URGENT **SECRET** 18

SECOND WINDOW or SECOND MARKET: Toward a Rejoinder to IMF

1. The IMF (at senior staff level) has rejected the programme/letter of intent it negotiated with Mozambique. It wants a "market determined" "second window" - apparently an auction.

2. It is worth knowing that the Bank (Banco Mondiale) disagrees strongly. It views a "free auction" in Mozambique today as a road to a Zambian style disaster. It argued strongly with Fund (level of Sandstrom) on the specific case of Mozambique. General SSA exchange rate/credit policy differences have been argued with Fund up to and including by Conable. BM is unwilling to go public on this but it does strengthen your negotiating position as Fund does not want an open breach with Bank and thus may accept a proposal which is different from status quo and appears to meet their demand but is not the same as their 'proposal' in substance. (The information is from Ferranti and Collear who

stressed I should make clear to you that "The Bank is on your side." The judgement on Fund flexibility under Bank pressure is from 1985-86 Tanzania negotiations.)

3. A pure auction especially with all export earnings (presummably including services ie CFM and remittance) would be a nonsense:
   a. it would be likely to fall like a rock not to Mt 1300 or even Mt 2000 but to MT 3000-4000 on the Zambian model;
   b. even if it stayed at MT 1350 it would give MT 50 billion windfall to exporters on the ½ of earnings they now surrender at official rate. This cannot raise output much Lomoe (cotton/tea), prawns, cashews, CFM are not constrained by forex price but by natural resources (weather, # of trees, prawn stock); their own capacity and war. Unless they simply put the MT 50 billion in Banco de Moçambique (totally unrealistic) demand will rise and especially demand for imports. The result will be to increase inflation and to

increase downward pressure on MT (indirectly via inflation and directly via sudden increase in import demand).

c. Unless $150 ... odd of IMF-BM - Bilateral Import Support can go to government to service debt — LAM clearinghouse - selected imports — embassies — army and that is additional (at least largely) to present flows, the Govt. will have to bid at auction with totally disastrous fiscal balance and exchange rate level consequences.

The proposal is the economics of a lunatic asylum (or à la George Bush - "vodoo economics").

4. Only one broad coverage truly free market auction for Forex exists in SSA - Gambia. Gambia's basic economic sector is (illegal on non-Gambian partner sides) entrepot trade carried out in hard currency (CFA Franc is freely convertible to French Franc). This set of Forex flows is larger than Gambia's own use of imports (perhaps 3 to 4 times as large), therefore a commercial bank (private/foreign) run Forex market has had a

considerable degree of success and has resulted in a moderately stable rate for the dalasi.

5. Ghana and Nigeria are Treasury/Central Bank managed floats described (disguised) as free market auctions. My sources include both govt. officials and businessmen and (though one can't quote him) the 1987-89 IMF Res Rep in Ghana. The Fund — whatever it says — knows these are not free.

6. Ghana mechanism is "moral suasion" with Commercial Banks. A rate is set weekly. Usually allowed to vary 1 or 2 cedis from week before (+ or − 1%). When bids come in Bank of Ghana decides how many $ are to be sold and then disqualifies (has CB's disqualify) other bids on grounds "technical errors" in filing. I am told up to 65% (and down to 5% or 10%) of bids are thus disqualified some weeks. The "free" rate tends to vary very little for 3 to 6 months, then go down 20 to 25% in 2 to 3 weeks and then be stagnant for 3 to 6 months. No free auction

could conceivably behave like that!

7. I am less au fait with exact mechanisms in Nigeria. One is sharp alterations in amounts of $ auctioned weekly and another is moral suasion (eg to reduce a bank's share of $ if it doesn't keep its customers "in line"). As there is a non-legal market with up to twice as many naira for $1 it is clear this is not at all the market determined, free access auction it appears to be. As in the case of Ghana the Fund knows this whatever it may choose to claim.

8. In theory we could cobble up a de facto managed auction but:

a. because initial rate would have to be — say — MT 1350-1550 (old "second window" buying or middle rate plus a bit for inflation) the problems for quota forex would remain;

b. to be credible scale an auction needs to be via Commercial Banks (not just Central Bank) and the Banco Popular plus Standard Totta aren't up to it;

c. The administrative capacity of the Banco de Moçambique is probably not up to this kind of hidden hand juggling either.

Thus a managed 'auction' wouldn't seem suitable for us.

9. A second market may be an acceptable answer:

a. we had one MT 1,300/1,700 albeit briefly. It did seem to achieve a certain stability at rates well below old parallel market;

b. Ghana operates a "forex bureau" second market. Fund with varying degrees of enthusiasm approves of or acquiesces in it. Rates do track official/auction rate but are up to 30% higher.

10. IF we are to propose a credible second market we need to have:

a. Operator who is not Fazenda nor Banco do Moçambique. Presumably Banco Popular;

b. agreed flows to market –

i. any of 50% retention portion goods and services exporters wish to sell (as CFM did sell $1 million);

ii. any holder of Forex other than the exporters and (preferably) international agencies, embassies, etc. (Individual coopeants can't be blocked but many doubtless sell candonga now or so cooperants tell me even if each says "I don't, but....")

iii. preferably 50% of mined remittances.*

c. agreed purchasers / use of purchases.

i. exclude capital or dividend remittances large Firms,

ii. otherwise "anything goes" — one cannot really 'police' this kind of operation

d. allow European "bureau de change" type margins — 5% ± margin from central rate plus 5% commission on sales / purchases:

eg Central Rate MT 1,500 = $1

−5% Swing	75	→ 1425
−5% Commission	71.25	↓
Buy at MT	1353.75	
+5% Swing	75	→ 1575
+5% Commission	78.75	↓
Sell at MT	1653.75	

(This gives MT 300 margin)

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* For reasons of equity (all others get at least 50%) and limiting domestic political outcry. If Lomaco keeps 50% of export earnings and CFM why shouldn't 50% of mines export earnings be at 2nd Market? No good reply!

e. Agree that initially delivery on purchases is spot and on sales 30 days because no opening stock of $ and Rand. (I assume 2 currencies? Ideally 3 ie Zi $, but as cross rate would not be official one I suspect Zi might be angry and crack down on presently "benignly neglected" Zi $ use in Tete/Manica.) Say this would be reviewed in 6 months in light of experience and Banco Populares market trading stock of $, R by then.

F. Agree that merging of markets by sinking 'official' to second will be discussed/reviewed in 12 months on basis experience.

g. Fazenda / Banco do Mocambique would license, oversee, set general guidelines for second market. They would not intervene on day to day basis or publish fixed levels of central rates or charges. (What they order Banco Populare to do verbally is out of formal knowledge of Fund — like Ghana auction management!)

h. Banco Popular would "respond to market signals". It would not fine tune nor alter rates daily or even, necessarily, weekly. It would take note of official rate and (until steps were taken to unify markets) would normally [in practice always] adjust its central rate when official rate was changed. Before 'major' [ie all] changes would 'consult' Fazenda/B Moç.

i. Banco Popular would make a profit — on a willing buyer/willing seller basis in a risky [ha...] market. That you can tell the Fund is the nature of free markets and of capitalism. And it will pay company tax on it — that is the nature of proper tax collection systems. [How it uses — or is "relieved of" rest of profit is for Fazenda to decide outside agreement with Fund!] BP is a financial institution with own legal identity in commercial business.

9. In practice 8g and 8h allow Fazenda/Banco do Moçambique to instruct BP as to rates:

a. Initially say MT1500 middle rate and MT 1353.75 buying/MT 1653.75 selling rates as at 8d;

b. To consult weekly with F/BP on

balance between bought and sold. If too many sales relative to purchase F/BM would 'advise' to raise middle rate (probably useless to chang less than MT 100 at a time). If purchases exceed sales build up "stock in trade" of Forex at least until it reaches $10 million;

c. Whenever Banco de Moçambique changes main (ie official) rate the BP would move its middle rate by same amount (unless a process of rate unification had been begun).

10. I think the Fund might buy this:

a. a second market
b. one open (sort of) to market forces
c. run by a commercial enterprise (even if state owned) not Government nor Central Bank
d. avoiding Government/CB "two window"/"multiple rate practices"
e. avoiding "tax on foreign exchange"
f. having a certain appearance of autonomy.

11. From Fazenda's point of view:
    a. restores brief second window with restricted sources gambit/experiment which seemed to be working;
    b. restores profit element in Forex transactions in a way which is not an export tax;
    c. allows time to consider what more transactions should be slotted in when and avoids "rush to unification";
    d. costs $0 or $25 million in current govt. "Free use Forex" flow depending on whether 50% of worker remittances at this rate (perhaps you could get IMF or somebody to allow govt. to use $25 mn for LAM - invisible import - electricity - ditto ?);
    e. is actually controllable simply which an auction is not;
    f. gives IMF a chance to compromise gracefully while claiming won;
    g. gives Banco Mondiale ability to tell Fund # Mozambique is being reasonable. They are proposing a market determined rate for a substantial volume

of transactions. Now you — Fund — be reasonable and don't insist on a dual rate and an auction which we, like Mozambique, feel would be unwise in their context.

12. Yes – it would be nice to tell the Fund to go to hell or to stick with original agreement. Most unfortunately we cannot afford to do so. Fortunately Fazenda at least would like to restore the "parallel window" rechristened "second market"!

13. Appended memo was written before you informed me of Fund Faith Fiasco. It sketched same mechanism but with less window dressing "pour les beaux oeiles de la Fonde Internationale Monetaire".

RHG
Maputo
15-IV-90

ANNEX

EXCHANGE RATE/MARKET MANAGEMENT: Some Reflections and Ideas

1. The brief second market:
   a. buy $1 = MT 1300
   b. sell $1 = MT 1700 (delivery in 30 days)

   seems to have:
   i. generated significant volume;
   ii. taken over most of parallel business;
   iii. lowered selling rate from MT 2,200 odd to M 1,700;
   iv. been moderately stable in these respects (albeit period not long enough to be sure).

2. I understand the objections were:
   A. IMF — "this is a dual exchange rate" and/or "a tax on foreign exchange"
   B. Domestic — discriminates against legal operations of companies and against povo.

3. IMF objections (whatever their merits or otherwise) need to be met or bypassed. In Ghana IMF acquiesces (with varying degrees of enthusiasm) in two tier forex market:
   a. via Banks at supposed free auction rate [actually

a Treasury/Bank of Ghana run erratic downward float operated by moral suasion and deciding how many bids to accept and then eliminating others on "technical errors" in form filling]

b. a Foreign Exchange Shop (licensed) system which really is free market. It roughly parallels first tier movements but is 10% to 35% higher (ie if 'official' ₵ 200 = $1, exchange shop likely to be ₵ 250 = $1). Buy/sell spreads about 6% usually (certainly under 10%).

4. As companies could buy/sell on the second market here (CFM did sell $1 million to start paying workers' back pay) and povo did convert their unofficial Rand inflows there the domestic objections are either ill conceived or relate to the $60-70 million a year in official channel remittances from mines being at MT 800 not MT 1300 (per $).

5. Possible way forward:
A. Reestablish Market at some body other than Banco de Moçambique

B. Set rates at (say) MT 1,300 = $1 buy and MT 1,560 = $1 sell (cut 'tax' to 20%).

C. Use the MT 1,300 = $1 rate for worker remittances (and sell them at MT 1,560).

D. In three steps move rate on most import support sales to Empresas, Enterprises to MT 1300:

i. 800 → 1,000 (when reestablish rate)

1000 → 1,150 (after 4 months)

1150 → 1,300 (after 6 months)

[This may not unify rates as MT 1300 may have risen but — per Ghana — a divergence of up to 25% seems to be OK with Fund.]

E. Consider implications "D" for goods sold to govt. itself or NSA and Commercio parallels.

6. Effectively this would in 6 months move basic rate to MT 1300. (Nobody would by choice exchange at MT 800! 30 day rule could tie in visitors but not resident cooperants/agencies or exporters.) But if NSA excluded (for a time) it shouldn't be very inflationary. Shop prices for imported goods are linked to MT 1,900 – 2200 = $1 basis not MT 845.

7. Whether MT 1300 would stick for long depends on inflation. At 25% rate end 1990 would be 845 to 1060 and 1300 maybe to 1425 (ie gap could narrow).

8. The real gain is the price margin 1300 → 1560 (or 1700).
If the body doing the selling is neither Fazenda nor Banco do Mocambique IMF might accept argument it was a Financial institution setting its own margins and not a tax on foreign exchange, eg it could claim.

Central Rate	1450		
Swing Each Way	5%		
Commission	5%		
Buying	1450		
−5% (S)	72.5	=	1,377.5
−5% (C)	68.9	=	$\boxed{1,308}$
Selling	1450		
+5% (S)	72.5	=	1,522.5
+5% (C)	76.1	=	$\boxed{1,599}$

Those swings/commissions are not so very much above "Bureau de Change" shops in Europe!

9. There are issues on exactly which transactions would go this route and may be snags but this looks hopeful enough to try out.

14-II-90
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