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PROGRAM PERFORMANCE AUDIT REPORT

ZAMBIA: PROGRAM LOAN (LOAN 911-ZA)

March 8, 1977

Operations Evaluation Department

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TABLE OF CONTENTS

	<u>Page No.</u>
Preface	
Data Sheet	
Highlights	
 <u>PROGRAM PERFORMANCE AUDIT MEMORANDUM</u>	
Background	1 - 2
Fluctuations in Copper Prices and the Timing of the Loan	2 - 3
Disbursement and Supervision	3 - 4
Procedures for Withdrawal of Counterpart Funds	4
Policy Understandings	4 - 5
Conclusions	5
 Chart I	
 <u>Attachment: Completion Report</u>	
Introduction	A.1
Economic Situation Preceding the Program Loan	A.1 - A.3
Objectives	A.3 A.4
Implementation and Counterpart Funds	A.4 A.6
Disbursement Procedures	A.7 A.8
Conclusions	A.8 A.10

PROGRAM PERFORMANCE AUDIT REPORT

ZAMBIA: PROGRAM LOAN (LOAN 911-ZA)

PREFACE

This Report covers an audit of experience under Program Loan (Loan 911-ZA) to Zambia. Loan 911-ZA, for US\$30 million, was approved on June 14, 1973, was signed on June 18, 1973 and became effective on June 29, 1973. The final disbursement was made in June 1974, bringing total disbursement under to Loan to US\$12.5 million. In agreement with the Government of Zambia, the balance amount of US\$17.5 million was cancelled. This audit is based on review of related documents and discussions with the Bank staff and complements the Completion Report prepared by the Eastern Africa Regional Office. Comments on the Report were received from the Borrower.

PROGRAM PERFORMANCE AUDIT REPORT

ZAMBIA: PROGRAM LOAN (LOAN 911-ZA)

DATA SHEET

Amounts (in US\$ mln)

	<u>Original</u>	<u>Disbursed</u>	<u>Cancelled</u>	<u>As of 12/31/76</u>	
				<u>Repaid</u>	<u>Outstanding</u>
Loan 911-ZA	30.00	12.50	17.50	-	12.50

Project Data

	<u>Original Plan</u>	<u>Actual or Est. Actual</u>
Conception in Bank		Dec. 1972
Board Approval		6/14/73
Loan Agreement		6/18/73
Effectiveness		6/29/73
Loan Closing	6/30/74	June 1974

Mission Data

	<u>Month, Year</u>	<u>No. of Weeks</u>	<u>No. of Persons</u>	<u>Manweeks</u>	<u>Date of Report</u>
Identification	11/72	1			12/72
Preparation	1/73	3			
Preappraisal/Negotiations	5/73	1			
Supervision I	11/73	3	2	6	12/73

In addition, there were two other missions, one (one man, two weeks) in August 1973 to discuss disbursement procedures, and one (two men, one week) to discuss arrangements for cancellation.

Follow-on-Project

Loan 1322-ZA of US\$30.00 million, signed September 17, 1976 for Second Program Loan Project.

PROGRAM PERFORMANCE AUDIT REPORT

ZAMBIA: PROGRAM LOAN (LOAN 911-ZA)

HIGHLIGHTS

The audit focuses on the problem of providing a program loan to a country heavily dependent upon a single commodity for its foreign exchange earnings and resources for development expenditure. The loan was intended to provide resources to assist Zambia to carry out a reduced development program at a time when low copper prices had imposed a severe financial constraint on the economy.

At the time the loan was made the Government embarked upon a number of policy measures including a wage freeze and increases in prices of agricultural products.

More than half the Loan was cancelled because rising copper prices reduced the country's need for such support.

Other points of interest are:

- problems in disbursement of the Loan (para. 13 of PPAM and paras. 8, 11-13 of PCR); and
- role of counterpart funds (paras. 14-15 of PPAM and para. 9 of PCR).

PROGRAM PERFORMANCE AUDIT MEMORANDUM

ZAMBIA: PROGRAM LOAN (LOAN 911-ZA)

1. This memorandum reports on an audit of performance under Bank Loan 911-ZA for US\$30.0 million which was signed in June 1973; an amount of US\$12.5 million was disbursed by June 1974, and, in agreement with the Government of Zambia, the balance amount of US\$17.5 million was cancelled in June 1974. The audit is based on information contained in the Project Completion Report (PCR) prepared by Bank staff in the East Africa Regional Department (Attachment A), supplemented by information contained in Bank files and reports, and discussions with Bank staff concerned.

2. Since program loans are meant to protect as far as practicable the development process in a country facing serious resource and, in particular, balance of payments constraints, their purpose and objectives have to be reviewed in the light of the country's economic structure and development objectives, and the economic policies it pursues to support these objectives. In addition, in the case of the particular loan to Zambia, procedural problems arose relating to disbursement of the loan and withdrawal of counterpart funds.

Background

3. Zambia is a landlocked country which became independent in 1964, and has one of the highest per capita incomes in the region. The economy is dominated by the copper industry. On an average, copper contributes 25-30% of the country's G.D.P., 90-95% of its exports and (in a good year up to) 50% of government revenues. Zambia provides about 16% of the world's copper exports. In spite of its substantial share in the world copper trade, Zambia has little or no control over international copper prices which are determined by transactions on the London Metal Exchange (LME). Between 1970 and 1975, copper prices slumped and peaked twice and had a significant impact on the course of the Zambian economy.

4. Since production and export of copper is in the modern sector, its dominant role in the economy has been a major influence in the characteristic economic development of Zambia. This is visible in a marked tendency for concentration of development (and population) in the copper-belt and along the railroad line linking the copper-belt in the north and west with major urban centers and export points.

5. Substantial disparities in income exist between the "modern" sector and the "traditional" sector (largely divided between urban and rural). Agriculture is estimated to contribute less than 12% to G.D.P. There is a division between commercial and traditional agriculture, and large disparities exist in value added per worker between the two sectors. About 50% of the labor force is estimated to be in the subsistence sector, but because of emigration the proportion is declining. There has been a substantial growth of urban centers and a net migration from the countryside to the towns - about 35% of Zambia's population is in 10 towns with a population exceeding 50,000.

6. The major economic policy issues confronting Zambia are, first, how to use resources from copper to diversify the economy and reduce dependence upon one commodity; the sharp fluctuations in copper prices in recent years have added urgency to this problem. The second issue is how to narrow the gap between urban and rural incomes by improving output in the traditional agricultural sector. Other development objectives include raising the level of general education; developing a wide range of technical, administrative and managerial skills in order to lessen dependence on expatriates; and raising the general level of social welfare. Zambia has made important strides in education (although skilled manpower remains an important constraint), in developing power and transportation infrastructure and limited progress in diversifying its economy, particularly through modern manufacturing; to date, its success in reducing the rural-urban income gap has been small.

7. Although the price of copper is subject to wide fluctuations, in the years preceding 1970, the fluctuations were around an upward trend. Up to 1970 the Zambian economy did not face any serious financial constraints, and in early 1970, the country had a comfortable foreign exchange reserve position. Since 1970, however, copper prices have shown sharp fluctuations and have become a major disruptive influence on the Zambian economy. Since over 90% of Zambia's exports are copper, the impact on the balance of payments is almost directly proportionate to the fluctuations in copper prices. The budgetary consequences (through revenues) of the fluctuations were also substantial. It was in this context that the Bank began to consider a program loan to Zambia. The PCR describes in detail the steps in the negotiation and approval of the loan, the policy understandings reached and the procedures laid down.

Fluctuations in Copper Prices and the Timing of the Loan

8. Prices of copper have shown sharp fluctuations in the past. During the last 10 years, copper price movements can be divided into four phases:

- (i) 1966 to mid-1970: a generally upward movement, gradually increasing copper prices from US 40 cents a lb. to 90 cents a lb.;
- (ii) Mid-1970 to 1972: copper prices declined steadily, moving to around 47 cents a lb. by December 1970, and fluctuating around that level till December 1972;
- (iii) 1973 to mid-1974: copper prices began to rise, accelerating particularly after mid-1973, reaching 101 cents a lb. by December 1973 and a peak of 138 cents in April 1974; and
- (iv) Mid-1974 to 1976: copper prices came down as rapidly during this period as they had risen in the previous year and a half, falling a 58 cents a lb. by December 1974 and fluctuated around that level till 1976-end (except for April-September 1976 when they were around 70 cents a lb.).

9. The fall in copper prices, starting 1970, had a sharp adverse impact on Zambia's foreign exchange and budgetary position. Towards the end of 1972 it was felt that the low and falling copper prices might seriously affect Zambia's development efforts. These low prices had caused a sustained fall in Zambia's foreign exchange reserves from about US\$515 million equivalent at the end of 1970 to about \$165 million at the end of 1972. It was early in 1973 that an appraisal mission visited Zambia to examine the Government's investment program which had been scaled down in line with the diminished resources available. After further detailed discussions in April/May, which followed an agreement for a standby credit between Zambia and the IMF, the loan was approved in mid-June. At that time the copper price had already risen to 79 cents a lb. At the time the loan was made it was expected that copper prices would remain fairly low and that Zambia would still need additional resources to carry out its investment program. However, the world economic situation changed suddenly after mid-1973, with oil prices trebling towards the end of 1973 and the emergence of strong inflationary trends the world over. Commodity prices in this period were influenced to a large extent by factors which could not have been foreseen. Copper prices rose to 101 cents a lb. in December 1973 and to 138 cents a lb. in April 1974.

10. As copper prices rose, they were reflected in the revenues and foreign exchange position of Zambia which improved by an amount greatly exceeding the amount of the program loan. As a consequence, Zambia's need to draw on the program loan diminished. This, combined with procedural problems referred to in the PCR (paras. 11-13), meant that disbursement on the program loan was at a much slower pace than envisaged, being only US\$5 million by December 1973.

11. In the early 1974 discussions began which led to the cancellation of the balance of the loan. At that time the Bank had under consideration a request from Zambia for a supplementary loan for the Kariba North Power Project. This request had come a comparatively short time after the Bank had made a loan of US\$115 million for the Kafue II Power Project. As a result of the discussions with the Government it was agreed that the undisbursed balance of the program loan (US\$17.5 million) would be cancelled and the equivalent amount allocated to the Kariba North Project. In this way the Bank reverted to project lending once the program assistance was no longer needed.

12. The balance of the loan was cancelled in June 1974. During the following six months the effect of the 1974 world recession was reflected in copper prices which fell from about 111 cents a lb. to 58 cents a lb. and they remained at about that level throughout 1975.

Disbursement and Supervision

13. The PCR (paras. 11, 12, 13) describes the reasons for the slow disbursement of the loan. Part of the reason was that, despite eligible imports coming in at an adequate rate, the Zambian authorities were not able to present the necessary documents. Supervision was devoted primarily to

efforts to ensure rapid disbursement of the program loan and fulfillment of the policy understandings. The Bank offered its assistance to the Government in reviewing internal procedural difficulties in order to ensure faster disbursement, and the Government took steps in that direction. So also, detailed discussions were held in December 1973 by a Bank mission with the Government on progress in fulfilling policy understandings. If these did not achieve their purpose fully, it was mainly because, with rising copper prices, the economic context had changed and the urgency to draw on the Bank loan had disappeared.

Procedures for Withdrawal of Counterpart Funds

14. The PCR (paras. 7 and 9) refers to the procedure laid down for withdrawal of counterpart funds and the failure of the Government to observe them. The appraisal mission had discussed in detail the 1973 development expenditure of Zambia and found it satisfactory; a part of this was to be financed out of counterpart funds. Twenty-two heads under the Government's investment program, accounting for an authorized provision of K 110.40 million in the 1973 budget, were specified in the Loan Agreement, and, of this, K 101.6 million was eligible for counterpart financing. Expenditure categories agreed upon included education, health, local authorities, rural development, mining and national resources, transport, communications, power and works, and industry. Assuming the program loan had been fully disbursed, it would have generated counterpart funds of about K 19 million (or about 18 percent of the development expenditure). In fact, only US\$12.5 million out of the program loan was disbursed, generating counterpart funds of K 8 million.

15. The Bank of Zambia did not open a separate special account for counterpart funds, but instead credited them to the Ministry of Finance's general account along with the much larger amount of funds from the Government's regular fiscal sources. The Ministry then submitted to the Bank two certificates of expenditures under the approved investment program eligible for reimbursement in an amount totalling about US\$12.5 million equivalent. Since the amounts of counterpart funds accumulated at those times were less than the amounts due for reimbursement, they were in effect debited against anticipated deposits of counterpart funds (para. 9 of PCR).

Policy Understandings

16. Negotiations leading to the approval of the Program Loan covered Zambia's development program for 1973 as also economic policies which the Government proposed to adopt to cope with the crisis caused by low copper prices. These policies related to a number of matters, including a wage freeze, a reduction in subsidies and the pricing of agricultural products. The PCR (para. 10) discusses Government actions taken in respect of these policies.

17. Faced by budgetary difficulties, the Government had to prune development expenditures for 1973, including expenditure on ongoing projects. As regards wages, the Government was able to bring about a freeze in the remuneration of its employees and to moderate escalation in private sector wages, particularly in the copper industry. The Government made cuts in foodgrain subsidies, but had to withdraw them owing to agitation by affected groups. The Government had also proposed to increase the prices of import-saving food items and of export commodities such as cotton, tobacco, maize and groundnut. However, the price increases made in 1974 were moderate. Apparently, the adoption of a policy of wage-freeze restricted the Government ability to cut subsidies and raise prices of items of agricultural production for domestic consumption.

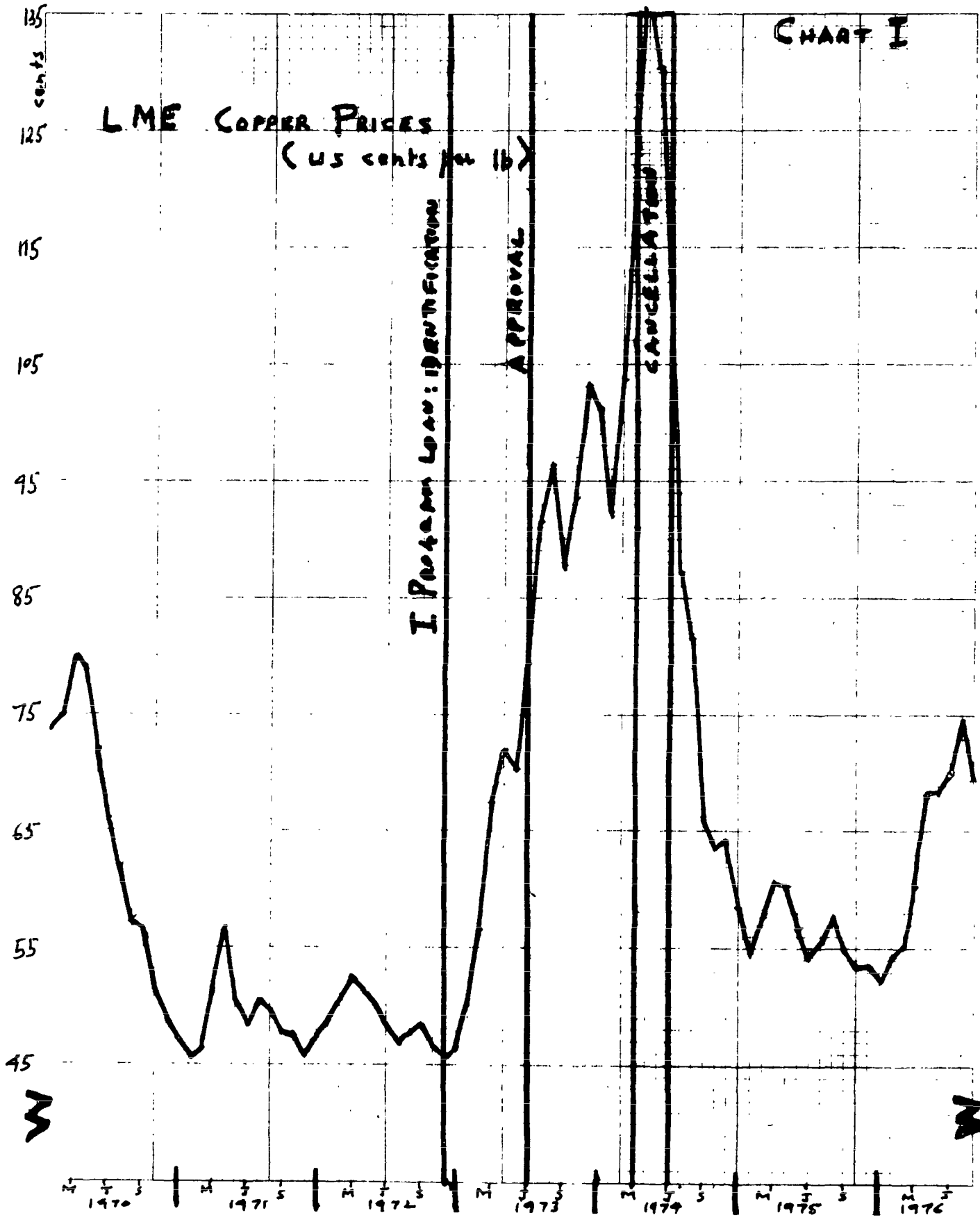
Conclusions

18. Probably the most significant conclusion to be drawn from the experience of the first program loan to Zambia is that where an economy is highly dependent on a commodity whose price fluctuates widely, the direct impact of the loan can be lost or nullified by the much larger forces which operate on the economy. The discussions which led to this program loan began at a time when world copper prices had been relatively low for some two years, after several years of rising prices. However, by the time the implications for the Zambian economy could be investigated, an agreement on the necessary policy response reached, a loan negotiated and arrangements for disbursement worked out, copper prices had recovered to a level which led the Zambian Government and the Bank to agree that the justification for the loan no longer existed. Therefore, by agreement with the Government of Zambia, the undisbursed balance was cancelled.

19. Although, in the light of events, the loan did not turn out to be essential, during the time-span originally envisaged, to enable Zambia to follow the development policies it had adopted to adjust to its new financial constraints, these policies continued to be necessary in view of the decline in copper prices in the second half of 1974. The economic policy discussions which were initiated with the first program loan have been continued over the last few years and led, in 1976, to a second program loan. A significant innovation which the Government has introduced is a Development Equalization Account which is intended to ensure that development expenditure grows more steadily and is less influenced by fluctuations in mineral revenue. If this Account can be successfully managed it could reduce the need for program loans arising from this cause.

CHART I

LME COPPER PRICES (US cents per lb)



I. Prolonged Loan: Identification

APPROVAL

CANCELLATION

W

W

ZAMBIA
COMPLETION REPORT

FIRST PROGRAM LOAN (Loan 911-ZA)

Introduction

1. The information in this report is drawn from the preparation, appraisal and supervision mission reports related to the First Program Loan to Zambia, the Loan Agreement and side letters, and reports by special missions that prepared the Second Program Loan signed in September 1976. A more detailed description and analysis of Zambia's economy since the time of the First Program Loan can be found in the President's Report (No. P-1811a-ZA, dated August 9, 1976) on the Second Program Loan.

Economic Situation Preceding the Program Loan

2. Zambia's economic situation began deteriorating early in 1970 when the world price of copper, the country's major export and source of domestic revenue, dropped sharply. Compounding this problem, the largest copper mine in the country, Mufulira, flooded in September 1970 causing a severe loss in production. The twin effects of declining copper prices and production dealt severe blows to Zambia's foreign exchange holdings and Government revenues. The current account in the balance of payments swung from a surplus of K86 million in 1970 to deficits of K187 million and K100 million in 1971 and 1972. Reserves fell from K380 million in mid-1970, a level equal to a year's worth of imports in 1972 terms, to K75 million, just over two months' worth of imports by the end of 1972. Government recurrent revenues in 1971 and 1972 were 25% below the 1970 level, and the recurrent budget showed deficits in both years. As a consequence, the Government's investment programs in current terms in 1971 and 1972 were 10% below the 1970 level.

3. Discussions about the Program Loan began in late 1972 as it became clear that the economic crisis had reached major proportions, even

Government was to review the whole structure of subsidies and prices to determine which subsidies should be eliminated, to establish a national pricing policy designed to promote economic diversification and resource mobilization, and to implement the necessary policy changes over a period of time.

Implementation and Counterpart Funds

7. Once the Executive Directors approved the Program Loan (June 14, 1973), it was quickly signed (June 18, 1973) and made effective (June 29, 1973). The loan was designed to be disbursed quickly. The proceeds could be applied to a wide range of imports of capital and intermediate goods for the private and public sectors. The Bank of Zambia was required to open a special project account in the name of the Government to which would be credited the Kwacha equivalent of the imports financed under the project. The Government could withdraw funds from the project account to cover capital development expenditures in amounts up to 50% of amounts actually spent under the 1973 capital investment program (only a few non-developmental capital expenditure items were ineligible.) The Program Loan and the counterpart funds were expected to be disbursed by the end of 1973.

8. Contrary to expectations, disbursements under the Program Loan started very slowly. By December 31, 1973, disbursements amounted to only \$5.0 million, or 17% of projections. When this trend continued into the first quarter of 1974, the Government and the Bank agreed to cancel \$17.5 million of the loan. The rationale for this decision was (a) that because of the sharp rise in copper prices the need for balance of payments and budget support had practically disappeared and (b) that considerations of Bank exposure in Zambia became important when the next Bank project in Zambia (Kariba North Power, Supplemental Loan) turned out to be more costly than anticipated and thus needed a larger Bank loan (\$42.1 million) than had been expected.

The cancellation of the undisbursed portion of the Program Loan and the corresponding increase of the Kariba North Supplemental loan thus in effect caused a reallocation of our lending to Zambia. The last disbursement under the Program Loan took place on June 17, 1974, when a disbursement level of \$12.5 million was reached.

9. Regarding the use of counterpart funds, the Bank of Zambia apparently did not open a separate special account, but credited them instead to the Ministry of Finance's general account along with the much larger amount of funds from the Government's regular fiscal sources. The Ministry submitted two certificates of expenditures made under the agreed-upon heads of the 1973 investment program and stating the amounts of counterpart funds due for withdrawal in each case. The first, in October 1973, was for the Kwacha equivalent of US\$7.0 million even though at that time only about US\$2.4 million of the program loan had been disbursed. Thus, some of the reimbursements from the counterpart funds were in effect debited against anticipated deposits. Although the Bank asked for an explanation from the Ministry, none was received. The second certificate, in December 1973, listed the equivalent of US\$5.5 million as eligible for reimbursement, but made no request for withdrawal since the initial application had covered all reimbursements "so far received into the project account." This procedure, though different from that agreed at the time the loan was made, achieved the purpose of assuring that counterpart funds were used for the approved investment program, and the Bank therefore accepted it.

10. On the policy level, the Government implemented several of the understandings agreed with the Bank during the formulation of the Program Loan. The Government maintained the investment expenditures, which the Bank had reviewed and considered essential for Zambia's development program. Wages were restrained in the urban sector, particularly those for miners and civil servants, although this made it difficult for the Government to quickly reduce the level of subsidies benefitting the

urban consumer and to restore realistic price levels. The Government made little headway on resolving the difficult problems associated with its pattern of subsidies and price controls in the two year period following the Program Loan. With the benefit of hindsight, it is clear that we had underestimated the political difficulties the Government was facing at the time. Several of the measures proposed would have started stimulating agriculture and would have brought about an improvement of the budgetary situation, but they would also have led to an increase in consumer prices, which the Government was committed to keep down. In fact, the Government did announce substantial consumer price increases in November 1974, but was forced to roll them back again because of political pressure. In mid-1975, however, certain consumer prices were increased again. The Government was also under considerable pressure, as a result of record high copper prices, to increase wages in the urban sector, particularly for miners and civil servants. The Government did not permit wages to increase significantly until early 1975 when a public sector salary commission recommended graduated wage boosts for civil servants. In brief, it is clear that the Government was not unwilling to carry out policy changes, but that it simply needed more time to overcome political constraints to implement these policies than the one or two years which the Bank had estimated to be feasible in its discussions leading up to the Program Loan. Although discussions on policies set in motion by the Program Loan resulted in little immediate effect on Zambia's economic development policies, a constructive discussion continued between the Bank and the Government on economic development policies and issues and, by the time of the Second Program Loan, significant policy improvements had been accomplished as a result of these policy discussions.

Disbursement Procedures

11. Several reasons could be offered to explain why the Government did not fully - or quickly - utilize the funds provided through the Program Loan. The improved price of copper enabled Government recurrent revenues in 1973 to exceed expenditures for the first time since 1970, and led to a current account surplus on the balance of payments. This situation undoubtedly created an optimistic atmosphere which lessened the pressures to utilize the Loan.

12. The particular procedures established for documenting withdrawal requests contributed to the slow disbursement of the Program Loan. For imports procured by the private sector, the Borrower was to provide the Bank with the following documents to be supplied by the commercial banks: application for foreign exchange allocation, supplier's invoice, bill of entry and/or bill of lading and evidence of payment. For goods obtained for the public sector by the Central Supply and Tender Board (CSTB), the Borrower was to provide the Bank with similar documentation (except for the application for foreign exchange) and a certificate from CSTB that the contract had been awarded in accordance with procedures for tendering and procurement set forth in the Loan Agreement.

13. The Ministry of Finance had considerable difficulty in assembling the necessary documentation for withdrawal applications, and several factors contributed to this problem. First, the Loan Agreement defined eligible import categories according to SITC groups, but on Zambian import documents goods are listed according to the BTN classification system. Although conversion from one system to the other is relatively simple through a conversion list, many ineligible imports were submitted to the Ministry of Finance and had to be sorted out. Second, commercial banks were slow in submitting the

necessary import documents against which the Bank could disburse; their own files were often incomplete and, in the absence of a fee, there was no incentive for the commercial banks to comply. Third, the Ministry of Finance was understaffed and the number of import transactions for which documentation was needed was very large. Finally, large amounts of imports entered the country financed outside the Zambian commercial bank channel. All imports of the mining companies, the largest importers of capital goods, were paid for directly through their overseas accounts under a general open license. Although these imports were eligible for reimbursement from the Program Loan, the Bank's documentation requirements effectively excluded them from consideration.

Conclusions

14. The Program Loan was designed to have an impact on three important areas of the Zambian economy: the balance of payments through provision of foreign exchange; the investment budget through the release of counterpart funds; and the direction of economic growth by maintaining the investment budget and influencing policy decisions to stimulate rural development and diversification. The impact on the balance of payments was minimal due to improving copper prices, which lessened the Government's need to utilize the Loan funds. Because of poorly designed disbursement procedures, the Bank disbursed only a small portion of the Loan. Clearly, the Bank was unfamiliar with Zambia's procedures for documenting imports, and during the Loan's preparation this matter was not investigated carefully enough.

15. The use of counterpart funds did not become a significant factor since only a small portion of the Loan was disbursed. One benefit of including provisions concerning counterpart funds in the Loan appear to have been the opportunity the Bank had to review in depth the Government's 1973

investment budget. The Bank, however, would have reviewed the appropriateness of the investment budget as part of the regular economic work program though not in as much depth, and in any case would have reviewed the investment program irrespective of the fact that there were provisions for the use of counterpart funds in the Program Loan. In any event, the widely defined range of items in the investment budget to which the use of counterpart funds could be applied did not offer any real means of control. Even though the Bank did not feel the need for more control, it should have paid closer attention to the Government's compliance with the requirement to set up a separate project account in the Bank of Zambia. Also, the confusion generated by the Government's proposed use of counterpart funds before they were available should have been clarified.

16. The most successful aspect of the Program Loan was the forum it provided for a constructive discussion of the Government's investment priorities and the policy initiatives required to strengthen the economy. The results for 1973 show that the investment budget remained intact (although the rise in copper prices was possibly the main factor), and that the Government implemented several of the policies discussed with the Bank. These achievements were the result of the discussions initiated with the Government and not the result of provisions in the Program Loan's legal agreement, as disbursements were not tied legally to implementation of the investment program, nor to the implementation of certain policies. In separating disbursements from policy objectives, the Bank was operating under the premise that the broad nature of the policy objectives and investment programs made it inappropriate to link their implementation to disbursements.

17. The Program Loan would have had a more significant impact on Zambia's balance of payments position if it had been made earlier than mid-1973 when copper prices already had largely recovered. Yet, determining the appropriate timing in the midst of a crisis can be difficult given the time required to prepare and negotiate a loan, and given the volatility of copper prices. Perhaps a more important lesson is that as long as the Zambian economy remains dependent upon copper, future program loans should be designed to result in the implementation of specific economic policies to diversify the economy. In the First Loan, these objectives were broadly discussed, some actions initiated, but no specific provisions were included in the legal agreement. The Second Loan embodies specific provisions to help achieve these objectives, including the strengthening of the Ministry of Rural Development, a periodic review of the price structure and the creation of a special equalization account to dampen the effect of cyclical swings in copper prices on Government investment expenditures.