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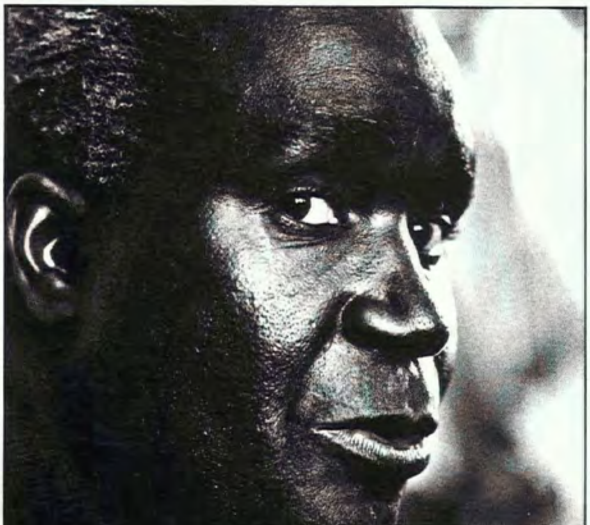
FOREIGN EXCHANGE ZAMBIA

An Evaluation of the Auction System in the Zambian Economy



By Rudolf Jalakas

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FOREIGN EXCHANGE ZAMBIA

An Evaluation of the Auction System in
the Zambian Economy

This report is the result of an evaluation mission to Zambia in November 1986. Formally responsible for the views expressed is the author **Rudolf Jalakas.**

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ZAMBIA

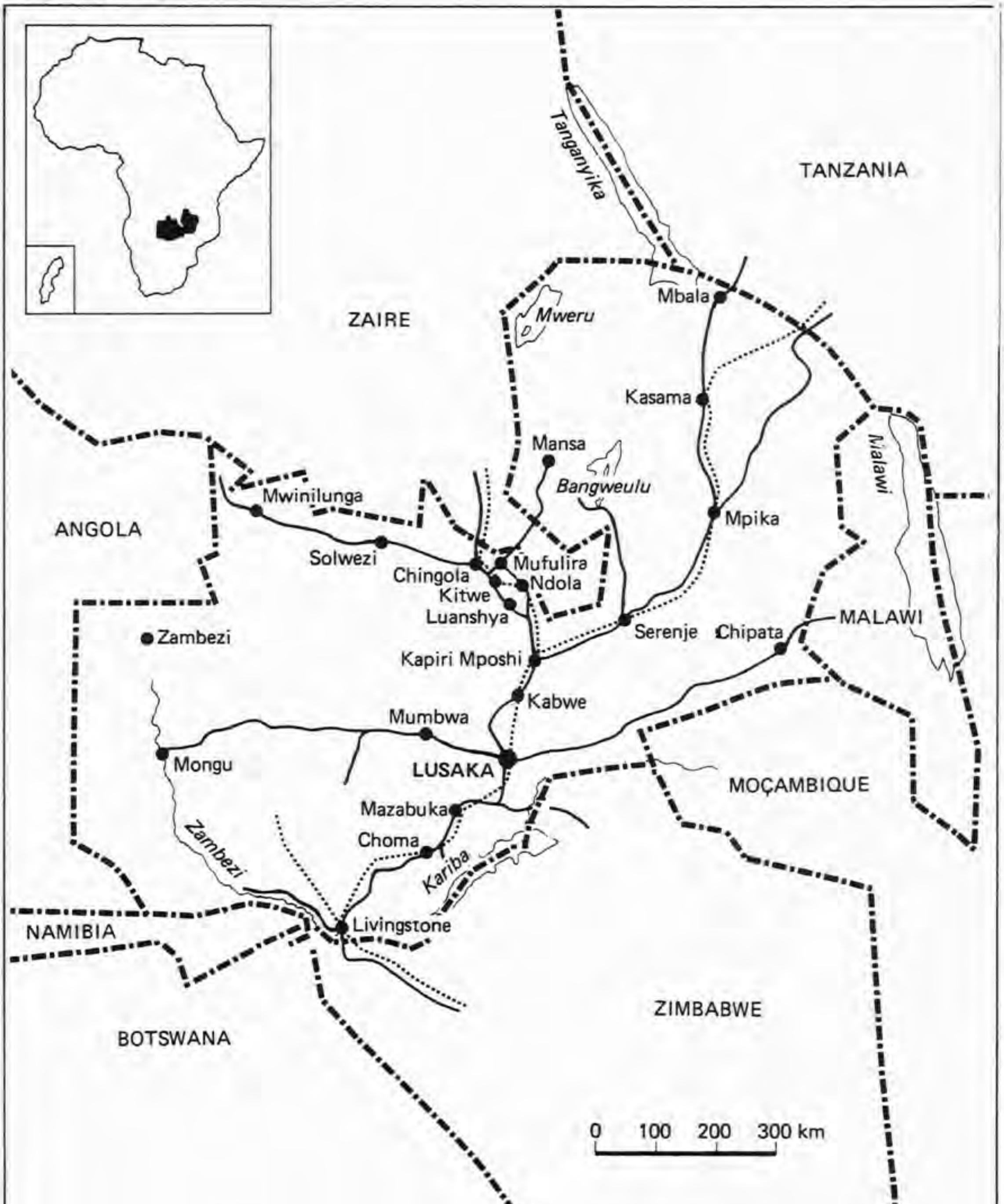

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TABLE OF CONTENTS

SUMMARY

Since the middle of the 1970s Zambia has been in a permanent economic crisis. The main cause of the crisis has been a drastic decline in income from the export of copper. The average price of copper during 1975/84, in stable value of money, was only half of the average price during the preceding decade. The volume of copper export also has declined, as shortage of foreign exchange has made it difficult for the copper industry to keep up its technological level. Zambia's share of world copper exports declined from 14 per cent in 1974 to 7 per cent ten years later.

Copper still accounts for 90 per cent of Zambia's total export but its role in production and employment, as well as in government revenues, has been declining.

This development, in combination with the expected exhaustion of Zambia's copper resources within the next 20 years, has made it growingly urgent to create conditions for a development towards a more diversified economy. The Zambian Government has launched a reform programme aiming at a far-reaching restructuring of the country's economy on a market-oriented basis. The programme which is now being carried through includes deregulation of prices, gradual abolition of subsidies and increasingly free competition in sectors earlier dominated by state monopolies.

One element in this reform programme is the introduction of a new system for the allocation of foreign exhcange and for the determination of exchange rates. On October 4, 1985, weekly auctions for foreign exchange were introduced. Importers and others who need foreign exchange have to submit their bids through commercial banks to a special committee at the Bank of Zambia whose weekly meetings are attended by a representative of the IMF. In their applications, the bidders have to declare the purpose for which foreign exchange is needed, the rate of US $ in kwacha which the bidder is willing to pay and the amount of foreign exchange needed. US $ is the only auction currency, the rates of other currencies being determinated on the basis of current international cross-rates. Government institutions are exempted from the auction system.

There are in principle no restrictions as regards the kind of goods which can be imported or the countries of origin. However, the Bank of Zambia has the right to refuse any bid without disclosing the reason.

The amount of foreign exchange allocated every week is fixed in advance. The lowest bid necessary for exhausting the weekly amount determines the exchange rates for all foreign exchange transactions until the next auction.

The names of all successful and unsuccessful bidders are published in the newspapers every week. In principle the bidders obtain the foreign exchange during the week following the auction. In practice the shortage of foreign exchange caused by excessive allocations in the autumn of 1986 has led to a considerable delay in actual disbursements.

Importers seem to be satisfied with the auction system. In the old system they had to wait many months before they got - or were refused - allocations of foreign exchange. The availability of imported goods has increased considerably since the introduction of the new system. This has made it possible, among other things, to raise the utilization of capacity in the manufacturing industry, which has been suffering from shortage of imported inputs.

The auction system is supported by the World Bank and a number of donor countries. The system has led to a devaluation of the kwacha by about 80 per cent which probably means that the kwacha has become undervalued.

The devaluation has increased the inflationary pressure. Inflation was already accelerating when the auction system was introduced, as a result of the deregulation of prices and the abolition of government subsidies.

The auction system has reduced the donors' possibilities to control the use of their funds. Once included in the auction system the funds of a certain donor cannot be traced. However, the procedure applied by the Bank of Zambia guarantees that the funds allocated to the bidders are used for the purposes declared in the applications. As the donors' contributions only account for about half of the total amount channeled through the auction system, it is highly probable that every donor without difficulty can find enough cases of imports which satisfy the donor's requirements as regards the kind of goods imported and the countries of origin.

The auction system is to be viewed as a link in a reformprogramme to make Zambia less dependent on exports, from one dominating product, copper.
Photo: Roan Consolidated Mines Ltd.

PART 1 - BACKGROUND

1 RADICAL CHANGE

In October 1985 Bank of Zambia carried through a radical change in its system for handling foreign exchange. The old method, based on fixed exchange rates and administrative allocation of foreign exchange through licences issued by Bank of Zambia, was replaced by a system of weekly auctions. Both exchange rates and the allocation of available foreign exchange resources have since then been determined by a bidding procedure.

The change is to be regarded as a link in the more fundamental reform programme for Zambia's economy, which is now being carried through. The basic idea of this programme is to make the country less dependent on copper mines, which have seen their market position gradually weakened and are expected to be exhausted within the next 20 years.

In order to give the unavoidable restructuring and diversification of Zambia's economy a market-oriented basis, the Zambian Government has decided to abolish the earlier system characterized by far-reaching regulations, subsidies and government-owned monopolistic conglomerates. Elements in this reform programme are deregulation of prices, gradual abolition of subsidies and increasingly free competition as well as the auction system for foreign exchange.

So far such an auction system has been tried only in a limited number of countries and no comprehensive study of the experiences made is available. The following attempt to assess the auction system as applied by Bank of Zambia is preceded by a survey of the general economic development in Zambia during the past ten years, during which the need of a fundamental reform programme has emerged with increasing urgency.

The study was carried out on behalf of SIDA in November, 1986. The local SIDA office and the Swedish Embassy in Lusaka made it possible to accomplish the study within the limited time available by giving excellent support.

2 A ONE PRODUCT ECONOMY

Since the middle of the 1970s the Zambian economy has been in a chronic crisis; production has declined and unemployment has increased. The country has been facing growing deficits both in the balance of payment and the government budget. Inflation has been high and accelerating.

This development stands in sharp contrast against what happened during the first decade of the country's independence; this was a period characterized by favourable and encouraging economic trends. Production and employment were growing rapidly without any disturbing imbalances.

The change of scene which has taken place since then is by no means unique in Africa. The economies of all oil-importing developing countries suffered from the set-back in the world economy which was caused by the oil-crisis in the 1970s. What is unique is the degree of change. The contrast between the situation before and after the oil-crisis is more dramatic in Zambia's case than in the case of any other African country. The explanation is not difficult to find. It lies in a factor partly beyond the country's own control, namely in the fact that the oil-crisis coincided within extremely weak export development for Zambia's dominating product, copper.

During the 1960s and early 1970s satisfactory prices of copper and an increasing volume of copper exports provided the basis for a rapid growth of both consumption and investments. During 1964-74 Zambia's gross domestic product rose by eight per cent per annum, which was among the highest growth rates in Africa. In spite of a high rate of population increase - more than three per cent a year - real income per capita improved considerably.

Growing copper exports led to buoyant government revenues. Massive investments were made in infrastructure, and public services were steadily expanded. Manufacturing industry also grew rapidly, not only for serving the thriving copper mining industry but also for deliveries to the rest of the home market. The contribution of manufacturing industry to the gross domestic product rose from five per cent in 1964 to twelve per cent in 1974.

Decay of the Copper Industry

In the middle of the 1970s this favourable trend came to a sudden end. The paralysing effects on the world economy of the fourfold increase of the price of oil started to make itself felt in the demand for raw materials. In 1975 the price of copper fell from 93 cents per lb to 53 cents. The price has since then fluctuated around this lower level without any real recovery except for a short rally in 1979/80. Calculated in stable value of money the average price of copper during 1975/84 was only half of the average price during the preceding decade.

To the adverse effects of the world wide recession were added the price-depressing consequences of the large excess capacity which had arisen in the copper industry of the world. At the end of the 1970s the extent of this excess capacity was estimated at 25 per cent.

It was not only the adverse development of price that hurt Zambia's copper industry. Zambia was also unable to retain her share of the world copper market. While the total world exports of copper rose gradually, Zambia's export of the metal declined. The result was that Zambia's share of the world copper exports was reduced from 14 per cent in 1974 to seven per cent ten years later.

Vicious Circle

One reason behind this development was the inability of the Zambian copper industry to keep up its technological level. The industry had come into a vicious circle. The falling foreign exchange income made it difficult to renew and maintain the equipment and this in its turn reduced the ability to earn foreign exchange. The volume of copper production declined from 710 000 tonnes in 1974 to 463 000 tonnes in 1986. The production of other metals - cobolt, lead and zinc - also declined but the contribution of these metals to Zambia's exports is limited - only about five per cent as against 90 per cent for copper.

The share of mining industry in Zambia's total domestic product fell from 34 per cent in 1974 to only 14 per cent in 1985. The mining industry's share in Zambia's exports has remained unchanged at about 95 per cent, which shows that total exports have declined at the same rate as the exports of mining products.

Zambias Gross Domestic Product Sectorial composition, per cent	1964	1974	1985
Agriculture	13	10	15
Mining	50	34	14
Manufacturing	6	12	21
Construction	4	5	3
Transport and Communications	4	5	5
Distribution	8	11	12
Community, Social and Personal Service	9	12	17
Others	6	11	14
	100	100	100
GDP at current market prices, million kwacha	480	1 830	6 330
Expressed in 1974 kwacha	850	1 830	1 890

Manufacturing Industry

The weakness of the mining sector has influenced the development throughout the whole Zambian economy. Manufacturing industry has to a large extent been built up to supply and serve the mining industry. Manufacturing is also highly dependent on imported raw materials, fuel and equipment. In the metal industry imported inputs account for as much as 80 per cent of total inputs. In industries which provide the local market with consumer goods such as textiles, shoes and processed food, the dependence on imported inputs is less than 50 per cent.

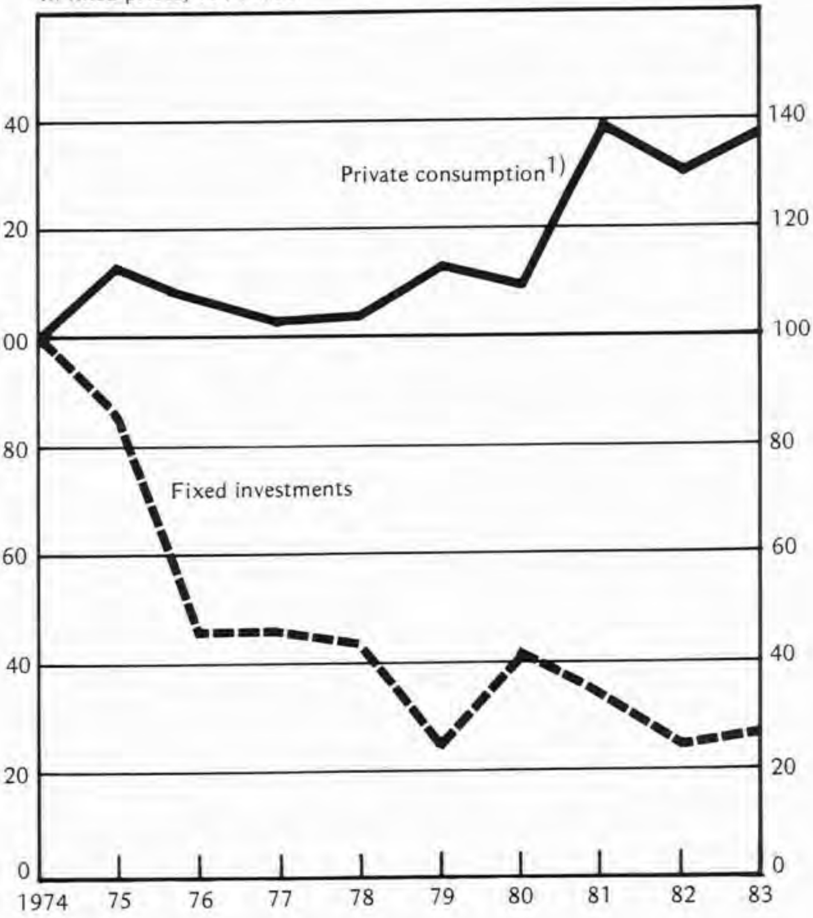
The decline in copper export has thus had a double effect on the manufacturing sector. It has reduced the manufacturing industry's sales to the mines and made it difficult to get foreign exchange for buying the necessary supplies from abroad.

The shortage of foreign exchange has prevented the industry from fully utilizing its capacity. Very low figures - 30 per cent of capacity and less - have been mentioned in this connection. During the past year capacity utilization seems to have increased considerably as the introduction of the auction system for allocating foreign exchange has increased the availability of foreign exchange.

In spite of all difficulties since 1974 the volume of industrial production has grown by about three per cent per year, which makes manufacturing the most expanding sector of Zambian economy during that period. Manufacturing accounts for more than 20 per cent of the

PRIVATE CONSUMPTION AND INVESTMENTS IN ZAMBIA

In fixed prices, 1974=100



1) Consumption per capita has remained practically unchanged during the period.

Balance of Payments Crisis

The fall in copper prices in 1975 cut the country's export revenues by more than 40 per cent and led to a balance of payments deficit equal to 30 per cent of Gross Domestic Product. This was the beginning of a balance of payments crisis that is still going on.

The duration of the decline in copper prices and the balance of payments deficit was gravely underestimated by all parties. Consequently, the measures of economic policy were never adapted to the gravity of crisis. Initially the deficit was financed by using existing gold and foreign exchange reserves and by commercial borrowing abroad. Zambia's creditworthiness was still high, as most lenders also underestimated the seriousness of the crisis.

As the accumulated debt increased, the annual payments of interest and amortization required a rapidly growing share of the diminishing export income. The amount available for import shrank year by year. An increasing part of this amount was needed to cover the rising cost of oil import. Oil accounts for 25 per cent of Zambia's total imports. A rigid system of import licensing and foreign exchange allocation was introduced. In 1985 the volume of imports was only one third of what it had been ten years earlier. A chronic cheapness of foreign exchanges, i.e. overvaluation of the kwacha, increased the pressure of demand for foreign exchange and led to a growing black market for currencies. The shortage of imported goods constrained economic activity, as both mining and manufacturing are extremely import-intensive.

Zambia's balance of current payments has been in deficit every year since 1975, with the exception of 1979, when a short rally in copper prices led to a small surplus.

With the help of severe import restrictions the deficit could be reduced essentially during 1983-85, but a substantial worsening is estimated for 1986.

IMF standby credit agreements

In recent years Zambia has been involved in a series of negotiations with the IMF. Sizable standby facilities have been agreed upon but most to them have been suspended before being fully utilized. The reason has been Zambia's inability to comply with IMF's conditions.

In 1981 IMF made available SDR 800 million (=US$ 940 million) - the second largest credit to an African country. The credit agreement prescribed, among other things, tighter fiscal and monetary policy and quicker payment of foreign debts. The conditions could not be fulfilled and after SDR 300 million had been drawn the facility was suspended in March, 1982.

In April, 1983, a new standby credit of SDR 211.5 million was granted. The Zambian Government agreed to remove price control on most consumer goods and to cut food and farm subsidies. The kwacha was devalued by 20 per cent and interest rates increased sharply. Indirect taxes were raised and a percentage tax was introduced on mineral exports.

In spite of these efforts, the standby credit was suspended in June, 1984, with SDR 67 million undrawn. A month later a new agreement was reached, this time for a 20 month standby facility of SDR 225 million. This facility was suspended in February, 1985, with SDR 145 million undrawn. The Zambian Government had not been able to cut subsidies as planned or to find other ways to reduce the budget deficit. Besides this, a sudden fall in copper prices made the government unable to make the necessary repayments to the Fund.

At the beginning of 1985, Zambia's unpaid debt to the IMF was around $ 100 million, and this blocked the way to new standby arrangements. This block was removed in January, 1986, when Standard Chartered Bank granted a "bridging credit" of $ 200 million to be rapaid from the first tranche of the next IMF credit.

In March, 1986, IMF granted a new standby facility of SDR 229,8 million to be rapaid in two years and besides this, granted SDR 68,8 as a so-called compensatory financing facility which is given on very soft conditions. The government immediately utilized the first tranche of the standby facility but quite soon fell into arrears with the IMF again which made it impossible to start using the second tranche. At present (November, 1986) the arrears are estimated at $ 130 million and the results of the latest round of negotiations which ended in the beginning of November are not yet known.

One of the most indebted countries in Africa

The decision of the board of the IMF as regards a possible new standby arrangement will be of great importance for the attitude of other lenders. Zambia's total outstanding foreign debt can be estimated at $ 5 billion, of which about 15 per cent is owed to the IMF. Zambia's debt-to-export ratio is about 600 per cent and this makes Zambia one of the most indebted countries in Africa. Foreign governments account for around a third of the country's total debt, multinational organizations one third and private lenders one third.

Zambia's "theoretical" debt service ratio can be estimated at more than 100 per cent. The debt service actually paid by Zambia is much less. It fell from 25 per cent in 1981 to eleven per cent in 1983 and 1984. In 1982 Zambia suspended external debt service payments altogether, whereafter negotiations started for rescheduling the debts. Debt due to Western governments has been rescheduled under "Paris Club" auspices in 1983, 1984 and 1985. After two years of negotiations in December, 1984, a similar agreement was reached with a "London Group" of commercial banks.

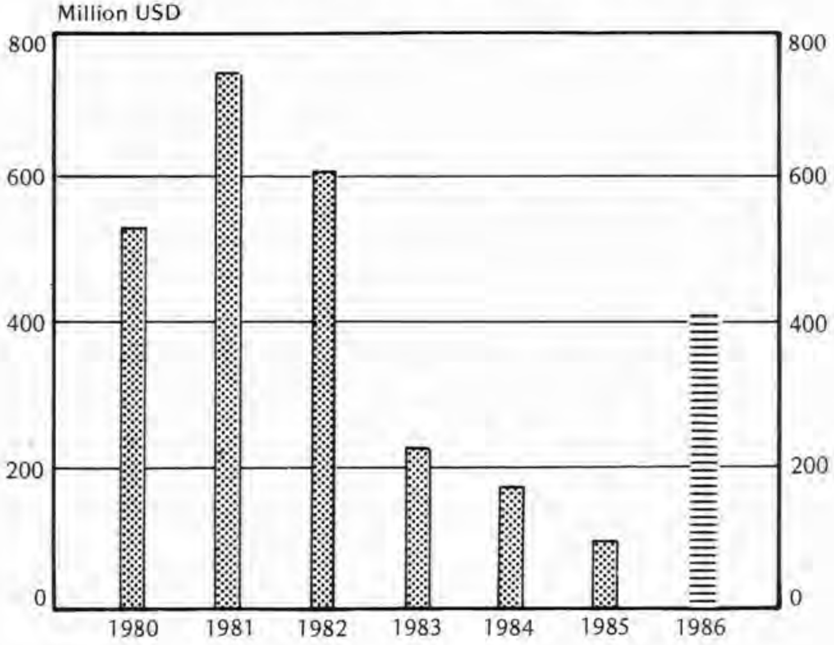
Zambia has been receiving foreign aid, mostly bilateral, since the beginning of independence. After a steady increase it was reduced quite substantially during the first four years of the 1980s, but in the past two years there has been a considerable increase, especially from the World Bank. In 1986 the total disbursements of aid and soft loans can be estimated at 300 million dollars. One unusual feature of the flow of aid to Zambia is that it mainly comes from bilateral sources. Between 80 and 85 per cent of all grants and concessionary loans have been bilateral. This may indicate that the country's economic prospects still are regarded as relatively promising as compared with many other African countries.

At a consultative group meeting of donor countries in May, 1984, Zambia presented a three year expenditure programme for restructuring the country's economy. The total estimated cost of the programme was \$ 1.7 billion of which donors were asked to provide \$ 1.5 billion. The programme was received positively and has probably contributed to the increase of donors' aid in the past two years, although Zambia's Minister for Finance and Development Planning has described the flow of funds as "not satisfactory". The opinion of the World Bank seems to be that the funding will materialize but a little slower than expected.

Government Finance

What has happened to Zambia's Government finances is perhaps the most extreme example of the paralysing consequences of the slump in copper prices. Income from copper mines was the dominating source of government revenue, but in 1975 the contribution from this source declined by more than 80 per cent. The Government Budget has been in deficit ever since. In 1980 the deficit rose to 29 per cent of the GPD.

ZAMBIA: DEFICIT ON CURRENT BALANCE OF PAYMENT



Source: Zambia, Country Profile.
The Economist Intelligence Unit 1986–87

Since then, considerable efforts have been made to strengthen the budget by cutting expenditure and increasing revenue. Subsidies have been reduced, the number of civil servants decreased, salary increases held back and capital projects delayed or abandoned. Indirect taxes have been introduced and raised. The four per cent tax on mineral export introduced in 1983 has been raised to ten per cent.

Indirect taxes are the main source of revenue, income and company taxes contributing only by about 15 per cent. The level of taxation is quite high. The highest marginal income tax rate is 80 per cent and tax on company profits is 45 per cent.

Efforts to save have impaired the maintenance of infrastructure which was developed with great ambition during the first period of independence. Roads, railways, schools and hospitals are suffering from shortage of funds.

The austerity measures led to a reduction of the budget deficit from 29 per cent of GNP in 1980 to seven per cent in 1984. In 1984, however, the ratio was doubled again and the increase continued in 1986. The rising cost of debt service in kwacha terms has contributed to the increase.

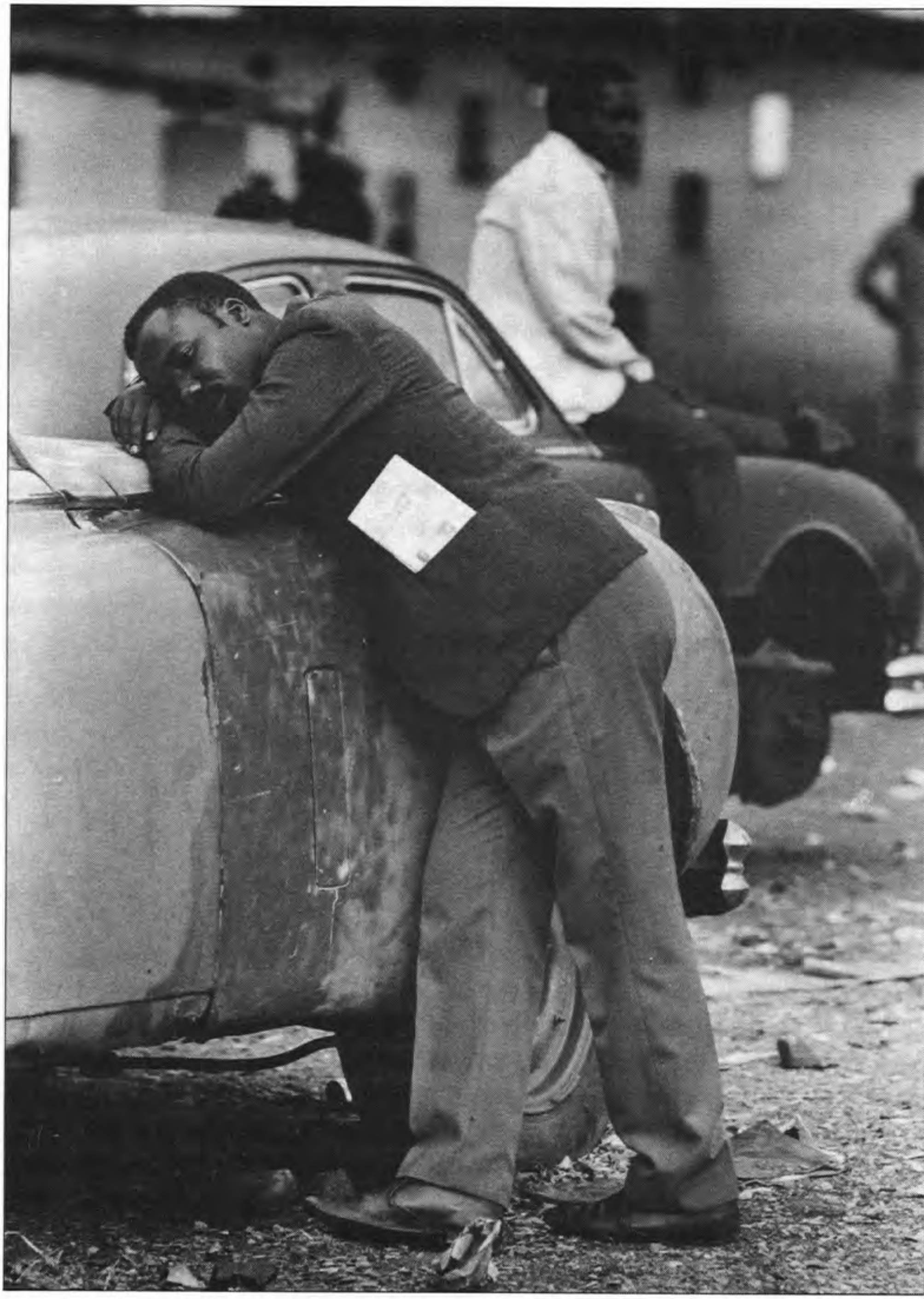
Up to 1984 the main source of financing the budget deficit was domestic bank borrowing but during the past two years foreign loans have taken a dominating place.

Unemployment

Parallel with staff reductions in the public sector the number of employees in mining has also declined. This has contributed to intensifying the problem of unemployment which the country has been facing ever since the beginning of the copper crisis. During the first happy decade of independence employment increased by about four per cent a year. During the period since 1974 it has been falling at an average rate of one per cent a year. At the same time the population has grown by more than three per cent a year. The number of unemployed is now estimated at more than one million. This means a rate of unemployment of about 30 per cent.

The high degree of urbanization - about 45 per cent - makes the unemployment problem more complicated in Zambia than in most other developing countries. One alleviating factor is the "extended family" tradition which means that people take care of their relatives - even remote ones - who have run into economic difficulties.

The main emphasis in the official policy now is on generating employment in rural areas by stimulating agricultural production. Increasing attention is also paid to the development of small scale and labour intensive industries.



The problem of unemployement has increased ever since the beginning of the coppercrisis.
Photo: Per L-B Nilsson.

3 ECONOMIC REFORM PROGRAMME

The need to do something about the one-sided dependency on copper and the development-impeding system of regulations, subsidies and bureaucratic state enterprises was recognized a long time ago. As early as in 1975, the Zambian National Council decided to abolish subsidies and in the same year president Kaunda talked about the necessity of stimulating agricultural production. No concrete measures followed, but gradually the extreme shortage of foreign exchange has increased the sense of urgency in these matters.

Rationalization and Diversification

In recent years a more elaborated programme for rationalization and diversification of Zambia's economy has taken shape. On some essential points it is already being carried through.

Liberalization

In 1983, price control was abolished on all goods except on maize, wheat, bread and candles. Most subsidies have also been withdrawn. An action to reorganize parastatals and put them on a more business-like basis is going on. Some of them have been deprived their monopolistic positions.

After the decontrol of prices trade unions were given the right of collective bargaining. This gave them the opportunity to get at least partial compensation for the loss of purchasing power that the employees had suffered through the abolition of price control. The government thus abandoned the strict income policy they had applied earlier.

The next round of liberalization followed in 1985, this time in the financial sector. In September, 1985, the government abolished the direct regulation of credit volume and interest rates. The interest rates would freely adapt themselves to changes in liquidity in the economy as reflected on the market for treasury bills.

In October, 1985, followed a fundamental change in the country's foreign exchange policy. A new method for both allocation and pricing of foreign exchange was established through the introduction of weekly foreign exchange auctions. For most purposes foreign exchange has to be acquired through a bidding system. The lowest bid necessary for selling the week's supply of foreign exchange determines the rates for all foreign exchange transactions during a week.

These measures of liberalization are aimed at creating a more efficient institutional base and framework for the next phase of the economic programme, namely intensified marked-oriented diversification of production and increased self-reliance.

Good prospects for agriculture

A diversification of production is especially urgent as the country's existing resources of copper are expected to be exhausted within 20 years. In the restructuring process there are great expectations of the agricultural sector. Agriculture has the greatest potential for positively contributing to employment, income and exports. Of the estimated 60 million ha of arable land only 12 million ha is currently cultivated. The climate is favourable for a wide range of crops.

The production is still dominated by maize which accounts for over 70 per cent of the total value of marketed agricultural products. But a good beginning has already been made in the direction of diversification. Wheat, soyabeans, sunflower, rice, cotton, groundnuts, sugarcane, tobacco, tea and coffee are being produced although most of them in limited quantities.

According to the expenditure programme presented in 1984, 26 per cent of the resources will be used to stimulate farm production. Until 1982, only three per cent of total budgetary expenditure went to agriculture.

Effects

Positive effects have already been noted as a result of the incentives which have been introduced in recent years, such as more market-oriented prices, tax allowances and the right to retain 50 per cent of foreign exchange earned through exports. In 1985, agricultural production grew by almost 10 per cent, and a growth of about the same rate is expected for 1986.

Another sector which is expected to grow is manufacturing production for non-traditional exports (i.e. other than copper, cobolt, zinc and tin), especially production based on domestic raw materials.

There are good prospects for widening the domestic raw material base. Production of cotton is rapidly increasing and may in a relatively short time become the base for a sizeable cotton textile industry. Canned vegetables and fruit are other examples of products with good development prospects. Conditions for an extensive forest industry production are favourable as far as raw materials are concerned.

Conditions for success

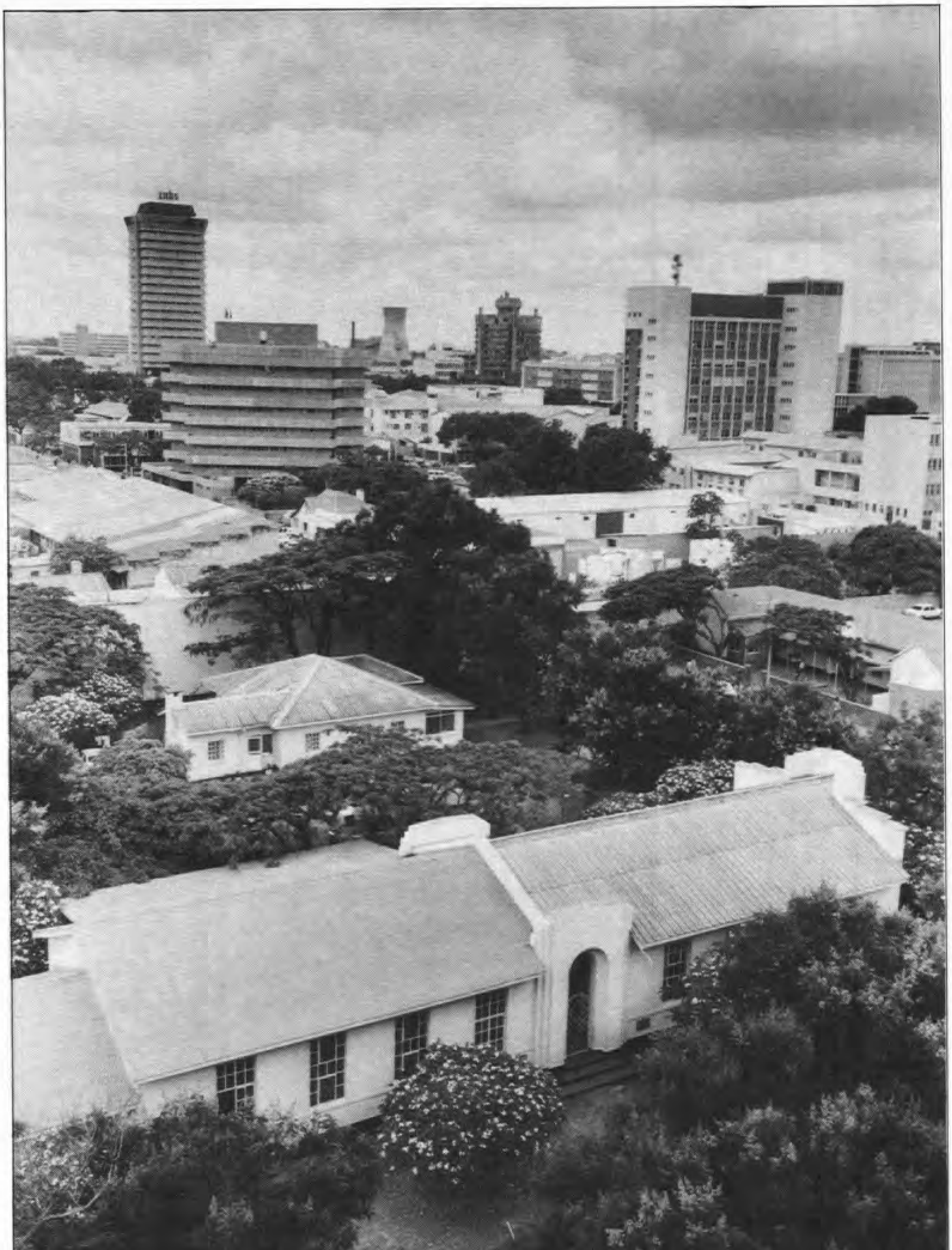
One condition for a successful diversification process and especially for the necessary growth of exports is the existence of satisfactory transport facilities. The shortage of transport capacity can be one of the bottlenecks in the restructuring process.

Since the railway transport through Angola and Mozambique has been practically stopped, the only outlets are those through Tanzania and South Africa. The port of Dar-es-Salaam suffers from chronic congestion, and an essential part of both Zambian exports and imports are dependent on transport through South Africa.

Summing up Part I

To sum up part I, Background, in the short term Zambia is facing serious problems. The shortage of foreign exchange, growing unemployment and accelerating inflation are the most pressing of them. But there are also bright spots. Farm production is rapidly increasing and in the manufacturing industry the period of stagnation also seems to have been broken.

Over the medium and long term, the country's prospects can be regarded as reasonably promising. The combination of unutilized natural resources, the Government's determination to carry through an elaborte reform programme, and the obvious willingness of international organizations and friendly nations to continue their support seems to justify such a conclusion.



Luasaka, the capital of Zambia.
Photo: Bror Karlsson.

PART II - THE AUCTION SYSTEM

4 ADOPTION OF NEW SYSTEM

During the first 20 years of independence Zambia applied a policy of fixed exchange rate. Until 1979 the Zambian kwacha was pegged to the pound sterling, during 1970-76 to the US dollar, during 1976-83 to the Special Drawing Right and from July 1983 to October 1985 to a basket of currencies composed according to the different currencies' weights in Zambian foreign payments.

The Auction System in Practice

On October 4, 1985, the Zambian Government adopted a new system not only for the determination of the exchange rate of the kwacha but also for the allocation of foreign exchange. A weekly auction system was introduced. Foreign exchange for imports and service payments, including the remittance of profits and dividends declared after the 31st October, 1985, could be obtained by bidding at the auctions held every Saturday. The Government (but not the parastatals), the mining company and, in the beginning, the oil importing company and Zambian Airways were exempted and continued to obtain foreign exchange through administrative allocation, but at the rate established at the auction system.

Participation in the auctions is limited to commercial banks who bid for their customers but may also bid for their own requirements.

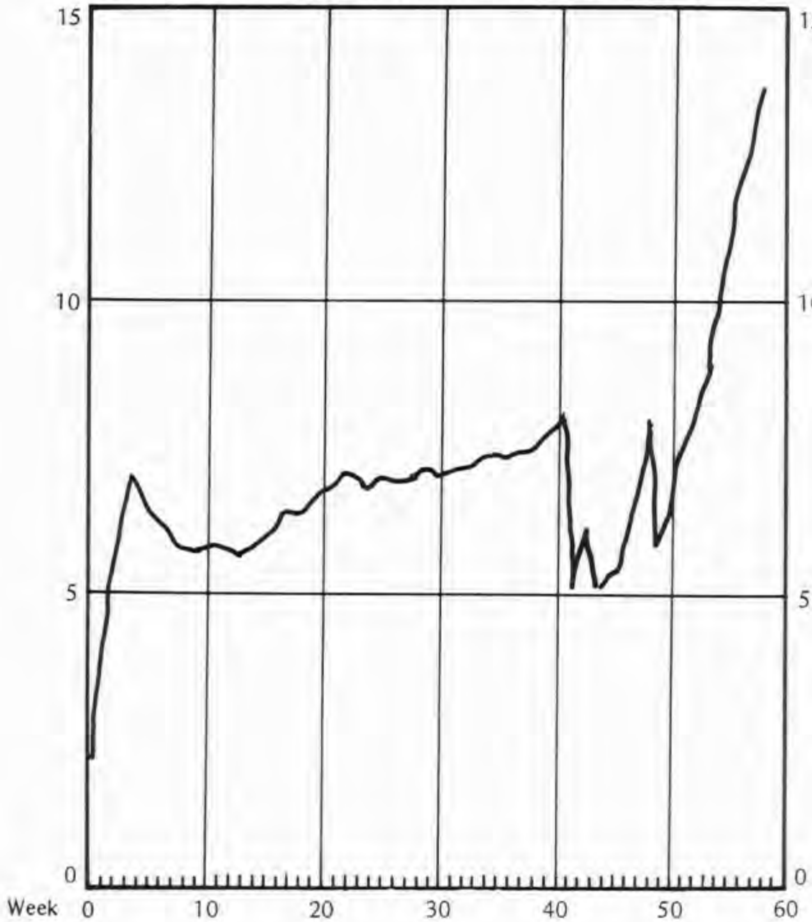
Sealed envelopes

Each commercial bank presents its customers' bids on a prescribed form and in sealed envelopes to the auctioning secretariat not later than 09.00 hours on the Friday preceding the auctioning day. Each application includes the name of the bidder, the rate kwacha/US $ the bidder is willing to pay and the amount of foreign exchange requested. US $ is the only auction currency, the rates of other currencies being determined on the basis of the crossrates for the US $ in the international market.

The applicant has also to declare the purpose for which foreign exchange is required. If the foreign exchange is to be used for value of the kwacha, therefore, was no surprise. But the decline continued and during the spring of 1986 the rate of the dollar was around seven kwacha implying a devaluation of 65-70 per cent.

THE RATE OF USD IN KWACHA

Weekly figures from October 1, 1985 to November 15, 1986



This high rate of devaluation caused dissatisfaction among politicians and trade unions who criticized the auction system for raising the cost of living. In April, both the Governor of the Bank of Zambia and the Minister of Finance were replaced, in both cases by persons who had strongly criticized the system.

When the first auction was held on the 12th October, 1985, the rate of the dollar rose from 2,23 kwacha to 5,01, which meant that the kwacha was devaluated by 55 per cent.
Photo: Britta Åsbrink.

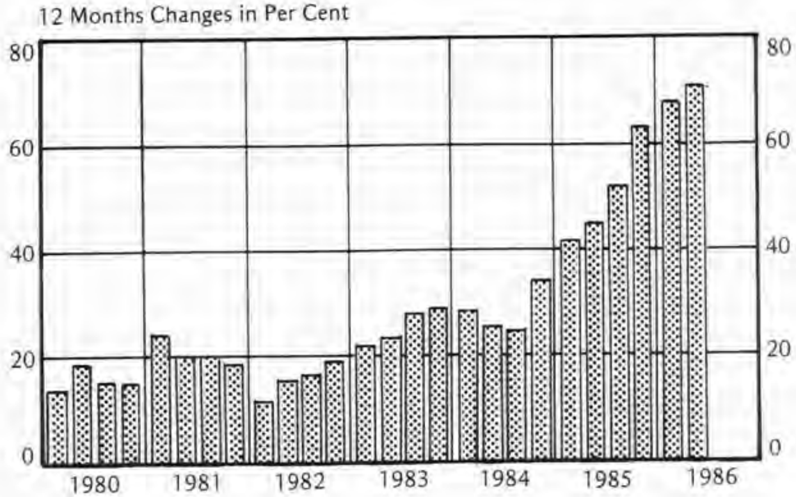
In July-August the Bank of Zambia started to make efforts to strengthen the kwacha. The earlier mentioned strong increase in the weekly amounts of dollars in the auction system was probably an expression of these endeavours.

Besides this, several new requirements were enforced in order to limit the demand for foreign exchange. One of the requirements was that only 20 per cent of the purchase of foreign exchange could be financed by bank credit. Further, the applicants had to produce evidence that they had paid their taxes, etc.

The IMF protested strongly against these interventions by the Bank of Zambia, and they were cancelled. Partly for this reason the measures had only a short-lived effect. In the middle of July the kwacha went up from eight kwacha per dollar to around five kwacha. But towards the end of August a new slide started and in the middle of November the kwacha was down to K 13.48 per dollar. Compared with the pre-auction rate, the kwacha had thus been devalued by 83 per cent.

said to be falling as the curtailed real buying power causes people to turn from luxuries to the necessities of life.

ZAMBIA: CONSUMER PRICES



Source: International Monetary Statistics, IMF

Eroded confidence

It is difficult to find out what has caused the strong undervaluation of the kwacha. A usual explanation heard from bankers and businessmen is lacking confidence in the system. The confidence was eroded when the Central Bank started to intervene in July-August. The fact that no foreign exchange has been paid out - although allocated through weekly biddings - during the past eight weeks has not strengthened the confidence. Importers doubt if the system is going to survive and are trying to get as much allocation as possible before the channel is closed.

Another explanation often presented is that the Zambian foreign exchange market is too small to make it possible to keep such a pricing system going. This explanation sounds less credible. Even a small country is able to maintain a realistic exchange rate, provided that the country is able to practise a consistent monetary and fiscal policy.

This leads to a third explanation and that is that the country has not been able to practise a consistent fiscal and monetary policy. This is, after all, the most plausible explanation.

The Government budget has been showing big deficits which have to a large extent been financed by short-term bank credit and by the printing of money. This has contributed to a growing money supply. The fact that the Bank of Zambia recently has introduced the requirement of a 30 per cent extra deposit by the bidders on non-interest bearing accounts is a clear indication that the Bank is worried about the volume of money in circulation. This extra claim of deposit was combined with a raising of the commercial banks' prime rate from 25 to 30 per cent and with an increase of the banks' compulsory cash reserve quotas.

If the reason lies in a combination of eroded confidence and a loose fiscal and monetary policy, the right thing to do is to try to restore confidence and to tighten the fiscal policy. The best way to restore confidence would probably be to eliminate the pipe-line of weekly payments.

To solve the problem

To some extent the auction system itself ought to contribute to a strengthening of the Government budget. In contrast to some other forms of international aid, the funds which donors put into the auctioning system can be used for reducing the money supply or for reducing the budget deficit. In kwacha terms there has been a strongly increased inflow of money to the Bank of Zambia through the selling of foreign exchange at rising rates.

A return to a system with fixed exchange rates would not solve the problem. It might temporarily calm the atmosphere but if no other measures are taken the excess money supply will with all probability lead to re-establishing the black market for foreign exchange and to continuing inflation, and soon a new devaluation would be necessary.

An improvement of the auction system could possibly be achieved through an increased elasticity on the supply side. The IMF has refused to accept any changes in the amounts allocated each week.

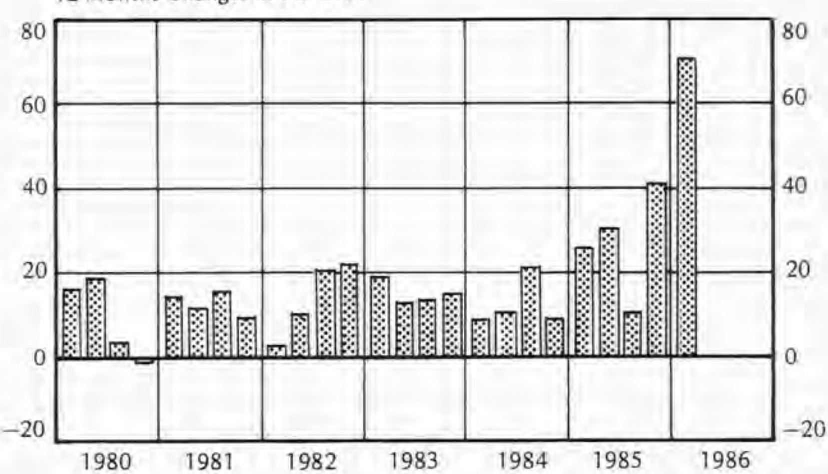
As a consequence, the Bank of Zambia has - if it follows the rules - no possibility to counteract temporary and erratic changes in exchange rates by varying its weekly sales of foreign exchange. A limited elasticity would of course not have helped much against the constant downward pressure which existed during the autumn months of 1986, but under more normal conditions it may play a stabilizing role. All central banks in the world intervene in order to avoid unnecessary fluctuations in exchange rates. What has been called "manipulations" by Bank of Zambia has in principle been the same type of interventions which are practiced by other central banks.

Effects on the Allocation of Foreign Exchange

When it comes to the other goal of the auction system - rationalization of the methods for allocating foreign exchange - the picture is much more positive. The system seems to get unanimous support from the parties most closely involved - bankers and businessmen.

ZAMBIA: MONEY SUPPLY

12 Months Changes in Per Cent



Source: International Monetary Statistics, IMF

"Unbelievable blessing"

The old administrative system is described by words "hair-raising" and "horrifying" and the change is characterized as an "unbelievable blessing" and a "tremendous improvement".

A normal waiting time for getting foreign exchange in the old system seems to have been eight to ten months. Half of it was needed for obtaining the import licence and the other half for obtaining the permission to buy foreign exchange. Sometimes it could take more than a year before the importer was granted - or refused - exchange.

The most appreciated merit of the auction system is that anybody who is willing to pay the price can get the currency almost immediately in principle.

Before the building up of the pipe-line an importer - if his bid was successful - obtained the foreign exchange during the week following the auction, and the letter of credit could thereafter be opened within a week. By quick payment (through letter of credit) Zambian importers are able to achieve lower prices from the foreign suppliers. This is one of the advantages strongly stressed by bankers and businessmen.

It is not difficult to understand the argument that "smallfarmers" have no possibility to hold money through the auction system.
Photo: Bror Karlsson.

One argument in the popular discussion has been that small businesses, especially "small farmers" have no possibility to get money in the auction system. It is difficult to understand this argument. The bidding is open for everybody and there is no minimum amount fixed. Anyway, the position of "small farmers" was definitely not better in the old system.

Another, quite often used argument is that the bidding is dominated by those who have plenty of kwacha. This is almost self-evident. The auction system is, as pointed out earlier, a part of a greater programme, which is aiming at giving more space for market forces in order to eliminate the least efficient uses of resources. According to this philosophy, which has been generally accepted by Zambia's own leaders as well as by donors, there is nothing wrong if the most successful businesses win in competition for the scarce foreign exchange resources. The Government's role is to keep the total effective demand for foreign exchange in balance with the existing total foreign exchange resources with the help of a consistent monetary and fiscal policy.

Lower share of imported consumer goods

When the auction system was introduced there were fears that it would lead to an uncontrolled import of consumer goods at the expense of capital goods and raw materials. Those fears seem not to have been realized. The existing statistics show that the share of consumer goods in the imports financed through the auction system has been much lower than the share of consumer goods during the year preceding the auction system.

In this connection it might be of interest to quote some views put forward by the Zambian Minister of Finance. He argued against the wide-spread opinion that consumer goods in all situations can be regarded as unproductive. In some situations an improved supply of consumer goods may have a positive effect on productivity. He did not mean food to a starving worker but a situation where a certain level of supply of consumer goods is necessary as an incentive to producers. For not more than a year ago, many Zambian farmers had only limited interest in bringing their products to the market as they were unable to buy something for the money.

A Swedish aid worker in a Zambian food-processing company expressed similar views. His company had reached a preliminary agreement with a farmer to buy a quantity of pineapples of unusually high quality. When the company's people went to fetch the pineapples, the farmer had just sold these to a Lusaka trader who had offered a barter trade - pinapples against boots and shirts of questionable quality.

South African imports

As regards the geographical distribution of the Zambian imports, South Africa's share seems to have been rising rapidly. After having been normally around 15 per cent it is said to have grown to around 40 per cent in the past year. This development can, however, not be regarded as a consequence of the auction system. Many Zambian importers have forced their imports in order to be better prepared for a possible abruption of deliveries from South Africa. In some cases, especially in the mining industry, supplies of spare parts etc are said to be difficult to replace by deliveries from other sources. Besides this, it takes normally only two weeks to get a safe delivery from South Africa, while imports from Europe take at least two months, are much more expensive (South African rand has continuously depreciated) and exposed to damage on the way.

6 THE AUCTION SYSTEM AND SWEDISH AID

In November 1985 SIDA agreed to put 60 million kronor (nine million dollars) into the auction system for 1986. This implied an increase in SIDA's total import support from 25 to 81 million kronor. At the same time project aid was reduced. SIDA's total aid for 1986 was raised to 190 million kronor (27 million dollars) from 175 million kronor for 1985.

Zambia's Qualification for Receiving Import Support

Judged on the basis of the goals and conditions for import support established by SIDA Zambia is highly qualified for receiving import support generally.

The main bottle-neck in the Zambian economy is the shortage of foreign exchange. As described in the foregoing survey, manufacturing industry in Zambia has in recent years been able to utilize only a limited part of its capacity. The main obstacle for higher capacity utilization has been the lack of imported inputs, although the eclipse of the copper mining also has contributed to the low level of manufacturing production. Against this background it looks quite obvious that an improvement in the supply of foreign exchange is a more efficient way to promote economic growth in Zambia than capacity-increasing project aid.

The Zambian foreign exchange crisis is mainly caused by factors beyond Zambia's own control, which is another condition established by SIDA for import support. The long depression on the world copper market and three years of drought in the beginning of the 1980s have drastically disturbed Zambia's external balance.

A third condition is that the aid-receiving country must have satisfactory capacity for a sound utilization of the aid received. Zambia is one of the most industrialized countries in Africa and has a relatively long industrial and commercial tradition. Thus, the third condition also may be regarded as satisfied.

Channelling Aid Through the Auction System

What is said above applies to import support in general. But the same arguments seem to a still higher degree be applicable to the part of import support which is channelled through the auction system, Disregarding the present pipeline situation, which hopefully is temporary, the auction system means a quicker and more flexible use of existing foreign exchange resources than the traditional form of import aid.

Channelling aid through the auction system also means less administrative work for SIDA, which means lower costs and more possibilities to alternative use of resources.

The increased quickness, flexibility and the saving of administrative work are to some extent achieved at the expense of more limited possibilities for SIDA to influence and control the use of funds.

Sectoral distribution can be influenced but in a more indirect way than in the traditional import aid. In the agreement for 1986 SIDA has earmarked agriculture, including agricultural transport, and parts of manufacturing industry as main receivers of its support. This means that SIDA's aid in a way is conditional. If it turns out that SIDA during the year has not been able to find enough import cases in those preferred sectors to absorb the whole amount put at disposal by SIDA, part of the aid will remain unutilized. Considering the wide variety of uses earmarked by SIDA and the relatively limited share of SIDA's aid in the total auction system (about four per cent) this is only a theoretical possibility.

In one respect there seems to be no difference between the traditional import support and the aid channelled through the auction system. In both cases reporting from the Zambian authorities can be regarded as satisfactory. With regard to the auction system the Bank of Zambia delivers detailed weekly reports giving both general information and information about the use of SIDA funds.

Sectoral and geographical distribution of SIDA funds

As can be seen from the following table the main part of the imports accepted by SIDA during the first 41 auctions was in the manufacturing sector. In most cases the funds were used for importation of raw materials and spare parts. Only 13 per cent of the total amount went to the agriculture sector, but the amount allocated to transport and communications - ten per cent of the total - also went to rural areas.

In accordance with the agreement no funds were used for the importation of consumer goods.

Sectoral Distribution of SIDA Funds in the Auction System (Auctions up to No. 41)

	Amount 1 000 US $	Percentage share
Manufacturing	2 300	74
Agriculture	408	13
Transport and Telecommunications	313	10
Health	86	3
Total	3 107	100

Note: Allocations below 10 000 dollars are not included.

The dominance of manufacturing as receiver of Swedish funds is not surprising. Dependence on imported inputs is, as mentioned before, much higher in the manufacturing sector than in agriculture. The degree of unsatisfied need was certainly also higher in manufacturing than in the agricultural sector. Theoretically, the marginal use of imported inputs must also have been higher in manufacturing.

The next table shows the geographical distribution of the amount of SIDA funds. Of the total amount 20.5 per cent was aimed at imports from Sweden with the UK in second place. It is interesting is to note the high share of the two neighbouring states Zimbabwe and Tanzania which normally are not among Zambia's main trading partners. The relative share of the UK and the USA correspond roughly to their shares in Zambia's total trade. It must be noticed, however, that the latest figures available for the distribution of Zambia's trade by countries is from 1982.

Distribution by Countries of SIDA Funds in the Auction System

	Per cent
Sweden	20.5
UK	18.9
Zimbabwe	14.4
Tanzania	14.3
USA	9.0
Others	22.9
Total	100.0

7 FLOW AND CONTROL OF FUNDS IN THE AUCTION SYSTEM

SIDA's contribution to the auction system is paid quarterly to a blocked account at Sveriges Riksbank (The Bank of Sweden) in the name of the Bank of Zambia. From this account funds are released weekly after the following procedure.

Flow procedures

Four days after every auction SIDA's representative together with representatives of other donor nations goes through the list of successful winners at the latest auction. This takes place at Bank of Zambia's office where all the documents belongning to every bid are available for checking. SIDA's representative choses a number of bidders whose planned imports comply with SIDA's sectoral priorities and other conditions (no import from South Africa, no import of consumer goods).

The Bank of Zambia makes a list of the importers chosen and sends it to SIDA's office for confirmation. The list also includes the aggregate value of the imports on the list. SIDA's office sends a confirmation to the Bank of Zambia and informs SIDA in Stockholm about the cases chosen and the total amount involved.

By order of SIDA in Stockholm the corresponding amount is then released from the blocked account at Sveriges Riksbank and transferred to a special account at the same bank. Now the money is at Bank of Zambia's disposal and is automatically transferred to an interest bearing account with Svenska Handelsbanken, Stockholm. From that account funds can be transferred by order of the Bank of Zambia's to any bank in the world.

Before the funds in this way are made available to the Bank of Zambia, the Bank has already from its own resources deposited foreign exchange on special foreign exchange accounts with the successful bidders' commercial banks. These deposits are normally made within 48 hours of every auction. (Since the middle of August the payments have been lagging behind see page 23.) The commercial banks pay interest to Bank of Zambia on these deposits.

The commercial banks have now to open letters of credit within ten days.

When the purchase abroad is made, the Zambian bank's co... bank abroad produces a "payment advice". This is done after the usu... controls by the corresponding bank according to the international rules for letters of credit. When this "payment advice" arrives in Zambia the commercial bank presents it to Bank of Zambia.

Bank of Zambia now releases the amount of foreign exchange involved from its account with the commercial bank.

Control

The procedures described above mean that Bank of Zambia is controlling that the foreign exchange allocated for a certain import project actually is used for purchasing goods abroad according to the bidding documents. This is not a "physical" control but a documentary control of the type which traditionally has been used in international trade.

The control exercised by SIDA provides evidence that there are enough acceptable import projects among the week's allocations to absorb the amount of money SIDA is willing to make available for the week. On the basis of this control funds are made available by SIDA to the Bank of Zambia, as described above.

That does not mean that just the projects chosen are financed by SIDA. The importer buys the foreign exchange he needs and carries through his transaction without even knowing that the transaction has been earmarked by SIDA. Once SIDA's money is put into the big auction pot it is impossible to trace. To ask which transaction is financed by a certain donor's money is like asking which part of a government's expenditure is financed by a certain taxpayer's money.

Not worthwhile strengthening the control

It is therefore questionable if it is worthwhile using more resources for strengthening the control now exercised by SIDA. If it were to be proved through a rigid control that a certain case was fake and that the money allocated was not used for the declared purpose, it would only mean that SIDA had happened to chose a "wrong" case. The general control exercised by Bank of Zambia should be sufficient to guarantee that such cases can be regarded as rare exceptions. A sample study carried out on behalf of SIDA seems to prove that.

There were certainly plenty of cases not earmarked by any other donor, which satisfied SIDA's conditions and were carried through correctly but which happened not to come on SIDA's list. As mentioned earlier, SIDA's support covers only four per cent of all imports channelled through the auction system. Of Zambia's total imports SIDA's contribution to the auction system is only one per cent.

From these quantitative proportions follows also that SIDA certainly has no possibility essentially to influence the composition of the geographical direction of Zambia's imports. Not even all donors together can do that. The main part of Zambia's imports is financed by Zambia's own funds. The more "clean" import is financed by the donors, the more Zambia's own resources can be used for other imports.

Transfer, from a rigidly regulated to a more market-oriented economy, can not be done without sacrifies. But the auction system has some essential advantages to offer citizens of Zambia.
Photo: Charlotte Thege.

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ANNEX 1

PERSONS MET

President Kenneth Kaunda

BANK OF ZAMBIA:
- Mr. L. Chivono, Governor
- Mr. Chalwe, Deputy General Manager
- Mr. Mumba, Research Division

BARCLAYS BANK:
- Mr. K.G. Stirzaker, Executive Director

BRITISH HIGH COMMISSION:
- Mr. Reginald Williams, 1st Secretary

EMBASSY OF FEDERAL REPUBLIC OF GERMANY
- Mr. Eberhard Schinze, 2nd Secretary

GRINDLAYS BANK:
- Mr. G. Nicholson, General Manager
- Mr. R. Binns, Country Marketing Manager

MINISTRY OF FINANCE AND PLANNING:
- Mr. B. Kabwe, Minister
- Mr. Nsingo, Minister of State
- Mr. J. Mtonga, Permanent Secretary
- Mr. F. Siame, Senior Under Secretary

NATIONAL WESTMINSTER BANK:
- Mr. D. Kern, Manager and Chief Economist

NORAD:
- Mr. T. Vigtel, Chief Procurement Officer

PALATINE BUSINESS SERVICES, LUSAKA:
- Mr. Solly Patel

THE PRESIDENTIAL TARIFF COMMISSION:
- Mr. M. Chona, Chairman, Former Political Advisor to President Kaunda

PRICES AND INCOMES COMMISSION:
- Mr. D. Phiri, Commissioner

ROYAL NETHERLANDS EMBASSY:
- Mr. Alonso Staelinga, 2nd Secretary

Mr. A. Sikwanda, businessman, journalist, former Permanent Secretary, Ministry of Agriculture

STANDARD CHARTERED BANK
Mr. J. Gledhill, Chief Administrative & Financial Executive

SWEDISH COMPANIES:
Atlas Copco: Mr. Peter Meyer, Managing Director
Sandvik: Mr. T. Wielbass, Managing Director
SKF: Mr. B. Ljunggren, Managing Director

SWEDISH EMBASSY IN ZAMBIA:
Mr. J. Ölander, Ambassador
Mr. J.O. Agrell, Head of Development, Cooperation Office
Mr. Sunit Ray, Economist

USAID:
Mr. L.A. Dean, Assistent Director
Mr. J. Snell, Senior Economist
Mr. J. Harbour, Economist

WORLD BANK:
Mr. S.A. Kahn, Dep. Resident Representative

ZAMBIA NATIONAL COMMERCIAL BANK:
Mr. T. Rajan, General Manager

ZAMBIAN INDUSTRIAL & COMMERICAL ASSOCIATION:
Mr. A. Kasihita, Chairman

TERMS OF REFERENCE: A STUDY OF THE AUCTION SYSTEM OF FOREIGN CURRENCY IN ZAMBIA AS A CHANNEL FOR SWEDISH IMPORT SUPPORT

Background

For the Calendar Year 1986, SIDA's import support to Zambia amounts to SEK 81 million. Of the said amount, about 60 million are set aside for purchase through the so called auction system. This has been in force since October 4, 1985, and the Swedish engagement started in January 1986. Up to September 9: 1986 about US$ 199 million have been auctioned by means of this auction system, of which SIDA's share amounts to about US$ 6 million.

Through the auction system, the Bank of Zambia sells foreign currency (US$) every week with the object of financing imports and other payments. The rate of exchange established during the auctions also applies to other transactions including foreign exchange.

According to information given in a.o. Zambian press, it would seem that part of the money auctioned has not been used to pay for actual imports. It is said, for instance, that foreign currency is being accumulated in foreign bank accounts. According to other sources of information, the importing agencies have not been able to account for more than 30-40 per cent of the currency allotted to them for import purposes. Manipulation of the system has also occurred, especially after the appointment of a new management at the Bank of Zambia. From the Swedish point of view, the question has been raised whether channelling import support via the auction system corresponds to SIDA's policies regarding import support and whether the present system is satisfactory as far as Swedish requirements on reporting and follow-up are concerned.

Against this background, SIDA wishes to investigate the functioning of the auction system in order to ascertain whether it is suitable as a channel for Swedish import support with regard to the socio-economic and political development effects. Furthermore, SIDA wants to find out whether the auction system satisfies SIDA's policy on follow-up and control of import support.

Purpose

The investigation will form part of the foundation for a decision concerning continued support to the auction system at the half-yearly revision in December 1986 and for SIDA's follow-up and reporting on Swedish import support. Furthermore, the investigation, where applicable, should be used as back-ground material for a land report on Zambia in 1987.

The Task

The investigation shall describe the extent, the function and effects of the auction system and judge whether the system is an efficient means of using Swedish import support as compared to conventional import support (according to the latest rules laid down for Swedish import support).

The economic consequences of the auction system (effects on prices, state finance, currency reserves etc) will be confined to elucidating the efficiency of the auction system as an agent for Swedish import support. The consultant shall gather information from other aid-giving agencies and experts in order to find out about their experiences and conclusions.

The investigation shall include, but not be limited to, the following components:

Description of the System

A short description of the circumstances which led to the auction system (balance of payments deficit, economic policy etc).

A description of the changes in the earlier system and the effects of such changes.

A detailed description of the functioning of the auction system, including the roles played by the banks involved (Bank of Zambia, commercial banks and foreign banks).

An analysis of parallel markets with a different method of establishing their rate of exchange.

The role of the public sector vis-à-vis this system (parastatals etc).

The use of the country's own resources as compared to aid resources.

Investigation into the flow of payments

Distribution of imports from exporting countries (Bias to sources of imports? Which countries are preferred?)

Distribution of imports through the auction system to firms, sectors and products and the estimated effects on development.

An examination of Zambia's reports to donors, control and follow-up.

A rendering of account as to what extent the allotted currency has resulted in actual imports.

A description of the payment system, reporting and follow-up of the Swedish support to the auction system. How the conditions for documentary credit were modelled, how these have been applied, especially with regard to the Swedish funds.

Appraisement

An appraisement of the auction system. To what extent does it satisfy SIDA's demands for control, follow-up and rendering of account according to the new policy for import support?

Proposal for an alternative use of the import support.

Appraisal of the cost-efficiency of SIDA's support to Zambian firms through the auction system.

The investigation shall be limited to that part of the import support which goes to the auction system and should result in concrete recommendations concerning a continuation and/or changes in the support to the auction system.

Methods

A considerable amount of the information needed is available at SIDA/Stockholm and at the SIDA office in Lusaka. Information can also be obtained from the Zambian authorities, banks, parastatals and Swedish firms.

The work shall be done by an external consultant who will be primarily responsible for the study. A local consultant has been engaged by the Lusaka office in order to collect material on the use of Swedish funds provided for auction. This local consultant shall, in addition, perform other tasks, when this is convenient.

Time-table

The external consultant is expected to spend about one week in Sweden, three weeks in Zambia and a further week in Sweden to finish his work. Two weeks work is estimated as sufficient for the local consultant.

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FOREIGN EXHANGE ZAMBIA

In October 1985 Zambia introduced an auction system for allocating foreign exchange. The new system – a step toward a more market-oriented economy – led to a strong devaluation of the kwacha and added to inflationary pressure. On the other hand, the supply of imported goods improved and the industry was able to raise its capacity utilization considerably.

These are among the findings of this study carried out on SIDA's behalf by *Rudolf Jalakas*, former chief economist at Svenska Handelsbanken and economic advisor to the prime minister of Lesotho 1984–1985.

In January 1987 it was decided that the auction system would be strongly modified.

Sweden's bilateral development co-operation, handled by SIDA since 1965, comprises 17 program countries: Angola, Bangladesh, Botswana, Cap Verde, Ethiopia, Guinea-Bissau, India, Kenya, Laos, Lesotho, Mozambique, Nicaragua, Sri Lanka, Tanzania, Vietnam, Zambia and Zimbabwe.

Each year about 30 of SIDA's over 200 projects are evaluated. Some of these evaluations are published in the Evaluation Series. Copies of the reports can be ordered from SIDA, S-105 25 Stockholm, Sweden.

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