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Central Intelligence Agency

FILE

Washington, D.C. 20505

DATE 7/11/86

DOC NO ALA M 86-20032

OCR 3

P&PD 1

DIRECTORATE OF INTELLIGENCE

8 July 1986

Zambia: Tampering With Economic Reform [redacted] 25X1

Summary

In our judgment, President Kaunda may be setting the stage to backslide on economic reform by tampering with Zambia's foreign exchange auction system. A review of reporting by the US Embassy, the IMF, and the press indicates that the auction, which has reduced the rate of exchange, is the centerpiece of a number of reform measures designed to help the economy adjust to a long-term deterioration in the country's terms of trade. The steep devaluation of Zambia's currency and consequent inflation resulting from the auction have spurred widespread domestic opposition to its continuation [redacted] 25X1
[redacted]. Although we do not believe that Kaunda is 25X1
politically threatened at this juncture, the auction's unpopularity--coupled with Kaunda's fears of violent opposition and his belief that the auction is contributing to poverty--is causing him to backtrack somewhat. Recently, Kaunda ousted the major proponents of the auction as part of a larger cabinet shuffle. The government also has diverted foreign exchange from debt service and other foreign payments to support the exchange rate, according to US Embassy reporting, and has appointed a tariff commission that will likely recommend ways during the next few months to limit the demand for foreign exchange. [redacted] 25X1

This memorandum was requested by Raymond Smith, Deputy Director, Office of Southern African Affairs, Department of State. The paper was written by [redacted] Central Africa Branch, Office of African and 25X1
Latin American Analysis. This paper was coordinated with the Directorate of Operations. Questions and Comments are welcome and may be directed to the Chief, Africa Division, ALA [redacted] 25X1

ALA M 86-20032

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We believe that any desire by Kaunda to end the auction probably is tempered by his concern that the IMF and major Western aid donors that have supported it might cut their aid. Leaving the auction intact but limiting demand for foreign exchange [redacted] Kaunda's goal of boosting the exchange rate to at least $.20 per kwacha from the present $.14. We believe, however, that doing so would undermine prospects for improving the competitiveness of Zambian products on international markets. In our judgment, this would reduce long-term prospects for economic growth, which depend heavily on Zambia's ability to increase exports. [redacted] 25X1 25X1 25X1

* * *

Centerpiece of Reform

President Kaunda's announcement last October of a foreign exchange auction--conceived as the centerpiece of an IMF-supported austerity program--marked a major turning point in the government's effort to come to terms with Zambia's decade-long economic decline, according to US Embassy reporting. The auction has cut the dollar value of the kwacha by about 70 percent, according to the Embassy, reducing the exchange rate of Zambia's currency be roughly the same amount as the deterioration in Zambia's trade position. Embassy and IMF reporting indicates that over time the devaluation should improve the competitive position on foreign markets of agricultural and manufacturing exports. [redacted] 25X1

Zambia's economic decline mainly stems from a sharp deterioration in its terms of trade and a fall in the production of copper, which historically has accounted for over 90 percent of exports. Industry data indicate that Zambian copper production has declined by one-third since it peaked in 1976. The production decline has been compounded by falling world copper prices and rising import prices, thereby reducing the foreign purchasing power of each ton of copper by three-fourths over the same period. (See Appendix I for a fuller discussion of Zambia's copper problems.) [redacted] 25X1

Zambia's previous system of allocating foreign exchange through government agencies and of determining the value of the exchange rate by linking it to a basket of foreign currencies had led to corruption and a major black market in foreign exchange, according to press and US Embassy reporting. The government had feared that the steep devaluation that would follow an auction would cause violent protests by military, labor, and other groups. Embassy reporting indicates that, aside from the IMF and major donors, such as the United States, only the head of the Central

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The Foreign Exchange Auction

The auction involves a four stage process:

— Importers submit requests to commercial banks, including information on amounts wanted, purpose, and kwacha/dollar bid rate.

— The commercial banks set aside the required amounts of kwacha from the requesters' accounts and send the bids to the auction secretariat.

— The secretariat arranges the bids from highest to lowest and at 3:00 P.M. on Friday of each week, allocates the available foreign exchange beginning with the highest bidder.

— The secretariat then sets the exchange rate for all successful bidders for any given week at the rate that exhausts the amount of foreign exchange on offer for that week.

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[redacted] 25X1

Bank, David Phiri, and Finance Minister Luke Mwananshiku were in favor of the auction. [redacted] 25X1

In our judgment, Kaunda's reluctant decision to take their advice and initiate the foreign exchange auction reflected his tacit recognition that the decline in copper prices and production was likely to be permanent. In past years, massive borrowing from foreign suppliers and banks, including seven loans from the IMF between the initial falloff in copper production in 1976 and the start of the auction, was intended mainly to sustain the economy until world copper prices recovered. In our judgment, the $4 to $5 billion foreign debt that accrued during this period left Lusaka in a much tougher economic position than it would have faced if the government had decided early on to make the decline in living standards keep pace with the deterioration in trade. [redacted] 25X1

Government Backtracking

Opposition to the auction--particularly the lack of government control over the exchange rate and the rate of inflation in excess of 50 percent--has increased within the regime, and we believe has led to a softening of President Kaunda's support for it. Less than three weeks after the first auction, [redacted] 25X1 government officials wanted an immediate halt to the auction because of the sharp devaluation of the currency. US Embassy reporting indicates that members of Parliament have questioned the wisdom of the auction and the resulting price increases. They believe the auction has forced the price of essential goods too high and are worried about the possibility of serious domestic unrest if prices are not reduced. Aside from the auction, the parliamentarians believe that the government's decision last January to reduce the fertilizer subsidy would further increase the costs of corn production in Zambia. In early February, Parliament passed a non-binding motion to roll back the price of fertilizer by nearly half to its 1985 subsidized price. (Appendix II explores domestic reaction to the auction system in detail.) [redacted] 25X1

Much of the criticism of the auction apparently is by individuals in the party and government who had profitted under the old system by selling foreign exchange on the black market, according to US Embassy reporting. In contrast, access to foreign exchange is much more reliable now for the business and farming communities, which strongly support the auction. According to our Embassy, Kaunda--despite his continuing public support for the auction--has stated privately that the exchange rate for the kwacha is "unrealistic," [redacted] 25X1

25X1

[redacted] 25X1

In our view, President Kaunda's announcement on 4 April of dramatic changes in his top economic leadership signaled the beginning of an effort to gain more government control over the foreign exchange rate and to slow down the decontrol of the state-run economy. Among those replaced were the two pro-Western proponents of the auction and of free-market policies, Finance Minister Mwananshiku and head of the Central Bank Phiri. US Embassy reporting indicates that Mwananshiku's replacement has no experience in economics, while Phiri's successor studied socialist economics in the Soviet Union and has no administrative background. [redacted] 25X1

Kaunda's appointment of weak administrators who probably favor more state intervention will put him in a position to push through the changes he is seeking. Kaunda has been quoted in the press as saying that while the old economic team had done a commendable job, it had failed to raise the kwacha to its "real value" against the dollar. According to the US Embassy, the new head of the Central Bank has echoed this sentiment and said that several modifications in the auction are being considered to ensure "a more stable and acceptable rate" for the currency. [redacted] 25X1

To boost the exchange rate without interfering directly in the auction system, in our judgment, the government would have to either increase the supply or limit demand for foreign exchange. So far, the regime has done the former. It has diverted foreign exchange from debt service and other foreign payments and has borrowed foreign exchange from commercial banks to increase the flow of funds through the auction, according to Embassy reporting. [redacted] 25X1

The US Embassy reports, however, that Kaunda has appointed a tariff commission which, we believe, will recommend ways during the next few months to limit demand for foreign exchange by reducing the number of importers eligible to bid in the auction. The commission probably will ban further bids for imports that it designates as "luxury" goods. It may also erect import barriers for "protected" manufacturing industries, thus disallowing bids for foreign exchange to import goods that would compete with the protected industries. In contrast to the fall in the exchange rate that accompanied an increase in the average number of bidders this spring, reducing the number of bidders probably would limit demand for foreign exchange, in our judgment, and put upward pressure on the exchange rate. [redacted] 25X1

Prospects

Although limiting demand should help slow the rate of decline in the exchange rate, Kaunda's efforts to regain a rate of $.20 = 1 kwacha may be frustrated in the second half of this year because of foreign exchange shortages. Foreign exchange allocations to the auction will fall short of

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[redacted] 25X1

Lusaka's goals by $50 to $70 million, according to US Embassy reporting. Pressures to end the auction will increase if, instead of rising, the rate falls significantly. Any desire by Kaunda to terminate the auction system, however, will be tempered by his concern that such a move probably would induce the IMF and major donors to review aid policy and cut donations. [redacted] 25X1

In addition to its preoccupation with controlling the auction system, we believe Lusaka will soon have to cope with the impact of further subsidy-related reforms on inflation. [redacted] 25X1 a corn price increase of between 40 and 45 percent planned for this summer could spark demonstrations or riots. 25X1 If major protests should occur, we judge Lusaka probably would rescind the price increases and call upon the police and paramilitary forces to restore order. If this failed and the demonstrations worsened, we believe Kaunda would be tempted to lower the price of corn, suspend the auction, and set the exchange rate at $.20 per kwatcha. [redacted] 25X1

Despite the present level of auction-related economic grievances within the government, there does not appear to be significant organized opposition within the military. Any bid for a takeover from the military would require the cooperation of several different tribal groups, which we judge would be difficult to obtain. Moreover, we believe Kaunda's intelligence service is loyal and effective enough to uncover coup plotting. With the regime apparently set on a course of easing off gradually from unpopular austerity measures, we believe grumbling will subside and that Kaunda's position likely will remain relatively secure over the next year or so. On the downside, however, any softening of austerity could undermine already limited prospects for increasing the competitiveness of Zambian commodities on international markets and promoting longer term economic growth. [redacted] 25X1

Over the longer term, we judge that substantial political courage will be required to resist temptations to renege on further devaluations as copper production declines, or to water down the impact of inflation by raising wages. In our view, any backsliding by Zambia on economic reform and efforts to muddle through with half-steps will pose increased risks for stability. If donor confidence is allowed to flag, Lusaka could lose access to foreign assistance now used to prop up its sagging economy. In our judgment, a serious, prolonged decline in the domestic economy--compounded by a series of grievances accumulated over the years--could finally pose a significant political threat to Kaunda.
[redacted] 25X1

Appendix I

Zambian Copper Problems

Zambia is the world's third largest copper exporter after Chile and Canada. Zambian government statistics indicate that copper production has declined from a peak of 713,000 tons in 1976 to 479,000 tons in 1985. According to industry experts, the decline is the result of a number of factors that make Zambia one of the world's highest cost copper producers despite an abundance of rich ores. Problems include excess labor and labor turnover, faulty equipment, spare parts shortages, and difficult access to some ore deposits:

-- Government pressure to provide jobs has kept Zambian copper employment at about 60,000 workers. In comparison, Chile produces almost three times as much copper annually with less than 35,000 workers.

-- Expatriates dominate critical managerial and skilled positions in Zambian copper mines and annual turnover among this group averages nearly one-fourth of the total expatriate labor force.

-- Capital expenditures have fallen behind equipment replacement needs for more than a decade, and production is hampered by critical shortages of explosives, diesel fuel, lubricants, and spare parts.

-- Ten of Zambia's 15 copper mines are underground and many are located in mountainous regions with harsh terrain.

Economic and industry journals indicate that, in a vicious circle, the decline in copper exports has cut foreign exchange earnings that are crucial to operating and maintaining copper mining machinery and equipment, thus contributing to further cuts in copper production and exports. Foreign exchange shortages have:

-- Forced mines to forgo imports to replace aged machinery and equipment and to postpone development of new ore deposits, thus reducing productivity and output.

-- Induced the government to siphon off ever larger amounts of foreign exchange income for non-mining needs such as food imports, thus reducing foreign exchange allocations for maintenance and development of mines.

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Extensive minerals surveys have not revealed any large new ore deposits in the Zambian copperbelt rich enough to offset the depletion of ores at existing mines, and copper production is expected by mining experts to decline even more sharply by the mid-1990s. This prospect led President Kaunda to say in a speech earlier this year that "the mining industry has now at most only a decade or two to go before ending its domination of the Zambian economy." [redacted] 25X1

A review of international commodity statistics shows that world copper prices peaked in 1974 and 1980 at just under $1.00 a pound, and subsequently fell in each period to about $.60--roughly the current price. Two factors account for the price decline:

-- Larger quantities of copper are being delivered to international markets because major foreign competitors have increased production and exports, according to industry data. Increases in copper production and exports by Chile, for example, have more than offset the decline in Zambian output since 1976.

-- Industry experts report that the development of fiber optics, satellite transmission, and processes such as multiplexing are beginning to reduce the consumption of copper in communications systems in Western countries. [redacted] 25X1

As a result, in a significant break with historical patterns, strong economic growth since 1982 in the United States and other developed countries has not resulted in an upsurge in copper prices. For the same reasons, any significant economic slump in developed countries may lead to further cuts in copper prices. [redacted] 25X1

[redacted] 25X1

Appendix II

Domestic Reaction

Lusaka's fears of a popular uprising or military revolt following the introduction of the foreign exchange auction system--and the resulting inflation and layoffs--have proven to be exaggerated. Nevertheless, the US Embassy reports that in President Kaunda's eyes the program has created enough political tension in the government and criticism among consumers, labor unions, and the military to make him backpedal. [redacted] 25X1

Public demonstrations. Violent public demonstrations in opposition to price increases and layoffs have been scattered and easily controlled. Demonstrations occurred one week after the first auction in October, when taxi drivers demonstrated in downtown Lusaka against a doubling in fuel prices. Although this demonstration seemed to be an ominous sign of increasing public resistance to the economic situation and had to be broken up by police, further expression of opposition had been confined to widespread public grumbling [redacted] 25X1 25X1 The US Embassy has reported that government officials trying to justify economic reforms have met with unfriendly crowds. In other forms of protest, Zambians have occasionally refused to sing the national anthem, according to press reports. [redacted] 25X1

Student Unrest. The introduction of boarding fees for primary and secondary school students as part of larger efforts by the government to reduce budget expenditures led to demonstrations by university students in Lusaka and Kitwe last December, according to the US Embassy. These demonstrations [redacted] 25X1 occurred spontaneously and did not attract outside support. No further outbreaks of economically-motivated student unrest have been reported. Nevertheless, Kaunda was reminded of the potential for student militancy in mid-May when the government was forced to close the Lusaka campus of the University of Zambia due to the violence that followed the explusion of a student leader for non-attendence of classes. [redacted] 25X1

Labor Unhappiness. Soon after the auction system went into effect, the Secretary General of the Zambian Congress of Trade Unions (ZCTU)--the parent labor organization--stated that labor wanted to maintain a good industrial climate, but would not cooperate with the government in allowing prices to skyrocket, according to the US Embassy. Subsequent Embassy reporting indicated that ZCTU Chairman Chiluba directed member unions shortly after the first auction to start negotiations for a general wage and salary increase, arguing the need to ease the impact of inflation resulting from the currency devaluation. Some unions have won pay increases, while others are still negotiating. [redacted] 25X1

[redacted] 25X1

[redacted] mineworkers demonstrated on three occasions soon after the first auction. These demonstrations were timed to coincide with a visit to the region by the Prime Minister. Although the demonstrations were nonviolent and no arrests were made, they added to Lusaka's fears at the time of a violent backlash due to the auction [redacted] 25X1 [redacted] 25X1 Moreover, according to the Zambian press, at least 53 strikes involving 24,000 workers occurred between January and May of this year. Kaunda predictably has tried to curb publicity for labor's opposition to the auction system. [redacted] 25X1

[redacted] 25X1

Military Concerns. Military personnel have been hard hit by budget cuts over the past several months. These measures have led to complaints about pay and living conditions from enlisted personnel and some junior officers [redacted]. Although the military has 25X1 had some morale and discipline problems for years, Lusaka has become more sensitive to the grumbling since the beginning of the auction. [redacted] 25X1

[redacted] 25X1

Pay increases of 40 percent for enlisted personnel and 17 percent for senior officers appear to have blunted the worst effects on the military of inflation resulting from the auction [redacted] 25X1

[redacted] 25X1

[redacted] Kaunda seems to have 25X1 forestalled more outspoken criticism by appointing officers to government positions traditionally held by civilians. According to the US Embassy, the President has made several Army commanders district governors and promoted General Malimba Masheke from Commander of the Army to Minister of Defense, a post previously filled by a civilian. [redacted]

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SUBJECT: Zambia: Tampering With Economic Reform

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