now covers approximately 95% of all imports. These liberalization measures have been accompanied by a significant deepening of the market from $94 million in 1991 [$58m OGL + $36.5m retro-financing] to $285m in 1992 and to an anticipated level of $322 million in 1993.

1. Operational Procedures to end of 1992

The OGL market functions as a retail market with the commercial banks operating principally as agents for the importer. In a typical transaction, applications from intending importers (supported by required proforma/ICB, SGS and MER forms, and certified cheque for 100% Kwacha cover) were submitted to BOZ through the representing local commercial

[2] *See Tables 1 and 2 above.*

bank. Depending on the availability of funds, country of origin and other conditions, the BOZ determined from what funding source the foreign exchange would be provided.

If the imports were financed from donor funds (i.e., with reimbursement), the commercial bank was instructed to open an LC with the exporter, and the offshore intermediary or confirming bank provided a reimbursement guarantee to the final accepting bank to make the LC operable. The Kwacha cover was encashed by BoZ but the foreign exchange remained on account with the BoZ until the final beneficiary was paid under the LC by the accepting bank. The foreign exchange was then transferred to the accepting bank. In this situation, the interest income on the foreign exchange balances accrued to the BoZ.

Approved applications received by the Receipts and Payments division for which funds were not currently available are queued according to a strict first-in-first-out [FIFO] basis. Over the past two years delays in allocating exchange through the OGL have averaged 3 - 4 weeks, reaching a maximum of 8 weeks on a few occasions.

2. The Retention and Bureaux Markets

Introduced in 1984, the export retention scheme (ERS) allowed exporters of non-traditional exports to retain 50% of gross export earnings to finance their own imports. The eligibility of the retention was originally 21 days but has been increased to 180 days since then, although in January 1993 the retention entitlement period was again reduced to 28 days. In the 1992 Budget, the retention rate was increased to 100% while further liberalization allowed some service account transactions to be financed through the ERS[3] and harmonized the negative list with that functioning in the OGL. By mid 1992 when the Bureaux market was introduced, the ERS had a turnover of approximately $150 million.

In October 1992 the government introduced a Bureaux de change market, principally to finance small denomination personal foreign exchange transactions. While there are no limits on sales of foreign exchange for imports through the Bureaux market, there are limits of $2000 for service payments and for foreign exchange. Since the introduction of the Bureaux market, the retention market has, *de facto*, been fully integrated with the Bureaux market. In practice, sales of export earnings through the retention market (operated by the commercial banks) are re-sold by the banks through separate windows, but at a single exchange rate. This applies to sales of funds for mainstream Bureaux transactions and of retention funds to eligible exporters. While the Bureaux rate applies to both markets, although differentials in the effective rate arise from differential commission charges.[4] By extension, the introduction

[3] *As of end-1992, foreign currency inflows and remittances by diplomatic missions and NGOs, TAZARA freight clearance, transactions and ZISC insurance payments on Zambia Airways had been transferred to the Retention/Bureau market.*

[4] *Concern has been expressed by the BOZ regarding evidence of excessive and discriminatory commission charges being levied by the bank bureaux on non-bank customers. (Bank of Zambia Circular 2/93, 22 March 1993).*

of the Bureaux market eliminated the "no funds" market, as funds originally channelled through the latter market are now traded in the Bureaux markets.

One consequence of the introduction of the 100% retention and the establishment of the Bureaux market, is that detailed statistical analysis of ERS market activity has ceased, and retention sales and purchase details are now integrated with daily Bureaux returns.[5] Aggregate data from the Research Department, however, reports a combined retention-cum-Bureaux market turnover of approximately $30 million in the first four months of operation, compared to the $80 million turnover in the OGL market. By December and January, turnover in the market was approximately $10 million per month, equivalent to approximately 50% of the OGL market turnover. Extrapolating from 1992 retention volumes, we estimate that the retentions market comprises at least 75 to 80 percent of the total turnover. The remainder of the market is accounted for by service and travel allowance purchases.

3. Exchange Rate Determination in the OGL

From inception until April 1991, the exchange rate for OGL imports was the second window rate, set administratively by the Bank of Zambia but at a premium against the official window. Unification of the two windows was achieved in April 1991 resulting in a single official (administered) exchange rate.
Prior to December 1992, this official exchange rate applied to all ZCCM, Government and OGL transactions. Market clearing was achieved through the retention and unofficial markets (see below). The introduction of the Bureaux de change market in October 1992 has consolidated the Bureaux and former retention market so that the system is now fully determined by only two exchange rates, plus an illegal parallel (i.e. black) market.

In December 1992, the official and retention/Bureaux rates were unified so that all foreign exchange is valued at a market rate, even though the bulk of transactions (OGL, ZCCM, Zimoil, Government direct transactions and debt service) are allocated outside the market. Strictly, unification was not absolute since the December unification proposal envisaged a two-tier system:

i) the buying and selling rates for all transactions excluding OGL transactions would be set equal to a weighted average of the Bureaux rates.

[5] *Specific reporting of retention market transactions has worsened since the introduction of the 100% retention limit, and BOZ has made attempts to re-establish regular reporting procedures (BOZ Circular 1/93, 26 February 1993).*

ii) OGL transactions would be valued at the same rate less a discount. It was anticipated that the discount would be set by the Bank of Zambia at a level of 15%.

The unification proposal thus meant that while foreign exchange allocation was still done by administrative fiat, the pricing was market determined.

4. Decentralization of the OGL system

On 13 January 1993 the OGL system was abolished and replaced by a decentralized OGL system, in which the former OGL market functions were handled by authorized dealers. Specifically, the de-centralization has involved:

i) the relaxation of the requirement by BOZ that the importer provides 100% Kwacha cover on application. The Kwacha cover now need only be provided once the LC is opened. In practice, however, most of the commercial banks still require full Kwacha cover from the importer prior to submission of application.

ii) up-front foreign exchange allocation: if the import is to be financed by BOZ own resources or through a retro-active financing arrangement with the donors, then BoZ will release the foreign exchange to the Zambian commercial bank which can then confirm the LC in its own name. This contrasts with the previous provision that foreign exchange is released to the accepting bank only on opening of the LC.

Since the beginning of 1993, delays in donor disbursement have obliged BOZ to finance the OGL almost exclusively from its own resources. In the quarter to mid April 1993, $51 million of OGL imports have been financed, of which $46 million have been from own resources, and the balance from EC retro-financing.[6]

[6] *See Table 3.*

Table 3: OGL Fund Allocation 1993 (Weeks 1 to 14)

	Applications		Approvals	Rejections	Funding				Effective[1]
Week	No	Value	Value	% by value	BOZ	Donor	Donor	Rate	Rate
1	118	3.10	2.80	9.7%	0.84	1.96	EC	379.3	339.47
2	77	4.28	4.16	2.8%	0.98	3.18	EC	383.5	339.53
3	n/a	0.00	0.00	n/a	0.00			392.5	
4	119	5.33	4.19	21.4%	4.19			408.2	
5	152	5.14	4.63	9.9%	4.63			423.3	
6	128	5.64	4.89	13.3%	4.89			438.7	
7	159	4.96	4.25	14.3%	4.25			458.2	
8	151	5.03	3.65	27.4%	3.65			471.4	
9	106	2.98	2.62	12.1%	2.62			478.8	
10	118	4.60	3.61	21.5%	3.61			491.4	
11	127	2.67	2.35	12.0%	2.35			504.5	
12	n/a	7.15	6.70	6.3%	6.70			537.4	
13	158	6.14	5.14	16.3%	5.14			502.7	
14	80	4.03	1.94	51.9%	1.94			538.4	

Note: [1] Bureaux rate less 15% discount on donor funds.

B. The Feasibility of the Modified OGL System

There is a perception that the current OGL system (i.e., the system introduced in December 1992 and "decentralized" on 13 January 1993) has worked relatively efficiently. Non-market-allocated funds have been valued at the Bureaux market rate, as have all OGL transactions. Much of this perceived efficiency is due to the fact that OGL imports has been funded exclusively by BOZ own resources (i.e., metal export earnings) and retro-active financing The domestic banking system has therefore been handling the LC business, has received the up-front foreign exchange allocation and has been primarily responsible for the preliminary handling of documentary evidence.

The central issue of whether it is advisable to continue with this method of foreign exchange pricing and allocation of OGL funds turns on four general issues:

1. Is the foreign exchange pricing mechanism rational?
2. Does the Bureaux exchange rate carry a premium which should be discounted for other transactions?
3. Is the administrative foreign exchange allocation justifiable?
4. Can the system be made transparent and accountable?

In this section we concentrate on the first three issues. Detail discuss of issue 4 is discussed in the working papers on accountability.

1. Pricing OGL Transactions: is the Bureaux rate representative?

A fundamental concern with the current system is the pricing of the transactions in the OGL. There is a concern that while the Bureaux rate is undoubtedly market determined, the rate set by the Bureaux is not "representative". Specifically, there are worries that:

(i) the Bureaux market is designed as a fringe market for the intermediation of small volume, retail, transactions;

(ii) it is a very thin market subject to large daily variations in volumes and rates;

(iii) the market is dominated by illegal or quasi-capital account transactions;

(iv) the Bureaux market is too concentrated and therefore prone to collusive behavior.

Are these concerns valid? Since the Bureaux market is relatively new, there is necessarily limited evidence on which to assess these claims. However, what evidence we do have suggests that the Bureaux rate probably provided an acceptable reference price for foreign exchange. We deal with each concern in turn.

Is the market too thin? As noted, BOZ estimates indicate that the Bureaux market is approximately 50% the size of the OGL, or about 15% of the total non-debt foreign exchange budget. The rapid growth and depth in the market reflects the integration of the bank-Bureaux and retention markets. While both markets exist *de jure*, the practice of the banks to sell export retentions purchased from exporters direct through the Bureaux market, *de facto* there is a single Bureaux-cum-retention market. As a consequence the Bureaux market is reasonably sizeable and is used for the intermediation of predominantly current account transactions: i.e., the Bureaux does reflect the value of a marginal dollar.

Is the Bureaux rate excessively volatile? Over the first six months of operation, day-to-day movements in the Bureaux market has been relatively smooth. As Figure 1 indicates, despite an initial overshooting-related volatility in the first weeks of operation, the weighted average Bureaux rate has been depreciating relatively smoothly. It remains the case that since the exchange rate is presently dominated by the trend depreciation, recent experience may understate the likely day-to-day volatility in the rate under more stable medium-term conditions. This is a moot point, but if it were found that the short-run variance or "noise" in the rate were excessive it would be straightforward to switch the reference rate from a daily weighted average of the Bureaux to a weekly moving average of the Bureaux weighted average.

Is the Bureaux rate dominated by capital account transaction? Preliminary evidence from the BOZ Banking Supervision report examining possible abuses of Bureaux market regulations on capital transactions, suggests that there is some use of the market to finance capital-flight through repeated use of the personal travel allowance. If this function of the market were to dominate then the Bureaux rate would indeed overvalue foreign exchange and would therefore be an inconsistent reference for all other current account transaction. There are two reasons why this problem is probably not too severe.

First, as noted, it is estimated that approximately 80% of transactions in the combined market are accounted for imports through the retentions (sub) market, in other words genuine current account transactions. Second, the 10 to 15 percent premium in the black market (where capital flight can be financed) may indicate that the Bureaux market rate does not fully reflect the capital-flight rate. However, to the extent that the premium could be accounted for solely by the lower cost of transacting on the black market, this may suggest the converse and that the Bureaux rate does reflect a capital flight premium.

Is there collusion in the market? Measured in terms of market share, the Bureaux market is highly concentrated, with the largest three institutions accounting for approximately 80% of total turnover. In the main this reflects the relative youth of the market and, obviously, existing bank-customer relationship from the retention market. The pre-existing concentration of the former retention market creates a significant barrier to entry.

While, market concentration does not necessarily imply collusion or excess profits, although it does require effective regulation and competition policy on the part of the Banking Supervision department of BOZ. Some initiatives have been taken to curb anti-competition measures (for example the March circular on discriminatory commission charges), but there is, as yet, limited evidence on which to assess the effect of these measures.

Overall, we can conclude that the Bureaux rate is broadly representative of the rate of exchange for non-market current account transactions. There are a number of macroeconomic events which will serve to deepen the Bureaux/retention market and thereby make the market more representative:

(i) the growth in market supply from the non-traditional export earnings will increase inflows to the market;

(ii) macroeconomic stabilization and the restoration of Kwacha demand will ease capital flight pressure and thereby reduce the element of depreciation of the Bureaux;

Conversely, of course, failure to achieve stabilization will increase the amount of capital flight channelled through the Bureaux and make it a less representative market.

2. OGL Foreign Exchange Allocation

Although the pricing mechanism under the modified OGL would be market determined, the allocation process will remain an administrative function. As a consequence, the major difference between this approach and the tender is that allocation is based on a queue rather than on the basis of an allocation which reveal the importers' true valuation of the foreign exchange. Since the Modified OGL system cannot allocate funds on a valuation basis, its success depends on transparency and accountability. Since funds are released against approved applications subject to availability of foreign exchange, a queuing process become inevitable. At present the BOZ operates a First-In/First-Out (FIFO) procedure.

To ensure continued transparency in the operation of this procedure, clear guidelines for the criteria under which applications are rejected (during January to April an average of 17% of all applications by value were rejected). In addition, applicants, or their representative banks should be able to find out the status of an application in the queue.

3. Discounting and Donor Funds

The discount rate for the OGL, as perceived by BOZ, represents a method of offsetting the additional transactions costs of importing through the OGL using donor funds as opposed to BOZ own resources. This rationale represents only one of three. A second relates the discount to the reference market and treats it as adjusting the reference rate to account for the excess devaluation premium of the Bureaux due to the presence of capital-flight pressures. Third, and related, the discount can be justified as a mechanism for official short-term intervention to buffer the OGL from excessive movements in the reference rate which reflect factors unrelated to the determination of the current account exchange rate.

This raises a series of questions:

i) is a discount necessary? An if so, at what rate should it be levied?

ii) should there be a single discount or donor-fund specific discount?

iii) if the discount is to be interpreted as offsetting adverse movements in the level/volatility of the reference market, to what classes of transactions should it apply?

Is the discount necessary? Introducing a discount factor necessarily moves the system away from strict exchange rate unification, and back towards a dual-window system, albeit one which is market-driven. Moreover, given that demand can flow between the OGL and retention-cum-Bureaux markets the discount factor cannot affect the prevailing exchange rate beyond the short-run (without continuing to increase the discount rate). Unification is thus maintained in the medium-term.

While we have noted that the Bureaux-cum-retention rate is a valid reference rate for foreign exchange pricing, we did acknowledge that the market has certain deficiencies and may be vulnerable to erratic short-term movements, even though none have yet occurred. Given these circumstances, the use of a discount as a buffering instrument against short-run volatility may be appropriate.

In addition, if significant differences in the perceived transactions costs of using OGL funds emerge, it may be possible to use the discount factor to transfer demand from the retention-cum-Bureaux back to the OGL market. This would be particularly important in the case where disbursement of donor funds is being curtail because of low demand on the OGL and no mechanism to disburse through the retention market.

The most controversial implication of this proposal is that this move may raise of concern about the extent of official intervention in the market, and hence the credibility of the system with such an adjustable discount factor. The introduction of such a mechanism will require the establishment of a clear set of guidelines on the use of the discount factor.

The level of the discount rate. If the discount is introduced simply to offset the additional "transactions cost" associated with using OGL funds, then its appropriate level becomes an empirical issue of what the market "requires". The required level of discount will be determined principally by the price elasticity of demand in the OGL market, and also by the extent to which demand for foreign exchange can be transferred between the OGL and Bureaux markets. Two examples illustrate the problem. If demand is price-sensitive and can move between the two markets easily, then the discount factor will be readily market determined: if the discount is too high then there will be excess demand in the OGL which will switch to the Bureaux, driving up the rate there, and thereby increasing the rate on the OGL. On the other hand, if the rate is too low, there will be a shortage of demand on the OGL. Thus the optimal discount rate will be found. However, in the converse example where there is limited switching between the markets, increasing the discount factor will mainly effect the OGL market by lengthening queues (as demand increases at the discounted price) and providing an unnecessary "subsidy" to those at the front of the queue. The lower the level of spillover between the market, the slower the adjustment of the discount rate to its optimal level and hence the greater the queue/subsidy effect.

Given that the discount factor was in operation for only a few weeks at the end of December 1992, at a time when there were only limited donor funds in the OGL, it has not been possible to assess what an appropriate rate might be. However, the fact that there is generally excess demand in the OGL (as evidenced by the 3 to 4 week backlog in applications) despite the coexistence of a liberalized market, suggests that the spillover effects may be low and thus the latter case may be prevalent. The discount may not strictly be necessary on these grounds alone. Anecdotal evidence from the time when the 15% discount factor was applied suggests that there was no discernable impact on the demand or queuing.

The appropriate level for the discount when used to offset adverse capital-flight effects or short-term deviations cannot so readily be determined. To the extent that it is felt that the Bureaux market is appropriate, there is no need for a positive discount rate at present.

Single or multiple discount factors? The efficient functioning of the market requires a single discount rate. Moreover, despite the desire for accountability, the donors are unlikely to welcome explicit a donor-by-donor discounting system which would create a "beauty contest" problem.

Coverage of discount factor? Acknowledging only the transactions cost motive for the discount, the 7 December proposal applied the discount to only donor OGL funds. However, it the alternative rationales are considered, the discount should apply to all non market funds, including non-donor OGL funds.

4. Transparency and Accountability

See Working Group B Papers.

C. Options and Recommendations

Aside from issues of documentary management and accountability, which will be covered in the Working Group B papers, the operation of modified OGL system depends solely on the question of the role of the discount factor designed to offset any excess premium on the reference exchange rate. The two options are:

1. Retain the system without a discount factor so that the Bureaux-cum-retention rate will serve as the reference rate for all transactions in the economy. The Bureaux rate will *de facto* be the official exchange rate. This option has the advantage that it denies the authorities access to any direct price intervention in the market and thereby achieves full exchange rate unification. Any interventions on the part of the authorities in the foreign exchange market must be achieved by altering the quantity of foreign exchange supplied to the OGL and/or retention-cum-Bureaux market.

2. Retain the system as is including the discount rate. This option has the advantage that while the official exchange rate will be market determined, there is the facility to buffer the exchange rate from excess short-term variations in the Bureaux rate which may be unrelated to the goods market price but which, if not buffered would be immediately transmitted to all non-Bureaux transactions.

If this second option is pursued a number of recommendations are required concerning the setting of the discount factor.

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i) There should be a single discount factor, the level of which will compensate for excess "transactions costs" associated with using donor OGL funds, and the capital-flight premium on the Bureaux market funds, but which can be altered from time to time by the Bank of Zambia to offset adverse short-term fluctuations in the Bureaux exchange rate.

ii) All official foreign exchange transactions not directly priced in the Bureaux-cum-retention market should be valued at the Bureaux rate less the discount rate.

iii) The rate of discount should initially be set at a low level, between 2 and 5 percent, and be subject to periodic review. In the normal course of events the discount rate should not be changed frequently.

iv) Guidelines should be prepared on the procedures on the setting of the discount rate to offset the transactions cost element of donor funds, and on the rules for altering the discount rate to offset excess short-term deviations in the Bureaux rate.

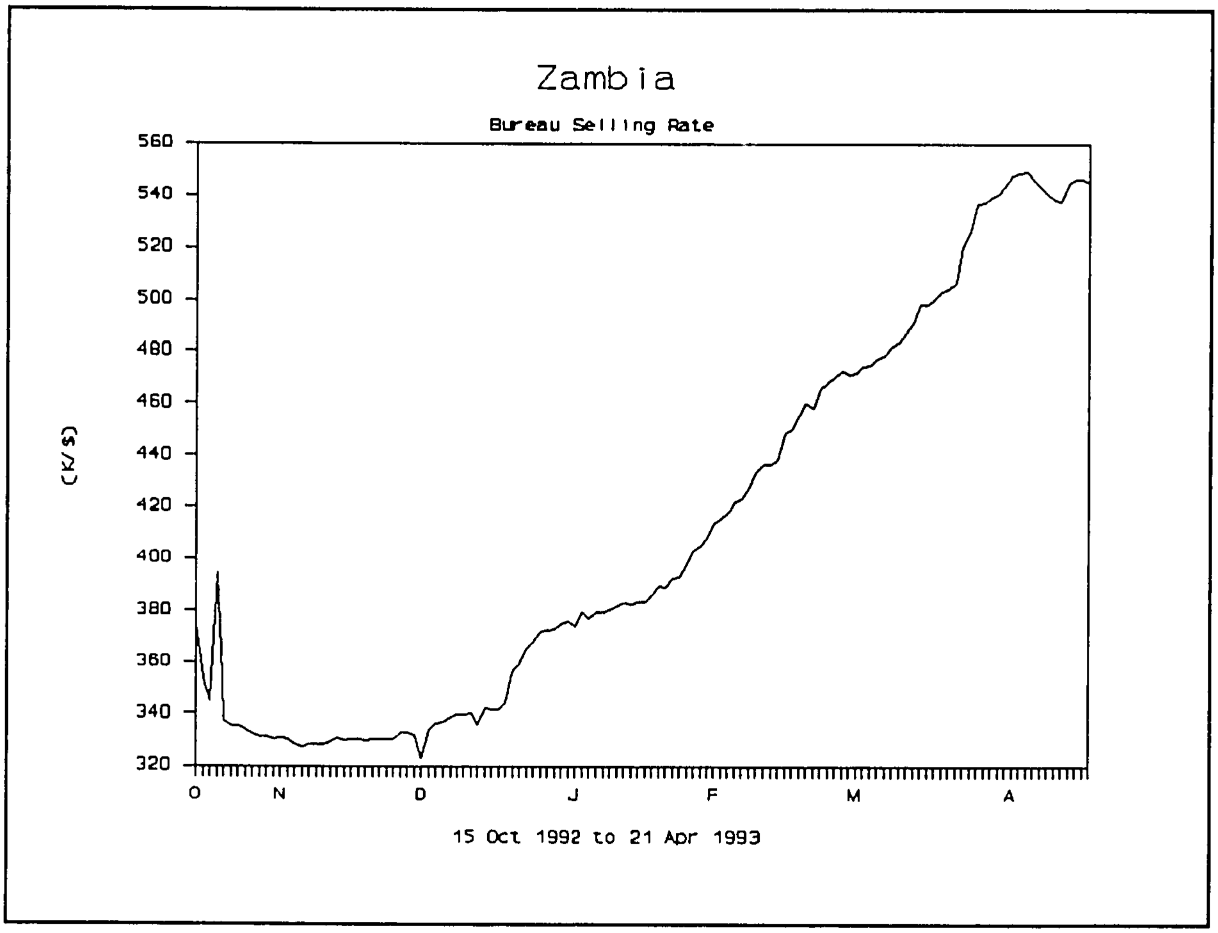
Other Recommendations:

1. On the institutional level, the use of the Bureaux-cum-retention rate will require that continued efforts are made to address the question of competition policy and market regulation to ensure that the high level of market concentration does not lead to excess profit to the financial sector.

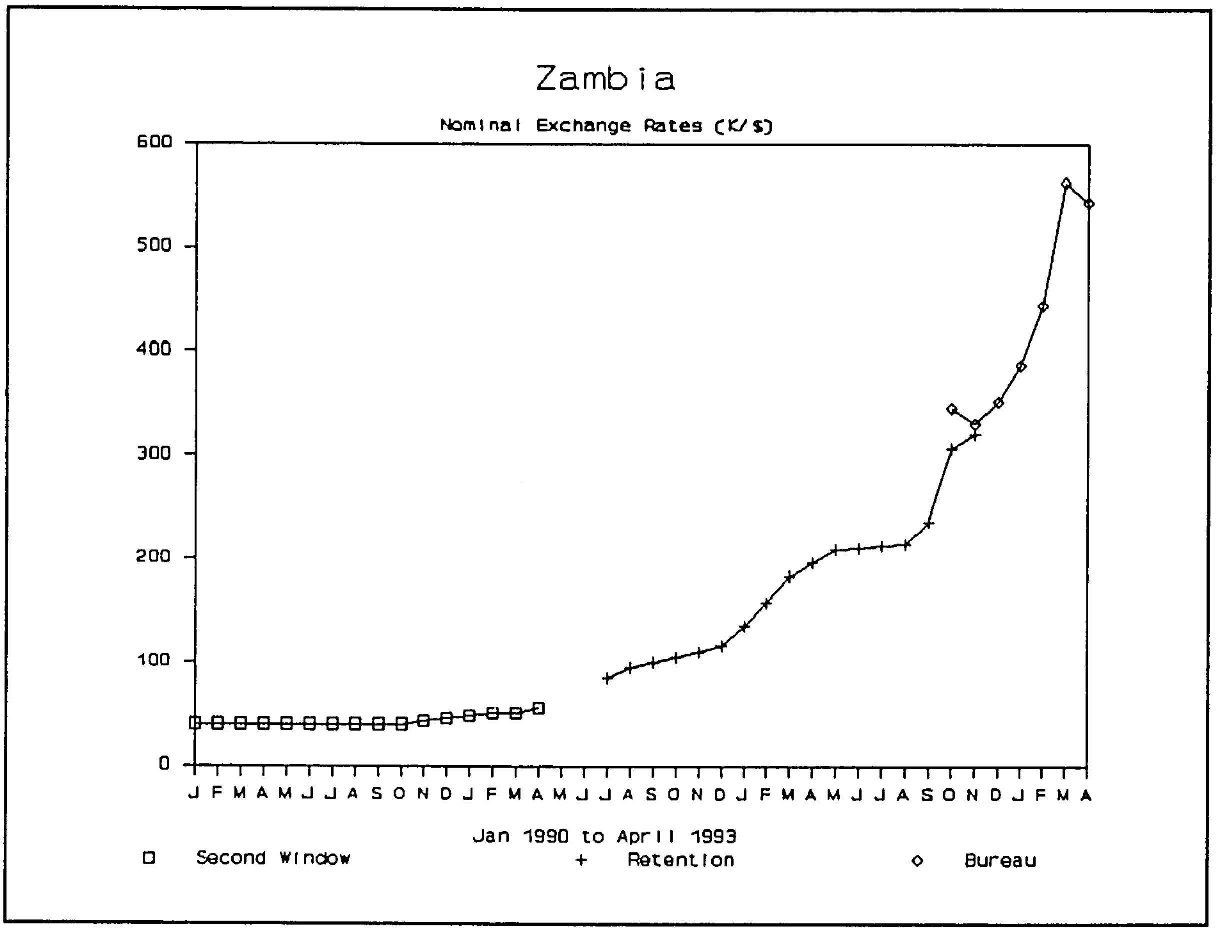
2. To ensure transparency in the operation of the FIFO system for foreign exchange management, it is recommended that:

i) Guidelines be published describing the OGL queuing system and specifying the criteria for rejection of application;

ii) Procedures are established to ensure that importers or the representative of their bank are able to track the progress of unfunded applications through the OGL system.


Zambia
Bureau Selling Rate
560
540
520
500
480
460
440
420
400
380
360
340
320
(K/$)
O
N
D
J
F
M
A
15 Oct 1992 to 21 Apr 1993

47



OGL and Export Retention System Negative List

SITC	Description
11	Alcoholic Beverages, Liquors and Spirits
12	Tobacco
6811	Silver
6812	Platinum
761	TV receivers
762	Broadcast Receivers
	VCRs/Camcorders
7811	Motor Cars
8946	Guns and Ammunition
89731	Jewelry
951	Weapons
971	Gold

VI. TENDER SYSTEM

A. Purpose

In its Policy Framework Paper and Adjustment Programs, the GRZ has committed itself to the establishment of a sustainable, market-based system for the pricing and allocation of foreign exchange. In December 1992 the multiple exchange rates (Bureaux de Change and official) were unified and the decision was that the exchange rate would be based on the average rate established in the Bureaux de Change market. As discussed above in Section V, the Bureaux de Change are handling approximately $150 million on an annual basis or eight percent of Zambia's foreign exchange receipts (including donor financing) or 50 percent of OGL imports. In addition, there are suspicions that the Bureaux de Change system may be functioning as a mechanism for illegal capital flight. These factors have led the GRZ to question whether the Bureaux market is appropriate for establishing the general exchange rate.[7] The GRZ wishes to introduce the tendering process in order to establish a deeper, commodity-based market for determining the appropriate, market-based exchange rate.

B. Description of the Proposed System[8]

The proposed system would effectively introduce two changes to the current system. The mechanism for pricing of foreign exchange will be shifted to a commodity-based market demand, and away from the Bureaux de Change market which incorporates some commodity, services and possibly capital demands for foreign exchange. In addition, the current proposal is to shift the actual allocation of foreign exchange to individual importers from the Bank of Zambia to the commercial banks. The basic structure proposed is as follows:

a) Daily offering of a previously announced fixed amount of foreign exchange, the announcements will indicate any special restrictions which might be associated with the foreign exchange to be made available.
b) Commercial banks will submit sealed tenders, based on previous customer requests for OGL imports which are accompanied by required documentation, indicating the amount of foreign exchange requested and the exchange rate (price) which the customer(s) are willing to offer for that amount. The tenders will be accompanied by authorizations for the Bank of Zambia to debit the current account of the bidding bank for the kwacha cover associated with successful bids.

[7] *See section V.B for a discussion of the appropriateness of these concerns.*

[8] *This section is based on the "Report of the Technical Committee on the New foreign Exchange Allocation System for OGL Imports" dated February 26, 1993. This is only a general description of the key structural characteristics of the proposed system and does not deal with proposed modifications of procurement and documentation requirements.*

c) The tenders will be opened and rank ordered according to the exchange rate (price) bid. Tenders will be accepted commencing with the highest price until the amount available for allocation is exhausted. No single commercial bank will "be allowed" to successfully tender for more than 50 percent of any single day's foreign exchange offering.

d) The Dutch system (each bidder's kwacha cover is based on the price bid) will be used and "the exchange rate" for non-tender official transactions will be based on the weighted average of the rates of the successful bids.

e) Three days following the tender, the Bank of Zambia will release the foreign exchange to the successful commercial banks and debit their accounts for the kwacha cover. The commercial banks may collect the kwacha cover from their customers at the time of submitting the tender offer, only upon the opening of a letter of credit (LC) or effecting a direct transfer, or at any time in-between.

f) To maintain/support transparency, broad details of the tenders will be made available. Probable items are: total number of bids, total amount quantity bid for, number and quantity bid for of successful bids, minimum price bid, minimum successful price bid, maximum price bid, and weighted average successful price bid.

g) Commercial banks will be responsible for selling the foreign exchange (at their tendered rate) to their customers with appropriate OGL import requirements. It will be the responsibility of the commercial banks to ensure that all requirements are met and that appropriate documentation is collected and forwarded to the Bank of Zambia. If commercial banks do not comply with the requirements, they will be barred from participating in the tender system.

C. Issues

1. Extent of Participation

a. Sources of Funds

The current proposal is that the tender system be primarily donor funded, with the GRZ providing funds only if a shortage of donor funds were to arise. The goal would be to maintain a consistent supply of funds to the tender market. A variety of donors have raised the question of why the GRZ is not committing its own resources to the proposed system.

Table 2 above presented a breakdown of the foreign exchange resources available to the GRZ (public sector) in 1991 and 1992 and budgeted for 1993. The source of these funds are the export earnings of ZCCM while the required uses are the financing of debt service, financing of ZCCM foreign exchange requirements, the financing of petroleum imports of ZimOil, and the financing of other GRZ foreign exchange requirements.

The foreign exchange requirements of ZCCM are provided for at source, i.e., a portion of ZCCM's earnings are not surrendered to the GRZ. Thus, there are no foreign exchange conversions into kwacha and then repurchase of foreign exchange of these retained earnings.

These retentions are based upon a fixed foreign exchange budget and not a fixed percentage of earnings. In 1991, ZCCM import requirements amounted to 36 percent of ZCCM earnings, while the same figure for 1992 was 40 percent. For 1993, the expected percentage is 51 percent, with the increase due primarily to a lower level of expected earnings.

The financing of ZimOil's imports currently must be funded (unless donor funds are explicitly provided) directly from ZCCM earnings since copper shipments have been used as direct collateral for a commercial line of credit for financing these imports.

As the data in Table 2 show, the GRZ's resources were significantly over-subscribed in 1991 and 1992 (deficits of $124.4 million and $190.2 million, respectively), and are expected to again be in a deficit in 1993 by approximately $171 million. These figures clearly demonstrate that significant donor support was and is required simply to meet these areas of GRZ foreign exchange requirements. Even greater levels of support would be required in these areas if the GRZ were required to make a fixed commitment to funding the proposed tender system with its own resources.

b. Market Participants

The current proposal is that the private sector will be purchasing foreign exchange through the tender system, along with most parastatal commodity purchases. GRZ debt service payments, ZCCM, ZimOil, and other direct GRZ foreign exchange requirements will continue to receive foreign exchange allocations from ZCCM/GRZ foreign exchange earnings, or donor funds which do not move through the tender/OGL system. These non-competitive allocations would be priced, however, at the tender determined exchange rate.

Several donors have raised the question of why the tender system should be restricted to the private sector and not include a greater portion of the parastatal sector, especially ZimOil. With the exception of ZCCM and ZimOil, all parastatals are currently required to acquire foreign exchange either through the OGL/tender systems or from the Bureaux de Change market. The explanation for exclusion of ZimOil was presented above and is based on the fact that copper earnings are being used as direct collateral for securing a revolving line of commercial credit for financing petroleum purchases.[9]

[9] *While not directly relevant to the consideration of the tender system, one question for the medium term is how to deal with ZCCM and other foreign exchange earnings will be handled in the future given the on-going privatization process. The current justification for the required surrendering of ZCCM's foreign exchange earnings (even with provision at source for import requirements) is that the GRZ owns the majority position in ZCCM. This ownership position is expected to change over the medium term as ZCCM is privatized. If the retention system for non-traditional exports (introduced to provided incentives to export when the kwacha was highly over-valued) continues, the future forced surrender of ZCCM earnings to the Bank of Zambia could be viewed as an equity problem. To deal with this future problem consideration should be given to the elimination of the export retention system so that all export earnings would be surrendered to the Bank of Zambia. The rationale for this change is that with the establishment of a realistic exchange rate and positive real interest rates, exporters would not be penalized for holding kwacha or kwacha denominated assets rather than foreign exchange. (In absence of a major shift in the*

Another participation question is whether or not the Bureaux de Change should be allowed to also offer tenders in the system. From the point of view of market efficiency and integration, there is a strong basis for having the Bureaux participation in the tender system. There may be some concerns on the capacity of the smaller (non-bank) bureaux to meet the proposed documentation requirements. In addition, to the extent that the tender system is tied to the use of LCs, this might be problematical for the Bureaux.

Recommendations:

- Given the general non-availability of GRZ-owned foreign exchange currently and for the foreseeable future, the proposal that the GRZ would only supply resources as a supplement to donor funds in the tender system is proper. If the GRZ's foreign exchange position were to significantly improve, however, a more active GRZ role in financing the tender system would be appropriate.

- Given the existence of the commercial revolving line of credit for the financing of ZimOil's imports and the fact that this is directly secured with copper shipments, ZimOil and it's related foreign exchange allocation should not be moved into the tender system. To promote ZimOil's financial efficiency, greater efforts should be made to ensure that ZimOil functions as if it were participating in the tender system, i.e., maintain appropriate prices on its products and remain current on its payment of countervalue funds.

- Allowing the Bureaux de Change to participate in the tender system is desirable from an efficiency and market integration viewpoint; it should be allowed provided that the Bureaux can satisfy the documentation requirements established for the system in general.

2. Exchange Rate Determination: Existence of a Reserve Price and Exchange Rate Volatility

This is a pressing issue given the fact that proposing a daily tender as opposed to a weekly tender since a daily auction would be expected to be a thinner market. Thus, it would be possible that if on a given day there are a limited number of bids, some of which are very low, there could be extreme revaluations of the exchange rate. Such an occurrence could then prompt an overreaction in the opposite direction which could generate unnecessary volatility in the exchange rate.

appropriate real exchange rate, the nominal rate would move more or less in line with the inflation rate and interest earnings would exceed the inflation rate. Thus, unless transaction costs exceed the differential between nominal earnings and increased nominal costs, the holding of domestic (kwacha) assets would be profitable compared to foreign exchange assets and would not penalize the exporter.

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In order to avoid this phenomenon, a floor price could be introduced. Uganda has essentially been using the previous auction rate as a floor price, but such an approach would guarantee that the exchange rate could only devalue and would not allow for adjustment if the system were to overshoot the appropriate exchange rate. An alternative would be to allow a revaluation of the exchange rate from day to day. In this case if there were a shortage of qualifying bids, the exchange rate would fall to the reserve price and the full amount of foreign exchange offered for tender that day would not be sold that day. The reserve price could either be based on the prevailing exchange rate (the weighted average of the successful bids) or on the minimum successful bid.

The effectiveness of these two options in limiting unnecessary exchange rate volatility would depend on the composition and distribution of bids, as well as the likelihood of having a given auction only with very low bids. If bids are tightly clustered (low range of bids) so that the weighted average is relatively close to the minimum successful bid and the likelihood of a complete collapse of bids is small, both systems would effectively limit unnecessary exchange rate volatility. If bids are not tightly clustered and there is a high likelihood of a complete collapse of bids, basing the reserve price on the weighted average exchange rate would be most effective at limiting unnecessary exchange rate volatility. Presuming the rules of the tender system remain relatively stable and no attempts are made to interfere in the tender process, the probability of having a simultaneous broad spread of bids and collapse of bids is low. Bid ranges can be expected to start out with a broad dispersion, but will converge over time.[10] Given the general foreign exchange shortage in the economy, a bid collapse would not be expected until this foreign exchange shortage has been reduced. Thus, there is no *a priori* basis for selecting either rate for the purpose of setting the floor rate. For purposes of clarity and transparency, however, using the minimum successful bid would be preferable since it is clearly identified and easily verifiable (does not require calculation).

An alternative to establishing a reserve price would be to hold the auctions less frequently, e.g. twice a week with the possibility of moving to a daily auction at a later date. This would thicken the market, thereby reducing the likelihood of a collapse of bids, and would also provide a time period for all parties to test administrative procedures for the tender system.

***Recommendations*:**

- To help eliminate possible unnecessary exchange rate fluctuations:

  (a) initially, tenders should be held twice a week rather than on a daily basis; and

[10] *This is supported by the performance of the weekly auction in 1985-1987. The bid range in week one was 2.4 times the minimum successful rate. This ratio fell to 1.4 in week two, 0.5 in week four, 0.3 in week eight, and 0.2 in week ten.*

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(b) a reserve price of 10 percent of the previous days minimum successful bid should be included in the tender system. To maintain transparency, this policy should be announced or included in the published rules of the tender system;

3. Should Specific Monies or General Monies be Tendered

The current proposed tender system would offer monies from a specific source each day, for example funds from a given donor or given donors. The restrictions associated with the money would be announced to allow banks and their customers to take into account the possible additional transaction costs associated with those restrictions. The question is whether or not this system should be adopted. In the proposed system there could be different discounts applied to different pots of money, a situation no acceptable to some donors. In addition, if these differential discounts were applied, unnecessary exchange rate volatility would be introduced.

An alternative approach would be for the Bank of Zambia to make allocations from specific sources once a tender is approved. Such an approach, currently used in the Ugandan auction system, would allow the Bank of Zambia to manage the use of monies with greater restrictions without introducing donor specific discounts and without producing unnecessary exchange rate fluctuations. This approach assumes that it will be possible to maintain a sufficient pot of differentiated monies so that successful tender bids for non-restrictive imports can be consistently met. It also assumes that the Bank of Zambia can function efficiently enough to make these determinations within the three day time period proposed between the execution of the tender and the transfer of the foreign exchange to the successful commercial bank.

***Recommendations*:**

- The current tender proposal be modified not to have specific monies for sale on a given day, and that this system be replaced with a funds selection system managed by the Bank of Zambia ala the Bank of Uganda system.

- If the previous recommendation is accepted, the Bank of Zambia staff responsible for implementing the system should visit Uganda in order to get pointers on how to most effectively implement the revised system.

4. Limits on a Single Bank's Purchases in a Single Tender

The current proposal sets a limit of 50 percent of the funds in a given day's tender to go to any single bank. Some donors have expressed a desire to see this maximum level reduced to 30 percent to 40 percent. Looking at this issue from an efficiency point of view, there should be no limits on a single bank's purchases in a single tender. Those willing and able to pay the most should gain access to the funds. The justification for setting these limits, however, is based on the desire to maintain equity in commercial banks's access to the tender funds, while not wanting to place an unnecessary burden on possible large tender requests. With an expected daily tender of approximately $1.0 million, the 50 percent limit would allow a successful tender of up to $500,000. Reducing the limit to 30 percent would lower the possible tender size to $300,000 which would require a firm with a need for more money to be successful in two tenders rather than one. The 50 percent limit was reached as a compromise.

If the suggestion to shift the tender system to a twice weekly rather than daily basis is accepted, the problem of low funds availability will not exist and the 50 percent limit will not be necessary.

Recommendations:

- In order to promote efficiency, the 50 percent limit on a single bank's purchases in a given tender should be eliminated.

5. Timing of the Transfer of Funds

The issues concerning the timing of the transfer of funds involves both the transfer of title to the foreign exchange resources and the collection/payment of the kwacha cover (countervalue funds) associated with the purchase of the foreign exchange. These transactions are linked and any decisions concerning one has implications for the other.

Recommendations:

- See Working Group B Recommendations.

6. Conditions and Justification for Rejection of Tenders

The current proposal states that the Bank of Zambia has the right to reject any tender without the obligation to reveal why. In the interest of transparency, guidelines/rules for the tender process should be established and published. These guidelines/rules should cover not only the general rules and regulations associated with the tender system, but should also state the grounds for the rejection of tender offers. In addition, for any tender offer that is rejected, the grounds for the rejection should be provided.

Recommendations:

- To promote system transparency, the current tender system proposal should be modified to state that tenders will only be rejected in accordance with established and public rules and that an explanation for any rejected tender will be provided. A general explanation of the rejection should be provided publicly, with details available to the commercial bank which submitted the tender.

7. Monitoring and Management Responsibilities

The current proposal delegates the responsibility for collecting all required information and documentation to each participating commercial bank. The Bank of Zambia would then be responsible for reviewing this information and providing required reports and documentation to the donors providing the funds for the tender system. This is in contrast to the current system where the Bank of Zambia is responsible for assembling all required information and documentation, as well as reporting to donors.

An alternative proposal has been put forward that a group of commercial banks be designated official intermediaries in this system. The intermediary banks would be responsible for assembling and reviewing the documentation to make sure that it is complete before that documentation is forwarded to the Bank of Zambia. This alternative proposal would provide an additional level of verification and checking of documentation, but would require the shifting of normal banking relationships between commercial and correspondent banks.

***Recommendations*:**

- See recommendations of Working Group B.

8. Publication of Tender Results

The current tender system proposal provides for the publication of a minimal amount of summary information concerning each tender. Some donors have raised the question of why not publish the full range of tenders and their associated information, quantity requested and bid price.

The publication of the full bid information would provide increased transparency and with the wider availability of information could reduce bid spreads, market differentials in exchange rates, and promote the efficiency of the market by eliminating uncertainty. An argument could also be made that the full publication of information could provide a check on possible collusion in bidding practices.

***Recommendations*:**

- In the interests of system transparency and full information, the Bank of Zambia should post in a public place not only the summary information for each tender, as currently proposed, but also the listing of successful, unsuccessful, and rejected (with reason for rejection) tender offers.

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D. Recommendations

The following points are the recommendations concerning the issues raised concerning the proposed tender system:

1. Extent of Participation

- Given the general non-availability of GRZ-owned foreign exchange currently and for the foreseeable future, the proposal that the GRZ would only supply resources as a supplement to donor funds in the tender system is proper. If the GRZ's foreign exchange position were to significantly improve, however, a more active GRZ role in financing the tender system would be appropriate.

- Given the existence of the commercial revolving line of credit for the financing of ZimOil's imports and the fact that this is directly secured with copper shipments, ZimOil and it's related foreign exchange allocation should not be moved into the tender system. To promote ZimOil's financial efficiency, greater efforts should be made to ensure that ZimOil functions as if it were participating in the tender system, i.e., maintain appropriate prices on its products and remain current on its payment of countervalue funds.

- Allowing the Bureaux de Change to participate in the tender system is desirable from an efficiency and market integration viewpoint; it should be allowed provided that the Bureaux can satisfy the documentation requirements established for the system in general.

2. Exchange Rate Determination

- To help eliminate possible unnecessary exchange rate fluctuations:

  (a) initially, tenders should be held twice a week rather than on a daily basis; and

  (b) a reserve price of 10 percent of the previous days minimum successful bid should be included in the tender system. To maintain transparency, this policy should be announced or included in the published rules of the tender system;

3. Should Specific Monies or General Monies be Tendered

- The current tender proposal be modified not to have specific monies "for sale" on a given day, and that this system be replaced with a funds selection system managed by the Bank of Zambia ala the Bank of Uganda system.

- If the previous recommendation is accepted, the Bank of Zambia staff responsible for implementing the system should visit Uganda in order to get pointers on how to most effectively implement the revised system.

4. Limits on a Single Bank's Purchases in a Single Tender

- In order to promote efficiency, the 50 percent limit on a single bank's purchases in a given tender should be eliminated.

5. Timing of the Transfer of Funds

- See Working Group B Recommendations.

6. Conditions and Justification for Rejection of Tenders

- To promote system transparency, the current tender system proposal should be modified to state that tenders will only be rejected in accordance with established and public rules and that an explanation for any rejected tender will be provided. A general explanation of the rejection should be provided publicly, with details available to the commercial bank which submitted the tender.

7. Monitoring and Management Responsibilities

- See recommendations of Working Group B.

8. Publication of Tender Results

- In the interests of system transparency and full information, the Bank of Zambia should post in a public place not only the summary information for each tender, as currently proposed, but also the listing of successful, unsuccessful, and rejected (with reason for rejection) tender offers.

VII. Comparison of Systems

The following two page chart compares the to proposed alternative systems in terms of their performance/characteristics vis-a-vis ten objectives. The chart is relatively self-explanatory; the basic conclusions are that (i) both systems have their individual strengths and weaknesses, and (ii) both systems are compatible with movement towards the GRZ's medium-term objectives in terms of the foreign exchange regime.

COMPARISON OF ALTERNATIVE SYSTEMS

OBJECTIVES	MODIFIED CURRENT SYSTEM	MODIFIED TENDER SYSTEM
Minimize Short-Term Exchange Rate Volatility	» Dominated by Macroeconomic Conditions. » Use of a Weighted Average smooths. » Can use a General "Discount Factor".	» Dominated by Macroeconomic Conditions. » Use of a Weighted Average smooths. » Inclusion of Reserve Price Protects Against Specious Bids. » Possible Announcement Effect.
Encourage Movement Towards Long-Term Foreign Exchange System Liberalization	» Equivalent, Compatible with Long-Term Goal » Reliance on Market Forces for Exchange Rate Determination (Discount Factor Interventions Possible) and Use of Queuing for Foreign Exchange Allocation.	» Equivalent, Compatible with Long-Term Goal » Reliance on Market Forces for Both Exchange Rate Determination and Foreign Exchange Allocation.
Reduce Vulnerability to Fiscal and Monetary Policy Regime Variability	Equivalent, But Highly Vulnerable, i.e., Lack of Fiscal or Monetary Restraint Will Result in Exchange Rate Devaluation	Equivalent, But Highly Vulnerable, i.e., Lack of Fiscal or Monetary Restraint Will Result in Exchange Rate Devaluation
Promote Ability to Cope with Donor Funds' Lumpiness & Their In-Out Nature	» Equivalent » Excess Demand Presents Lower Public Profile since Evidenced in Queues & in Bureaux Market Rate	» Equivalent » Excess Demand Presents Higher Public Profile since Evidenced Solely in Tender System Rate
Promote Transparency to Minimize Risk of Abuse	» No Public Access to Verify First-In, First-Out Processing & Possible Queue Jumping » Uncertainty re Discount Factor Rules.	Perhaps Slight Advantage, since able to easily check allocation process (price).

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COMPARISON OF ALTERNATIVE SYSTEMS
(CONTINUED)

OBJECTIVES	MODIFIED CURRENT SYSTEM	MODIFIED TENDER SYSTEM
Maximize Degree to Which System Determines Exchange Rate and Rational Allocation	Equivalent	Equivalent, Possible Slight Advantage in Terms of Rational Allocation
Minimize Potential Collusion Problems	» Bureaux Market is Imperfect (Concentration) » Need for Competition Policy and Market Regulation	Collusion Possible, but can make information public for monitoring
Encourage Value for Money	Equivalent	Equivalent
Improve System Accountability and Auditiability	» Current Implementation System is Inadequate, i.e., Not Timely in the Collection & Processing of Documentation.	» Could Use Slight Modification of Current Implementation System. » Delegation of Authorities to Commercial Banks Would Necessitate the Strengthening of BOZ Supervisory Capacity. » More Difficult to Strengthen Supervisory Capacity than to Improve on Current Implementation System.
Other Considerations	» KIS (Keep It Simple), i.e., the current system is in place. » Current System is Not Suffering From Major Problems.	» Establishing new system, i.e., not simple. » If fails again, major problems. » Officials have essentially announced it already.

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VIII. RECOMMENDATIONS ON GENERAL ISSUES INDEPENDENT OF FOREIGN EXCHANGE REGIME

This section presents findings and recommendations concerning four issues or questions which arise no matter which foreign exchange regime or structure is selected.

Issue 1. Feasibility of Full Reimbursement/Retroactive System

The major aspect of this question is whether or not sufficient funds could be found to allow the start up of the system. Based on an average use of $25 million per month and setting up for a seven month stock (based on roughly six month turnaround for all documentation), plus a month's protection, an initial stock of funds of $175 million would be required. Since there are funds and (presumably) documentation for retroactive financing, reduce this by two month's worth so that the question is the mobilization of $125 million.

Does the GRZ Have the Money? The GRZ's resources were significantly over-subscribed in 1991 and 1992 (deficits of $124 million and $190 million, respectively), and are expected to again be in a deficit in 1993 by approximately $171 million. The only 1993 quarter which showed or is expected to show a surplus is the first quarter with a surplus of $32 million. These figures clearly demonstrate that significant donor support was and is required simply to meet these areas of GRZ foreign exchange requirements (debt service, petroleum, ZCCM imports, other GRZ). Even greater levels of support would be required in these areas if the GRZ were required to make a fixed commitment to funding the proposed tender system with its own resources.

Is Borrowing Feasible? Zambia is far from a credit-worthy commercial customer. While the GRZ has been able to get commercial credit, it is secured by copper exports. As pointed out above that without donor support in these areas, the GRZ is in a deficit position; thus, further use of copper to secure a line of credit is not feasible. As an alternative to the use of copper as collateral, it might be possible to use donor commitments to reimburse upon the presentation of appropriate documentation to secure insurance of such a loan. If the GRZ were to secure such a line of credit without copper collateral, the annual cost of what would need to be a revolving line of credit would be approximately $6-7 million (interest costs plus fees), which again the GRZ does not have. In addition, this would put the GRZ in violation of IMF short-term credit ceilings.

Is There a Donor Willing and Able to Supply the Up-Front Money? Not to our knowledge; however, there are donors with funds in place for retroactive financing of imports. These facilities could be used to generate free funds to initiate a partial reimbursement/retroactive financing system. The key problem constraining the use of such an approach is the accumulation and presentation of adequate documentation to allow the release of the funds.

Finding:

- A full reimbursement scheme is not feasible due to (1) the shortage of GRZ funds; (2) the questionable cost and feasibility of borrowing the requisite amount, plus the fact that such borrowing would violate existing agreements with the IMF; and (3) the absence of any donor willing and able to supply the necessary up-front funds.

- A partial reimbursement scheme may be feasible given the availability of donor funding for retroactive financing of imports with the provision of adequate import documentation.

Issue 2. The "Minimum Condition" Option

The efficient functioning of any system of allocation (either the amended OGL or the Tender) requires that the product allocated through the market should be as homogeneous as possible so that a single price prevails. This is not possible given the diversity of donor conditions, and raises the question of whether there is a sufficient volume of relatively homogeneous, untied OGL funds which will allow the OGL to be fully funded. If this can be achieved, many of the discount/discrimination issues will disappear.

In such a case other more conditional funds require to be allocated to other forms of funding (for example, direct financing of external debt), until the point at which the conditions under which they can be allocated to finance OGL imports meet the minimum conditions.

In the case of 1993 Budget the World Bank and EEC balance of payments support is projected to be \$314 million, 62% of total anticipated BoP support and 97.5% of anticipated OGL requirements (\$322 million). In 1992 these two institutions provided \$230 million in BoP support, equivalent to 47% of total BoP support and 81% of OGL requirements.

Thus, a "minimum conditions" system which is acceptable to these two multilaterals would be expected to almost fully fund the OGL. There are a sufficient number of other donors whose requirements are consistent with those of the World Bank and EC to allow a "minimum conditions" criterion to be established.

Issue 3. Monitoring and Management Responsibilities

- No matter what structure is selected, the Bank of Zambia is the entity responsible for the management, accountability, and auditability of funds. These functions can be handled by the Bank of Zambia itself, as is currently the case, or they can be delegated to commercial banks as in the tender system proposal.

    - The current system suffers from the inefficiency of the Bank of Zambia in the timely accumulation and tracking of documentation required by donors for the accountability and auditability of funds.

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  - o The proposed model of delegation suffers from the weakness of the Bank of Zambia in bank supervision.

  - o It is the opinion of the Joint Evaluation Mission that in order to improve the accountability of funds it would be easier to strengthen the current systems of documentation accumulation and tracking, than to provide the necessary strengthening of the Bank of Zambia's supervisory capabilities.

- The bank supervisory capacity of the Bank of Zambia would need to be strengthened as quickly as possible.

- For further recommendations, see the Working Group B recommendations.

IX. OVERALL RECOMMENDATION

We have examined two alternative systems for the allocation and valuation of foreign exchange not currently allocated through the bureau-cum-retention market. Both systems are feasible and are consistent with the medium-term objective of government to move towards a unified, market-determined foreign exchange system based around an interbank market. It is clear, however, that the tender system is a more market-oriented pricing and allocation system for allocating donor OGL funds (although both systems, in their current guise involve extensive non-market allocations of foreign exchange for priority use, albeit with reference to a market determined price.

While we agree that the tender system is probably preferable as a transitional mechanism towards an interbank market, we believe that given institutional constraints in the Bank of Zambia and in view of continuing macroeconomic imbalances, we believe that the current OGL-based system as described in this paper should be maintained at the present moment (subject to recommendations contained in Sections V and VIII above).

Five factors have shaped our recommendation:

1. We believe that the modified OGL system places a lower administrative burden on the Bank of Zambia. The system is simpler to manage given current resource and capacity constraints, and the accountability and audit requirements of the donors (see also Group B).

2. We believe that the modified OGL system is marginally more robust to short-run volatility elsewhere in the macroeconomic system, particularly if the OGL discount factor is used to buffer the system from adverse short-run movements in the bureau-cum-retention market.

3. In the face of short-term interruptions in the supply of foreign exchange the modified OGL system adjusts in the short-run through increases in the queue

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rather than through increasing the exchange rate (or even temporary cancellation of the tender), as may occur in the tender. While the economy and expectations remain sensitive to short-term movements in the exchange rates, this form of short-term adjustment, will have a lower "profile" and therefore less effect elsewhere in the economy.

4. Both systems necessarily carry risks of failure. However, given recent history in Zambia we feel that the political implications of the failure of the Tender system for the economic recovery program may be severe.

5. Finally, we feel that since the current system is functioning reasonably efficiently it should be continued with slight modification as an interim step towards introducing the tender. The efficiency gain to using the tender system is likely to be greatest when macroeconomic stabilization has been achieved, and inflation reduced to a low, stable, level (at which point price signals will be less distorted). Since the tender system is, in itself, not instrumental in promoting stabilization, the marginal gain in allocative efficiency in introducing the system immediately probably does not outweigh the adverse effect on achieving stabilization which its failure may engender.

We therefore envisage a three-stage evolution towards the medium-term goal of an interbank market. First, while stabilization is being sought, the modified OGL system is retained while preparations are made for the development of a tender system (particularly on the issue of documentary management). This stage may last for 12 - 18 months. Second, having achieved stabilization and, having established a stronger documentary tracking and audit capacity for OGL funds, the tender system may be introduced for OGL funds. During this stage the government can, in conjunction with the donors, establish the regulatory environment and develop institutional capacity required to sustain an efficient interbank market in foreign exchange. Running parallel to this would be negotiations with donors to establish the basis for using donor balance of payments support in an "open positions" wholesale market.