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Zambia: 2005 Article IV Consultation, Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver and Modification of Performance Criterion, and Financing Assurances Review—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Zambia

In the context of the 2005 Article IV consultation, third review under the three-year arrangement under the Poverty Reduction and Growth Facility, request for a waiver and modification of a performance criterion, and financing assurances review, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver and Modification of Performance Criterion, and Financing Assurances Review, following discussions that ended on October 26, 2005, with the officials of Zambia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 22, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) and a Press Release summarizing the views of the Executive Board as expressed during its January 11, 2006 discussion of the staff report that completed the review and the IMF arrangement, respectively.

- a statement by the Executive Director for Zambia.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Zambia*
Memorandum of Economic and Financial Policies by the authorities of Zambia*
Technical Memorandum of Understanding*
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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ZAMBIA

Staff Report for the 2005 Article IV Consultation, Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver and Modification of Performance Criterion, and Financing Assurances Review

Prepared by the African Department
(In consultation with other departments)

Approved by Siddharth Tiwari and G. Russell Kincaid

December 22, 2005

- Discussions on the 2005 Article IV consultation and third review under the Poverty Reduction and Growth Facility (PRGF) were held in Lusaka, during October 12-26, 2005. The staff met with the Minister of Finance and National Planning, Mr. Magande; the Deputy Governors of the Bank of Zambia (BoZ), Mr. Mfula and Mr. Kalyalya; other senior officials; representatives of the private sector, trade unions, NGOs, and the donor community.
- The staff comprised Mr. Caramazza (head), Mr. Dunn, Mr. Akatu (all AFR), Mr. Arnason (PDR), Mr. Baldini (FAD), and Mr. Kakoza (Resident Representative). The mission worked closely with World Bank Staff.
- The Board concluded the last Article IV consultation with Zambia on April 7, 2004. On that occasion, the focus of the Fund's advice was on the fragile economic situation and the structural reforms needed to achieve strong growth and poverty reduction. The authorities' policies since then have been broadly in line with Fund advice. Expenditure restraint, including on the wage bill, has helped to put the fiscal operations of the government on a sustainable course and contributed to the attainment of the HIPC completion point. Progress has also been made on the structural reforms agenda, including public expenditure management, public debt management, the resolution of insolvent nonbank financial institutions, and the privatization of the Zambia National Commercial Bank.
- Zambia's three-year PRGF arrangement was approved by the Executive Board on June 16, 2004 in the amount of SDR 220.10 million (45 percent of quota) of which SDR 176.08 million has been drawn. The second review of the program was completed on April 8, 2005 and, at that time Zambia reached the completion point under the enhanced Heavily Indebted Poor Countries Initiative.
- Zambia maintains a managed floating regime, with no pre-announced path for the exchange rate. Zambia has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 of the Articles of Agreement. Zambia maintains an exchange restriction arising from the external payments arrears accumulated prior to October 1985, which is subject to Fund approval.
- Presidential and parliamentary elections are due in 2006. A Constitutional Review Committee (CRC) appointed by the Government with broad terms of reference has presented a draft constitution and an interim report to the Government, after consultation with all stakeholders. A final report is expected by year end.

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EXECUTIVE SUMMARY

Economic Background

- **After more than two decades of economic stagnation, the Zambian economy has, since 2000, achieved sustained robust growth.** Inflation, however, has remained high and poverty, though declining, is still widespread.
- **Zambia's external position has strengthened in recent years**, as the terms of trade recorded a marked improvement and nontraditional exports grew strongly. The exchange rate has appreciated strongly in real terms during the past year, but foreign exchange reserves are low. Extensive debt relief has greatly reduced Zambia's external debt burden. Implementation of the MDRI would cancel the bulk of the remaining external debt.

Policy Issues

- **The main challenge facing Zambia** is to seize the opportunity provided by debt relief and the prospect of rising external assistance to build upon the recent improvement in economic performance. The authorities' strategy seeks to promote macroeconomic stability, private sector growth, improved public sector management and development of the financial sector.
- **A reduction in government domestic borrowing will continue to anchor the stabilization effort**. To avoid a renewed buildup of unsustainable external debt, the authorities are committed to a prudent borrowing policy and to strengthening their debt management capacity.
- **Monetary policy aims to reduce inflation to single digits by 2007**.
- **The high external value of the currency may pose a challenge for nontraditional exports**, which will have to rely on improvements in productivity to enhance international competitiveness.

Program for 2006

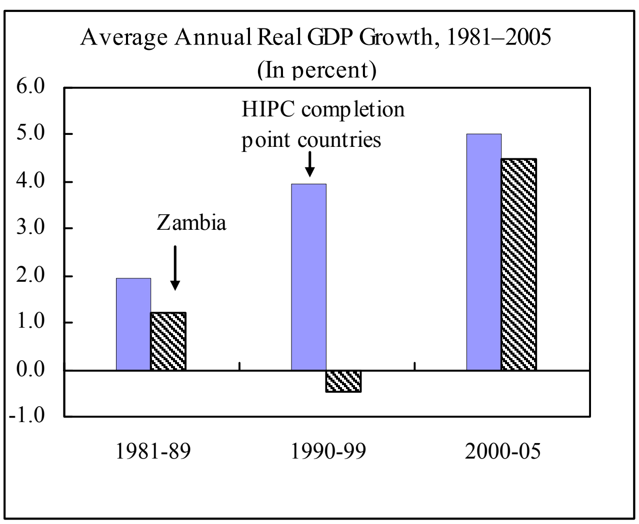
- **Performance under the PRGF program has been broadly satisfactory**. The authorities have requested two modifications to the program: one, an upward adjustment of the end-2005 ceiling on net domestic financing for the sole purpose of clearing the bulk of domestic arrears to road contractors; and two, a rescheduling of the initiation of the IFMIS pilot.
- **The program for 2006 aims to promote macroeconomic stability and achieve robust economic growth.** Real GDP is projected to grow by 6 percent, while end-year inflation is brought down to 10 percent. The overall fiscal deficit is projected to remain roughly unchanged, but domestic financing would be reduced modestly, notwithstanding spending for elections, while spending on poverty-reducing programs is increased. The structural program builds on the 2005 program in seeking to strengthen public expenditure and debt management, financial sector development, and governance and transparency.

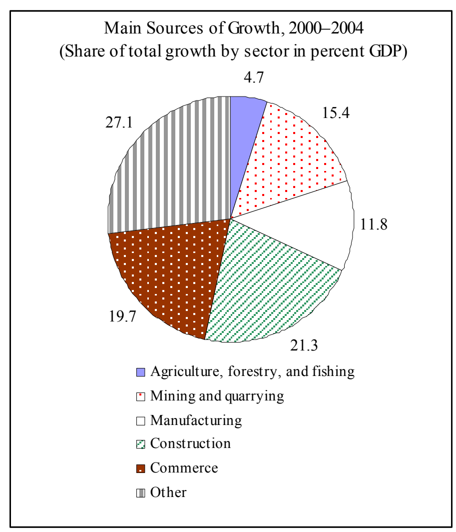
I. Economic Developments: A Marked Turnaround In Economic Performance

Real GDP growth averaged 4½ percent a year during 2000–2005, a marked turnaround after more than two decades of economic stagnation and falling per capita income. Inflation, however, remains high, international reserves are low, and poverty is still widespread. A significant fiscal adjustment begun in 2004, has reduced the government's domestic financing need, eased pressures to monetize debt, and curbed crowding out of bank credit to the private sector. In 2005, Zambia received extensive debt relief, which has greatly reduced its external debt burden. While this removes a major vulnerability, the Zambian economy is still susceptible to climatic and terms of trade shocks.

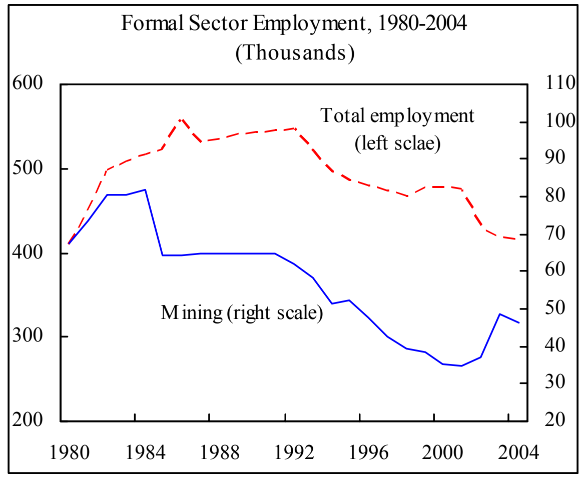
A. Robust Growth But Inflation Still High

1. **After two decades of poor performance, the Zambian economy has, since 2000, achieved sustained robust growth** (Tables 1 and 2 and Figure 1). The construction sector has performed particularly well, driven mainly by strong demand for housing, while the mining sector has undergone a substantial recovery in the wake of privatization and rising world prices for copper. Agricultural sector growth has been restrained, however, by adverse climatic conditions, which depressed production of food crops in some years. Economic activity in 2005 has been weaker than expected, owing to a drought-related shortfall in maize production and temporary setbacks in the mining sector associated with labor disputes and mining accidents. Moreover, in the second half of the year, fuel shortages caused by shutdowns of the country's oil refinery further curtailed mining production and disrupted economic activity more broadly. Real GDP in 2005 is projected to grow 4.3 percent in 2005, compared with 5 percent anticipated in the PRGF-supported program.



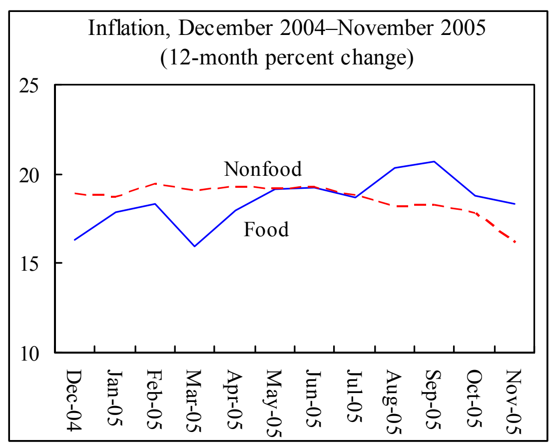


2. **Despite the broad-based economic recovery and the growth of employment in the mining sector, total formal sector employment has continued to decline.** Contributing to this have been declining employment in state-owned enterprises, the short- to medium-term effect of restructuring of privatized firms and the disincentives to new hirings created by costly regulations, especially high termination benefits. While Zambia scores relatively well with respect to the overall ease of doing business, it ranks as one of the costliest countries for terminating employment.[1] It should be noted that the data on formal sector employment does not present a full picture of the employment situation, however, as employment subject to fewer regulations, such as short-term contract workers and farmers in outcropper arrangements, has experienced strong growth.



3. **Poverty has been reduced, but is still widespread, reflecting, in part, the low growth rates in agriculture and the limited employment in, and multiplier effects of, mining.** In 2004, 67 percent of the population fell below the poverty line—a modest improvement from the 73 percent in 1998. While Zambia's prospects for reaching the Millennium Development Goals (MDGs) have improved in recent years, it still faces a number of challenges—in particular, sustained, higher pro-poor growth and greater financial and human resources for the social sectors will be required to accelerate progress toward achieving the MDGs (Appendix V).

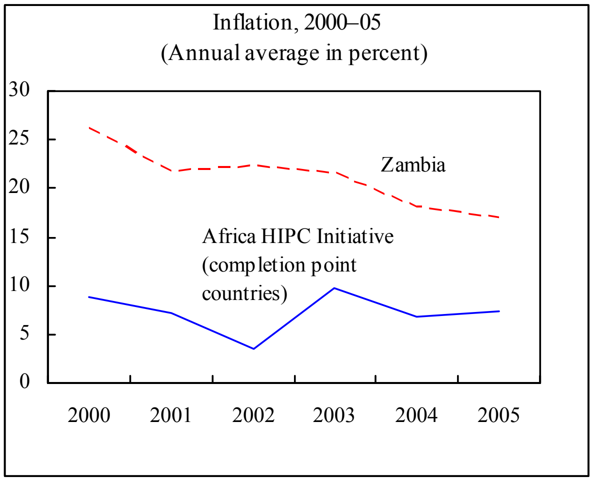
4. **Inflation has fallen sharply from the extremely high rates experienced during the 1990s, but has remained high at around 20 percent, well-above the single-digit rates achieved by other HIPC completion point countries.** Sustaining these high rates of inflation have been fiscally-induced rapid rates of monetary expansion with growth in broad money exceeding 30 percent a year, on average, in 2000–2004.[2] In 2005, broad money growth has been curtailed sharply, but inflation has remained high, partly reflecting the lagged effect of the monetary expansion in 2004, but

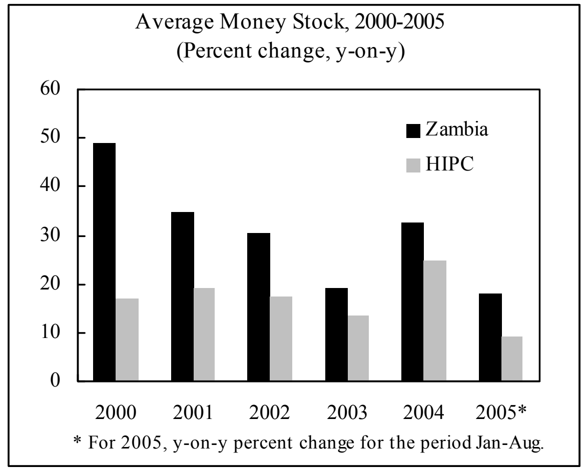


[1] The estimated cost of dismissing an employee, at 176 weeks of wages, is the second highest in the 155 countries surveyed in the World Bank's Cost of Doing Business.

[2] For a fuller analysis of the relationship between fiscal deficits and inflation, see Zambia: Selected Issues and Statistical Appendix.

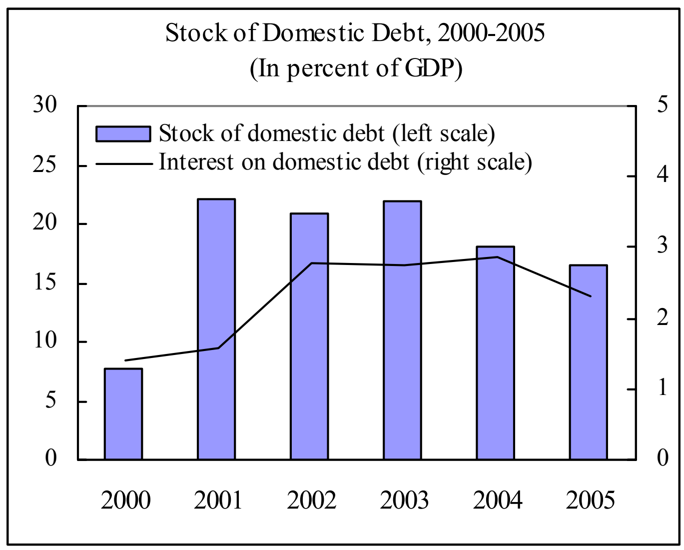
also the effects of the drought-induced increase in maize prices and higher world oil prices.





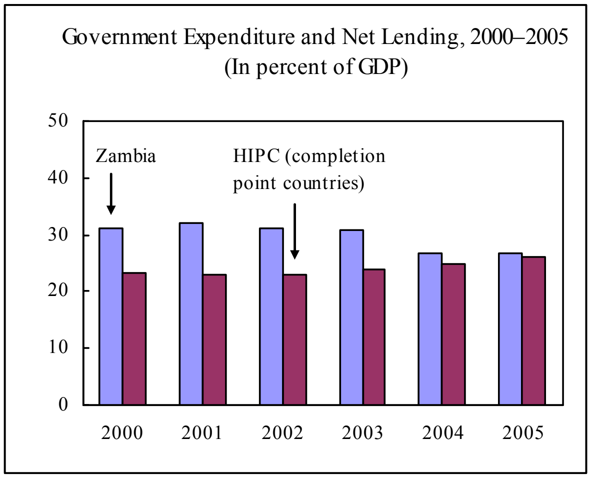
B. Fiscal Consolidation and Strengthened Public Expenditure Management Systems

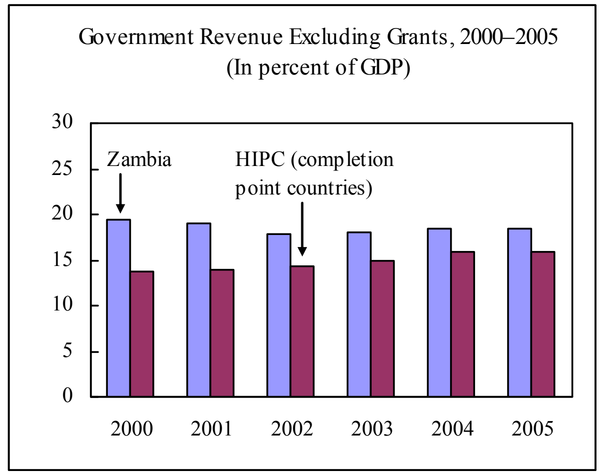
5. **Zambia has begun to address the weaknesses in fiscal policy that had hindered efforts to achieve greater macroeconomic stability, and in 2004-05 recorded a substantial improvement** (Tables 3 and 4 and Figure 2). Although government revenue has performed relatively well, poor control over spending, particularly of the wage bill, and a decline in net external financing resulted in large government domestic borrowing and rising domestic debt-servicing costs in 2001-03.[3] In addition, spending on poverty-reducing programs (PRPs) fell short of budget intentions. In 2004 and 2005, the government managed to turn this situation around. By exercising strict discipline on spending, including a



[3] In 2001, the restructuring of the balance sheets of the Bank of Zambia and the state-owned Zambia National Commercial Bank resulted in a large issuance of government securities.

cap on the wage bill, the government greatly reduced its domestic borrowing requirement, while meeting the expenditure target for the PRPs.





6. **In 2005, overall fiscal performance was satisfactory through the third quarter, with both revenue and expenditure broadly in line with program objectives.** In October, in the context of a fuel crisis brought about by the breakdown of the oil refinery, the government reduced import and excise duties on petroleum products for the remainder of the year so as to stem a sharp escalation in retail prices of fuel and encourage oil marketing companies to directly import-finished petroleum products. This is estimated to lower tax revenue by about 0.1 percent of GDP. Nevertheless, for the year as a whole, revenues are expected to be in line with the program target. Domestic financing of the budget is expected to be 1.9-2.2 percent of GDP, depending on the extent of clearance of arrears to road contractors (see below).

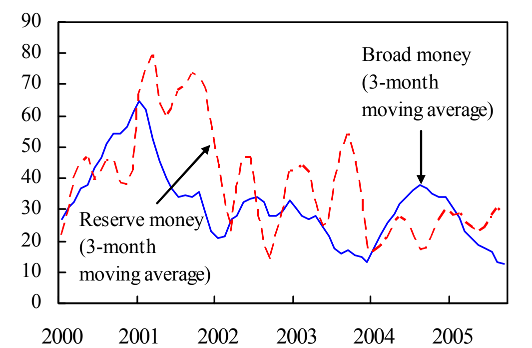
7. **Progress has also been made in strengthening public expenditure management (PEM) systems, but weaknesses continue to hamper the effective delivery of public services.** In 2003, Zambia ranked among the weakest performers among HIPC countries in regard to PEM—it met only 3 of 16 criteria for sound PEM.[4] Procedures for budget planning, execution, and monitoring allowed for little oversight, resulting in inefficiencies, the accumulation of domestic arrears, and limited accountability. By end-2004, an additional three criteria were satisfied, including the preparation of Zambia's first medium-term expenditure framework (MTEF). With support from donors, the government officially embarked on the comprehensive Public Expenditure Management and Financial Accountability (PEMFA) reform program in June 2005, aimed at (i) strengthening existing PEM systems, while implementing a modern integrated financial management and information system (IFMIS); (ii) improving debt management capabilities; and (iii) increasing transparency and accountability.

[4] On average, sub-Saharan HIPC countries met six benchmarks in 2003/04. See Update on the Assessments and Implementation of Action Plans to Strengthen Capacity of HIPCs to Track Poverty-Reducing Public Spending (April 12, 2005).

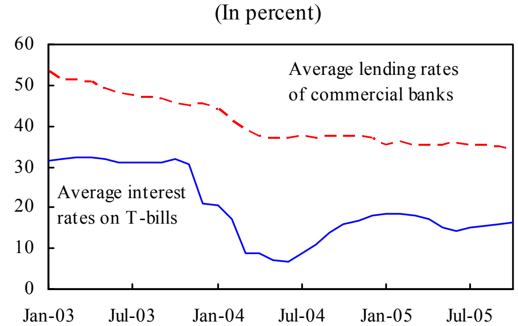
C. Monetary Expansion Being Brought Under Control

8. **After several years of excessive monetary expansion, driven by persistently large fiscal deficits, the Bank of Zambia (BoZ) adopted a firmer monetary policy in 2005 (Tables 5 and 6).** Fiscal adjustment and efforts by the BoZ to mop up excessive liquidity in the banking system contributed to a decline in the 12-month rate of growth of reserve money from over 60 percent in 2000 to 23 percent at end-December 2004. Over the same period, the growth of broad money fell by half, to 31 percent (Figure 3). Continued fiscal discipline contributed to a substantial further decline in reserve money and broad money growth, to a twelve-month rate of 12 percent and 16 percent, respectively, in September 2005. The cutback in government borrowing helped to lower market interest rates and crowd in private sector credit, which has expanded at a rapid pace, albeit from a low base. However, lending rates have remained high, largely reflecting the slow progress in lowering inflation. The expansion of credit to the private sector in 2005 has been supported also by a shift in bank's portfolios out of foreign assets to take advantage of more favorable yields on domestic securities. To foster the development of a long-term bond market, in August 2005, the government introduced three- and five-year bonds.

Monetary Developments, January 2000–September 2005
(Percent change, y-on-y)



Treasury Bill Rates and Average Lending Rates of Commercial Banks, January 2003–October 2005
(In percent)



Source: Zambian authorities.

9. **The recent improvement in the fiscal position has allowed the BoZ to exercise more effective control of overall liquidity. Nonetheless, liquidity management has at times continued to be problematic**, owing to inadequate coordination between the monetary and fiscal authorities and shifting objectives over the direction of interest rates, exchange rates, and reserve accumulation. This has tended to obscure policy signals.[5]

10. **The banking sector remains generally sound**. Risk-weighted capital-asset ratios are on average more than double the statutory requirement of 10 percent (Table 7), and the ratio of nonperforming loans (NPLs) to total loans declined sharply following the restructuring of Zambia National Commercial Bank (ZNCB) in 2001. Furthermore, loan loss provisions are generally adequate. Earnings have been generally strong and bank liquidity has continued to be high by regional and international standards. In recent months, however, NPLs have risen,

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[5] See the sector on implementation of monetary policy in Zambia: Selected Issues and Statistical Appendix.

mainly reflecting difficulties in the agricultural sector.[6] During 2005, commercial banks have reduced their net foreign asset position as they rebalanced their portfolios in favor of domestic assets. The desired portfolio adjustment has been mainly achieved and only a further small decline in commercial banks' NFA is projected in 2006. Banks' net open position in foreign exchange relative to capital has declined further during 2005, pointing to a reduced vulnerability.[7]

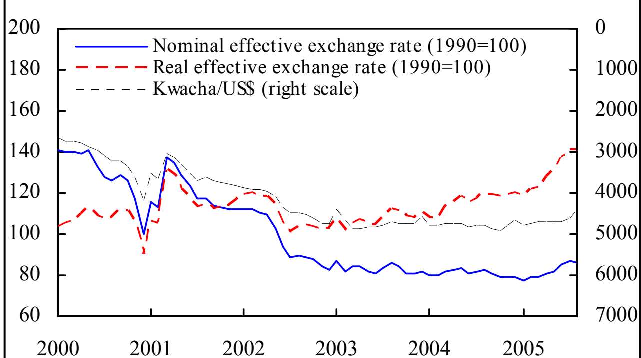
Bank Financial Soundness Indicators
(In percent)

	Regulatory capital to risk-weighted assets			Nonperforming loans to total loans			Return on assets		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Zambia	28.0	23.7	22.2	11.4	5.3	7.6	6.5	5.4	3.1
Sub-Saharan Africa	17.7	16.6	16.9	16.9	14.6	13.3	2.1	3.1	3.1

D. Improved Terms of Trade and Debt Relief Strengthen Exchange Rate and the External Position

11. **Zambia maintains a flexible exchange rate regime.[8]** During 2000-04, the kwacha was fairly stable in real effective terms, but it has since appreciated strongly (19 percent from December 2004 to September 2005).[9] The appreciation has been associated with a marked strengthening of market sentiment stemming from record high world prices for copper, a perceived continued commitment to prudent fiscal and monetary policies, and a marked improvement in Zambia's debt sustainability outlook with the

Exchange Rates, January 2000–August 2005



Source: IMF, Information Notice System.

[6] The ratio of NPLs to total loans rose to 10.8 percent in July 2005, from 7.6 percent in December 2004, before declining to 8.6 percent in August 2005. The ratio of the provision for loan losses to NPLs rose to 60.6 percent in August 2005 from 53.9 percent in July.

[7] The ratio of official reserves to foreign currency deposits also rose, from 51 percent in December 2004 to 72 percent in July 2005.

[8] The regime is classified as managed floating. The exchange rate is market determined, with BoZ intervention in the interbank foreign exchange market, aimed at smoothing short-run fluctuations and meeting the program's gross international reserves target.

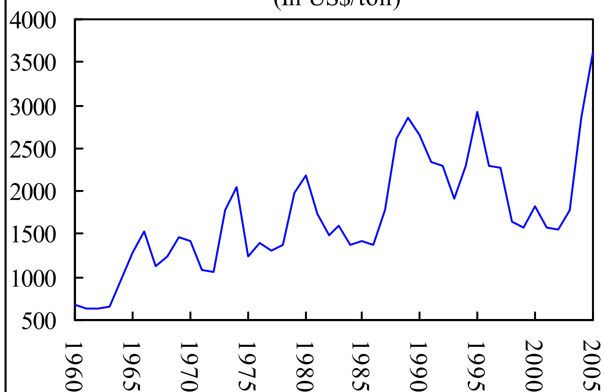
[9] The kwacha continued to appreciate in October and November. Against the U.S. dollar, the kwacha was, at end-November, 27 percent stronger than at the beginning of the year.

attainment of the completion point under the HIPC Initiative and the prospect of further substantial debt relief under the Multilateral Debt Relief Initiative (MDRI) (Box 1). Speculative inflows, aimed at taking advantage of relatively high yields on government securities, have also been reported.

12. **Zambia's gross international reserves have increased gradually in recent years, but import coverage remains low.** The import coverage of reserves is projected to rise to 1.4 months at end-2005, from 1.2 months at end-2004, reflecting BoZ purchases on the foreign exchange market at various times during the year. In the past, Zambia's policy on accumulating reserves was largely driven by the need to meet external debt-service payments. Having received extensive debt relief in 2005 the immediate pressure of facing a shortfall has eased. End-2005 reserves are estimated to be about three times higher than debt-service payments due in 2006, before taking into account the impact of the MDRI.[10] Moreover, the end-2005 reserve level is also about three times higher than programmed external budget support in 2006, thus providing a buffer for a shortfall in disbursement.

13. **Zambia's external position has strengthened in recent years**. Copper export volumes grew by almost 70 percent between 2000 and 2004, and are projected to increase by another 6 percent in 2005. World copper prices have at the same time risen to record levels. Nontraditional exports, have also grown strongly, more than doubling in U.S. dollar terms between 2000 and 2005. While imports have grown strongly as well, partly as a result of high levels of investment in the mining sector and, more recently, because of high world oil prices, the current account deficit (excluding grants) has narrowed sharply, from about 20 percent of GDP to 11 percent in 2004. In 2005, the current account deficit (excluding grants) is projected to widen slightly to about 12 percent of GDP. External grant financing, primarily in the form of project support, has remained fairly stable in nominal terms but has declined relative to GDP. In contrast, external budget support has exhibited considerable volatility but is estimated to roughly double in 2005, to about 2 percent of GDP, partly as a result of greater donor coordination under the Wider Harmonization in Practice program (Tables 8 and 9 and Figure 4).

Copper Prices, 1960–2005
(In US$/ton)



Source: London Metal Exchange.

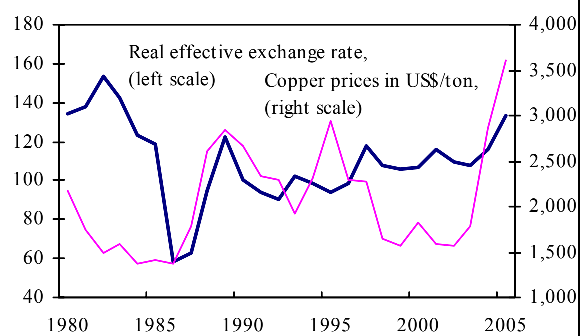
[10] Programmed end-2005 reserves are equal to 11 percent of the estimated end-2005 nominal public and publicly guaranteed debt of about US$3.5 billion. With implementation of the MDRI—through a stock of debt reduction of AfDF, IDA, and the Fund—for which Zambia is likely to qualify, reserves projected at end-2006 would cover about 97 percent of total nominal external debt of about US$500 million.

Box 1. A Long-Term Perspective on the Real Effective Exchange Rate

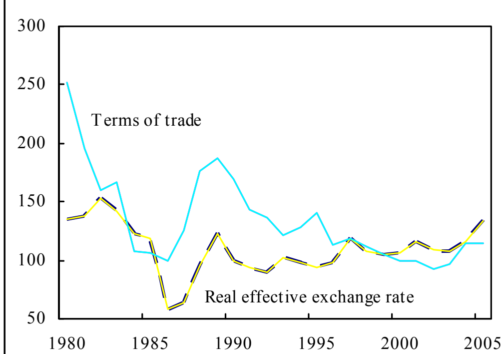
Long-term movements in the kwacha's real effective exchange rate reflect the vagaries of the Zambian economy and especially the swings in world prices of copper. During the first decade of independence, in 1964, Zambia enjoyed robust export earnings from copper. When copper prices collapsed in the mid-1970s, Zambia resorted to large scale foreign borrowing to finance its import needs and avoid an adjustment to the real exchange rate. However, when access to foreign loans was cut off in the early 1980s, a sharp depreciation of the real exchange rate was inevitable.

Zambia undertook extensive liberalization of the foreign exchange market during 1992-95. The introduction of *bureaux de change*, lifting of controls on current transactions, permission to citizens and non-citizens to hold foreign currency accounts enabled market forces to play a larger role in the determination of the exchange rate, although the Bank of Zambia was able to exert influence over it through the Bank's regular auctions. An interbank market in foreign exchange was established in 2003. Currently, the Bank of Zambia intervenes in the sometimes thin foreign exchange market to smooth excessive volatility and to meet its reserve targets.

Real Effective Exchange Rate and Copper Prices, 1980-2005, (1990=100)



Real Effective Exchange Rate and Terms of Trade, 1980-2005



Over the last year, the real effective exchange rate of the kwacha has appreciated sharply. The appreciation has been particularly steep in recent months. It stems from an improvement in the terms of trade and renewed confidence in the economy, resulting from the marked improvement in fiscal performance and the international commitment of extensive debt relief. Interest in government securities, both domestically and abroad, has also been strong owing to their high nominal yields. This has been reflected in the drawdown of the net foreign asset position of commercial banks.

From a long-term perspective, the appreciation of the kwacha during the past year may be seen as an adjustment to the upward shift in the equilibrium real value of the exchange rate, as a result of the greatly improved prospects of the copper sector and cancellation of the bulk of Zambia's external debt. But while this suggests that the kwacha may not be overvalued currently, the higher external value of the currency may pose a challenge for nontraditional exports, which will have to rely on improvements in productivity to enhance their international competitiveness.

14. **Zambia's debt sustainability outlook has improved markedly with the attainment of the completion point under the HIPC Initiative and the favorable trend in exports in recent years**. Taking into account HIPC Initiative and additional bilateral debt relief (Box 2), Zambia's stock of external debt relative to current year exports of goods and services is projected to be 66 percent at end-2005 based on calculations using the LIC DSA framework (Appendix VI).[11] Moreover, Zambia's external debt and debt-service indicators remain quite low over the long term. Stress tests suggest a sharp curtailment of export earnings—for example, associated with a precipitous drop in world copper prices—could cause the NPV of debt-to-exports ratio to temporarily rise again above its LIC DSA threshold of 150 percent. This scenario underscores Zambia's continued vulnerability to external shocks. Implementation of the MDRI would further improve Zambia's debt sustainability outlook as it would cancel the bulk of remaining external debt. It is the joint view of Fund and Bank staff that Zambia is at low risk of debt distress.

Box 2. Paris Club Agreement

Representatives of Paris Club creditors met on May 11, 2005 and agreed to recommend to their governments a reduction of Zambia's external debt. In order to contribute to the restoration of Zambia's debt sustainability, they recommended that debts of US$1,403 million in nominal terms be cancelled; this represents the Paris Club's share of the debt relief effort under the enhanced HIPC Initiative. All creditors but one (Russia) also committed on a bilateral basis to cancelling their remaining claims on Zambia of US$393 million. As a result of this agreement, Zambia's debt to Paris Club creditors would be reduced from US$1,920 million to US$125 million. Moreover, Russia agreed to defer one half of debt service due during 2005-07 to 2009-11. The Zambian government is actively pursuing bilateral agreements with Paris Club creditors, including Russia, based on the agreed minutes of the May 2005 Paris Club meeting.

15. **Despite the recent improvements in economic performance, many challenges lie ahead for Zambia.** For poverty levels to be substantially reduced and to attain the other MDGs, substantially higher rates of pro-poor economic growth will have to be attained; service quality and delivery will have to be markedly improved to address the HIV/AIDS pandemic and provide better quality and access to education and health care; and financial and human resources will need to be significantly scaled up. The government is preparing a New

[11] At the completion point, the end-2005 NPV of debt-to-exports ratio was projected to be 118 percent. The largest contributor to this difference is a higher denominator, both because of an upward revision in estimates of exports in 2004 and 2005 and the switch from a three-year average of exports to current-year exports. Another important contributing factor, is the use of the standard 5 percent discount rate, rather the average six-month CIRR rate in the completion point calculations of 4.2 percent.

Development Plan (NDP) aimed at addressing these challenges, which is expected to be launched in early 2006 (Box 3).

Box 3. The Fifth National Development Plan, 2006–10

The fifth National Development Plan (NDP), covering 2006–10, is expected to be issued in early 2006 and will serve as Zambia's revised Poverty Reduction Strategy Paper (PRSP). The NDP has been prepared through a highly participatory process, including consultations on local needs in each of Zambia's 72 districts. Sector Advisory Groups (SAGs), chaired by government officials and comprised of a variety of stakeholders, including representatives from civil society and the donor community, have drafted chapters for the NDP, which are now being finalized.

The NDP reviews Zambia's improved economic performance in recent years under the current PRSP. Building on lessons from this period, the NDP emphasizes macroeconomic stability as necessary for achieving sustainable high rates of growth under the baseline scenario. The NDP further proposes alternative scenarios that aim for greater pro-poor growth, mainly through higher growth in labor intensive sectors—notably, agriculture, agro-processing and other manufacturing, and tourism. Under the "core" alternative scenario, additional donor assistance would be used to finance infrastructure investments to support these sectors, as well as to step up provision of social services for the poor (mainly health, education, and water and sanitation).

II. Medium-Term Prospects and Policies: Consolidating Macroeconomic Stability and Advancing Structural Reforms

Against this background, the main economic task facing Zambia is to seize the opportunity provided by debt relief and the prospect of rising external assistance to build upon the recent improvement in economic performance. Policy discussions focused on achieving greater macroeconomic stability, anchored in a further reduction in government's domestic borrowing, and implementation of structural reforms to support private sector-led growth, improve public sector management, and increase competitiveness, as emphasized in the forthcoming NDP.

16. **Zambia's growth prospects over the medium term are favorable (Table 10).** Real GDP growth is projected to pick up to about 6 percent a year, partly as a result of the coming on stream of a number of recent and ongoing large-scale private investments in the mining electricity, and manufacturing sectors.[12] More generally, with the authorities' commitment to achieve greater macroeconomic stability and implement an agenda of structural reforms to support development in the financial and private sectors, it is expected that over the medium term, gross national savings and gross domestic investment would remain near the stepped-up levels achieved in recent years (18 percent and 23 percent respectively, during 2006-10). To

[12] Given that much of this investment has already taken place, the likelihood of a significant pick up in production is high.

enhance the poverty-reducing qualities of economic growth, however, it is important to also develop more labor intensive sectors. As discussed in the NDP, the authorities have outlined an alternative pro-poor growth scenario that, with a scaling up of donor assistance, includes greater infrastructure investment to support agriculture and manufacturing (mainly processing of agricultural and mining products) and extend growth opportunities to small and medium-sized enterprises (Box 4). The authorities agreed that sustained macroeconomic stability is essential for creating an environment conducive to savings and investment. Moreover, as recognized in the NDP, it is vital to pursue the reform agenda under the Private Sector Development Initiative (PSDI) and the Financial Sector Development Plan (FSDP) aimed at removing impediments to doing business and expanding access to credit.

17. **Low inflation, anchored on a prudent fiscal policy, is critical for attaining higher rates of economic growth.** The authorities remain committed to lowering inflation to single digits by 2007, supported by a reduction in government's domestic borrowing (see memorandum of economic and financial policies (MEFP)). With growth in broad money consistent with inflation of 5 percent a year, the attenuation in government borrowing would allow for a robust expansion of bank credit to the private sector, while simultaneously achieving a gradual buildup in international reserves (to about 3 months of imports by 2010). The authorities emphasized that extraordinary expenditures related to the constitutional review and referendum in 2007-08 constrain the scope for a greater reduction in government net domestic financing and a greater accumulation of international reserves.

A. Fiscal Policy

18. **In the years ahead, fiscal policy will be guided by the need to achieve and maintain macroeconomic stability and debt sustainability.** The LIC DSA shows that under projected fiscal deficits, the debt burden indicators, which are already well below the relevant thresholds in 2005, would decline further. While this suggests that Zambia has considerable room to run larger fiscal deficits over the medium term (by over 3 percentage points of GDP), if it aimed to simply stabilize debt relative to GDP, the authorities and staff agreed that the scope for using that room is very limited. Higher fiscal deficits financed by domestic borrowing would sustain inflation pressures and crowd out credit to the private sector. Moreover, under standard alternative scenarios and stress tests, the projected debt dynamics are less favorable than in the baseline scenario, which builds on the successful fiscal adjustment that Zambia has undertaken in recent years and incorporates the authorities' objective of limiting domestic financing to ½ percent of GDP a year over the long term. In particular, in a scenario in which key variables, including real GDP growth and the primary balance, are set at their historical averages, and the resulting financing requirement is met by additional domestic borrowing, the debt burden indicators deteriorate significantly—for instance, the cost of servicing public debt doubles over the next ten years to 25 percent of revenue.

Box 4. Macroeconomic Effects of Scaling Up of Donor Assistance

A significant scaling up of donor assistance would be required to finance the "core" alternative policy scenario being developed for the NDP, which envisages a strong expansion of government programs in rural infrastructure, health services, and education. In this scenario, annual donor inflows would increase by US$70 million (about 1 percent of GDP) a year during 2006–10,[1] before leveling off at US$350 million a year above baseline projections. The increased assistance is expected to be in the form of grants. Additional resources would also be available from the MDRI, which would peak at just over US$150 million in 2010.

Staff estimates that the projected rise in donor assistance and government spending over the next 5 years would provide a substantial stimulus to the Zambian economy (Table). Real GDP growth would rise to an average 6½ percent a year, as shortages of skilled labor, particularly health workers, would dampen the effect of the stimulus. The additional supply of foreign exchange, much of which would be sold by the BoZ to mop up injections of liquidity from higher government spending, would create modest appreciation pressures on the Zambian kwacha and contribute to a widening of the trade deficit in goods and services. Higher reserve accumulation would be desirable, given the greater dependence on donor support. To achieve this goal the authorities would need to issue additional government securities (less than ½ percent of GDP a year) to help mop up liquidity.

The positive impact on growth would extend over the longer term, as productivity increases from greater infrastructure investment and, with a longer lag, the higher spending on education and health. Real GDP growth is projected to remain at about 6½ –7 percent beyond 2010, while export growth would pickup substantially.

Table. Medium-Term Macroeconomic Effects of Scaling Up Donor Assistance

	2006	2007	2008	2009	2010
			(In percent of GDP)		
Donor support	8.3	9.1	9.7	10.3	10.9
Grants	6.0	6.9	7.3	7.9	8.3
Loans	1.7	1.3	1.3	1.3	1.3
MDRI assistance	0.6	0.8	1.1	1.1	1.4
Overall fiscal balance including grants 1/	-2.6	-1.8	-1.4	-1.6	-1.7
Overall fiscal balance excluding grants	-9.2	-9.6	-9.8	-10.6	-11.4
External current account balance excluding grants	-12.0	-11.2	-12.6	-13.1	-12.9
			(In annual percentage change)		
Real GDP growth	6.5	6.4	6.4	6.4	6.5
CPI (end of period)	10.0	5.0	5.0	5.0	5.0
Real exchange rate (appreciation +) 2/	1.6	1.3	1.3	1.0	1.3
Export 3/	9.5	6.5	-0.9	1.6	5.2
Imports 3/	12.7	9.1	7.9	7.2	7.6
Gross international reserves (in millions of U.S. dollars)	380	505	705	904	1,167
(In months of imports)	1.6	1.9	2.5	3.0	3.5

Source: Fund staff projections.

1/ Includes assistance from MDRI.

2/ Differences from the baseline projection.

3/ Percentage change of exports and imports as measured in U.S. dollars.

19. **To avoid a renewed build up of unsustainable external debt, the government is committed to a prudent borrowing policy and to strengthening its debt management capacity**. While the LIC DSA framework suggests that Zambia could have considerable scope for new external borrowing, Zambia's debt sustainability could be vulnerable in certain circumstances, in particular, in case of a strong negative shock to exports. The staff agreed with the authorities that this vulnerability and Zambia's past record on external debt management suggest caution regarding new external borrowing, whether on concessional terms or not. These considerations also underscore the need for Zambia to strengthen its external debt management capacity. The authorities noted that the government would continue to seek loans on concessional terms, and adhere to the general principle underlying its external borrowing strategy: that new loans be on terms aligned with the country's repayment capacity. Furthermore, consideration would have to be given to absorptive capacity and the need to further strengthen PEM systems to ensure effective use of public resources. Indeed, donors have made any scaling up of budget support contingent on good execution of PEMFA reforms. With regard to debt management capacity, since 2004, the government has been implementing a debt reform and capacity building program with support from the World Bank under the PEMFA project. In the initial phase, the focus has been on strengthening the back office function at the Ministry of Finance and National Planning. However, the objective is to have in place a comprehensive debt management strategy by 2006.

20. **A reduction in government domestic borrowing will continue to anchor the macroeconomic stabilization effort, and is needed to give the macroeconomic framework credibility in light of entrenched expectations of high inflation**. The medium-term fiscal framework envisages a reduction in government domestic borrowing to 1.6 percent of GDP in 2006, 1.0 percent in 2007, and 0.5 percent in 2008. This consolidation will be achieved while reorienting expenditures towards pro-poor growth programs, especially in the areas of infrastructure, development of agriculture, education, and health. Particular attention will also be paid to the payment of domestic arrears.

21. **The overall objective of the government's tax policy is to have a broad-based tax system that raises revenue in an equitable and efficient way.** In this respect, certain features of the current system will undergo a comprehensive review in 2006: the progressivity of the tax system; the relatively low yield from VAT; the narrow personal income tax base; and the extent and scope of tax incentives, especially in the mining sector.[13] Red tape in tax administration will also be a focus of attention. Efforts will also be directed to improving tax administration through the establishment of performance targets for the Zambia Revenue Authority. The staff further proposed a review of the structure and performance of nontax revenue, as the levels of fees and charges have been eroded by inflation and enforcement has been poor. Government revenue is projected to rise gradually to around 18½ percent of GDP.

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[13] In November 2005, an FAD technical assistance mission visited Lusaka to advise on taxation and royalty rates in the mining sector.

22. **Stronger economic growth, increased external assistance, and reduced servicing costs for both domestic and external debt should provide fiscal space for increased spending on infrastructure, health, education, and other PRPs.** Based on current commitments, donor support is projected to increase by about US$30 million a year over the medium term, while annual debt relief under the HIPC Initiative will average about US$130 million a year. Falling domestic interest payments (relative to GDP) would be a source of budget savings. The strengthening of budget planning and execution, however, is essential for achieving public sector efficiencies and sustainable savings. Moreover, donor assistance, primarily in the form of grants, could increase substantially in the event of strong progress with the PEMFA reforms and the implementation of a well-designed NDP, further increasing the scope for spending on the PRPs.

23. **The public pension system is insolvent and poses a serious risk to the public finances.** The two public sector schemes—the Public Service Pension Fund (PSPF) and the Local Authorities Superannuation Fund (LASF)—are both insolvent, with actuarial deficits equivalent to about 9 percent of GDP. However, both are owed considerable amounts in contribution arrears. The other pension fund, the National Pension Scheme Authority (NAPSA), which is the largest of the funds, is solvent but faces challenges with respect to capacity building in asset management. A financial reform program for PSPF and LASF has been prepared. Reform is likely to be contentious, however, since the benefit levels in these schemes are high relative to contributions and protected in the constitution.[14] To ensure that over the medium term (while the reform of the public pension system is being implemented) adequate resources will be available to meet the government's obligations on the cash-flow deficit of the PSPF, the PRGF program includes additional budget allocations (0.3 percent of GDP in 2006) for paying down the outstanding arrears on the government's contributions to the PSPF.

24. **In a significant step forward in the area of budget planning, the MTEF for 2006–08 explicitly allocates substantial resources to clear outstanding domestic arrears and meet forthcoming contingent liabilities, most notably statutory obligations associated with the projected cash flow deficit in the public sector pension fund (PSPF).** The PSPF is projected to incur cash-flow deficits on the order of ½ percent of GDP a year over the foreseeable future. Paying down outstanding arrears on government contributions to the PSPF (estimated at about 1¼ percent of GDP in 2005) would mostly cover the deficit over the MTEF's horizon, but a

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[14] The World Bank has the lead role in the reform of the pension system. The Economic Management and Growth Credit has two credit release milestones for the second tranche (December 2005). These are: One, Cabinet approval of (i) a proposal to the Constitutional Review Commission to change the relevant articles in the constitution to enable PSPF reforms to be applicable to existing participants in PSPF, and (ii) a reform program that ensures the financial sustainability of PSPF. Two, requesting that NAPSA has (i) adopted a revised investment policy, appointed a global custodian, and selected a pension fund manager; (ii) drafted an operations manual on corporate governance; and (iii) developed a program for training trustees. The World Bank staff has concluded that satisfactory progress has been made in both of these milestones. The World Bank is also providing technical assistance to Zambia on pension reform.

comprehensive reform of the PSPF is needed to achieve longer-term solvency. Moreover, the government is taking steps to identify and quantify all such pension obligations.

B. Monetary and Exchange Rate Policy

25. **Going forward, staff and the authorities agreed that the inflation outlook is more benign but saw the need for monetary policy to remain appropriately tight.** In particular, the supply-side pressures on prices experienced in 2005 were likely to dissipate. However, there was also agreement that expectations of high inflation are entrenched and that policy needs to remain sufficiently firm until inflation assumed a clearly downward trend. The authorities restated their commitment to reduce inflation to single digit over the medium term while recognizing the need to improve the implementation of policy. In this regard, to improve liquidity management, coordination between the MoFNP and the BoZ is being strengthened, including by improving the coverage and timeliness of data on government fiscal operations and improving the liquidity forecasting framework. Furthermore, the Bank of Zambia has submitted to the Constitutional Review Commission proposed changes to the Constitution to enhance the operational independence of the central bank.

26. **Staff and the authorities concurred that while the banking sector remained generally sound, lending portfolios would continue to be closely monitored.** Staff cautioned that the strong growth of private sector credit, especially since 2004, called for greater scrutiny of lending standards and close monitoring of the quality of assets in light of the rise in NPLs. In response, the authorities indicated that appropriate remedial actions had been mandated where warranted and that progress had been made in all cases. They observed that the surge in household credit carried relatively moderate risk as it was generally in the nature of asset-backed lending. In addition, the BoZ has increased the number of on-site inspections and is moving toward adopting risk-focused supervision, to enhance the effectiveness of available resources.

27. **The authorities remain committed to a flexible exchange rate regime**. The foreign exchange market in Zambia was substantially liberalized in 1992-95, and since 2003, the exchange rate of the kwacha is determined in the interbank market. The Bank of Zambia only intervenes in the interbank market to smooth temporary fluctuations in the exchange rate and to meet international reserve objectives. Staff concurred that this regime is appropriate for Zambia.

28. **The authorities were cognizant of the potential impact of a large, sustained appreciation in the real effective exchange rate on the international competitiveness of nontraditional exports and domestic manufacturers.** They felt, however, that it would neither be feasible nor appropriate for the Bank of Zambia to attempt to resist an appreciation of the currency brought about by a fundamental improvement in the country's external prospects and the resulting changes in market sentiment. The staff concurred, but noted that the monetary program provided some scope for leaning against the wind in the foreign exchange market to dampen the strong appreciation of the kwacha and buildup reserves. The authorities remarked that the Bank of Zambia's ability to engage in sterilized intervention is limited and can be costly, while nonsterilized foreign exchange purchases would conflict with the overriding

objective of bringing inflation under control through tight monetary policy.[15] Staff suggested that the authorities consider coordinating domestic financing operations and Bank of Zambia foreign exchange purchases to achieve the effect of sterilization. An important question was the degree to which the recent appreciation would be sustained. The authorities and staff agreed that exchange rate developments should be closely watched.

C. External Sector Policies

29. **The government's external sector objectives are to sustain a viable current account balance, improve the international competitiveness of the economy, and maintain a sustainable external debt position**. In the authorities' view, export growth is key to a viable current account balance and productivity growth is key to improved international competitiveness. Although the mining sector will continue to make a large contribution to exports over the medium and long run, especially with the reinvestments in the Copperbelt mines and the opening of new mines in the Northwestern province, Zambia's export development strategy will remain focused on diversification away from copper. The government, therefore, remains committed to an open trade regime that is supportive of export development and diversification of the economy. Zambia is a member of regional trading arrangements—COMESA and SADC—and the WTO. To derive meaningful benefits from these arrangements, Zambia will continue to push for improved market access while simultaneously addressing supply side constraints and improving the competitiveness of domestic economic activities. Regarding potential moves toward a COMESA customs union, the authorities are following discussions on the harmonization of the COMESA and SADC common external tariffs. Staff expressed support for the broad orientation of the authorities' external policies.

30. **Drawing on a recent Diagnostic Trade Integration Study, the authorities have incorporated a number of export promoting trade policy measures into the MTEF and NDP.** Key priorities in trade policy that would help remove impediments to export growth include: (i) making export incentives work for exporters, including through the streamlining of procedures for the duty drawback scheme and improved management of bonded warehouses and RIB (removal in bond), and the establishment of an accessible and affordable export financing facility; (ii) improving trade facilitation, including through greater efficiency in customs administration and strengthened standards and certification services; (iii) strengthening export-oriented investment promotion and export promotion functions; and (iv) strengthening capacity to formulate and implement trade policy and negotiate trade agreements.

D. Structural Reforms

31. **The authorities and staff agreed that macroeconomic stability is necessary but not sufficient to achieve sustained high growth and must be complemented by a broad set of structural reforms to:** (i) improve the business and investment climate; (ii) enhance the delivery of public services and the provision of infrastructure; (iii) strengthen expenditure and financial accountability; (iv) develop the financial sector and improve access to credit; and

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[15] In July, relatively large foreign exchange purchases proved difficult to sterilize and caused reserve money to spike well above the program path.

(v) reduce government's direct involvement in commercial activities and promote competition and improve the efficiency of state-owned enterprises. Reforms in many of these areas are already ongoing in the context of the Public Sector Reform Program (PSRP, which includes the PEMFA reforms), the Financial Sector Development Plan (FSDP), and the Private Sector Development Initiative (PSDI), but require speedier implementation.

32. **The authorities are convinced that progress on the implementation of the PEMFA reform is critical for improving the efficiency and effectiveness of public service and that sufficient confidence in the budget planning, execution, and monitoring systems is a prerequisite for any substantial increase in donor assistance.** The authorities explained that they have followed a two-pronged approach, namely, strengthening current systems (computerizing the existing financial management system, strictly enforcing the commitment control system, rigorously implementing the cash-flow framework), while developing new systems (initiation of an integrated financial management and information system (IFMIS)). In addition, under the PEMFA reform, public finance management, payroll management, debt management, and transparency are targeted for major improvements. While acknowledging that significant progress has been made in the past year in strengthening PEM systems, staff noted that progress in some areas had been slow. The authorities remarked that capacity constraints, including analytical capacities, particularly in line ministries, remain a major challenge but are being addressed with the support of development partners.

33. **Financial sector policies are focused on expanding financial intermediation and access to financial services both in urban and rural areas.** This involves developing a well-functioning micro and rural financial system, developing broad and deep primary and secondary bond markets, and strengthening banking and nonbanking financial institutions. While progress has been made in these areas in the past year, the staff stressed the importance of accelerating progress toward the resolution of state-owned financial institutions. The authorities noted that after having suffered a number of setbacks in recent years, the privatization of ZNCB was moving forward. In October 2005, the Zambia Privatization Authority (ZPA) chose a wholly owned subsidiary of Rabobank of the Netherlands as the preferred bidder for a 49 percent stake in ZNCB. However, this decision was subsequently challenged in court by a rival bidder and discussions between ZPA and Rabobank have been ordered suspended. Staff also stressed the importance of quickening the implementation of measures to broaden access to credit, in particular, the establishment of a credit reference bureau.

34. **The PSDI aims to remove impediments to business activity and investment, such as excessive licensing requirements and regulations, poor delivery of utility services, and restrictive laws on labor and land ownership.** Objectives include the creation of a "One-Stop-Shop" for business investment and the liberalization of the telecommunication gateway. The PSDI got off to a slow start; however, with the recent formation of a PSD steering committee and secretariat the pace of the reform program should quicken.

35. **The focus of the parastatal reform program over the next two to three years will be on improving the operations of the utilities in the energy and telecommunication sectors, namely ZESCO and ZAMTEL.** The strategy being followed is that of commercialization. The process of commercialization of ZESCO began in 2004 and is expected to be completed in 2006. As part of the process, ZESCO began operating under a new business plan on April 1, 2005. ZESCO's management has proposed a large investment agenda that would increase

generation capacity three-fold over the next 10 years at a projected cost of about US$1-1½ billion.[16] In addition to meeting a rapidly growing domestic demand, ZESCO would be prepared to become a major exporter to the region. An evaluation of ZESCO's commercialization will take place following the completion of the first fiscal year under the plan. With regard to ZAMTEL, reform should aim to open up the gateway, facilitate entry of new providers, and ensure the effective management and regulation of the sector.

III. The PRGF-Supported Program

Performance under the PRGF program has been broadly satisfactory. Quantitative program targets and structural performance criteria and benchmarks have generally been met. Progress toward the piloting of IFMIS continues to encounter delays, however. In the interim, the current financial management system is being strengthened. The program for 2006 incorporates a roughly unchanged overall fiscal deficit—but with a modest reduction in domestic financing—while increasing spending on poverty reducing programs and addressing pension arrears. The program targets an end-year inflation rate of 10 percent and a slight build up in international reserves. The structural program builds on the 2005 program in seeking to strengthen public expenditure and debt management, financial sector development, and governance and transparency.

A. Performance Under the Program

36. **Performance under the PRGF-supported program has been broadly satisfactory.** Continuous performance criteria have been observed. All quantitative performance criteria and indicative targets, for June 2005, the test date for the third review, were met and all but one were met for September 2005 (MEFP, Table 1). The September ceiling on government net domestic financing was narrowly exceeded (by K 17 billion or 0.05 percent of GDP), owing to outlays for emergency food relief and higher-than-anticipated expenditures on preparations for elections and the constitutional review exercise. The authorities have requested a waiver for the nonobservance of this performance criterion, based on the minor nature of the breach and efforts to contain government net domestic financing to within program limits for the year as a whole.

37. **On the structural side, both performance criteria were observed and, despite some delays, all but one of the benchmarks were implemented** (MEFP, Table 2)**.** With respect to the missed benchmark—the issuance of new regulations and revised accounting manuals for the new Finance Act—revised manuals are being prepared based on draft regulations proposed by an IMF-sponsored expert and should be available for review in December.

38. **The authorities continue to make progress in resolving the two claims by commercial creditors that are in arrears.** Agreement has been reached with one of the creditors on a reduced repayment schedule, while the second claim is in litigation in commercial court in London. The authorities are actively seeking to ascertain the validity of this claim, which originated in a debt to the Romanian government, to facilitate its settlement. Neither of

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[16] To ensure ZESCO's independent commercial operations, the Government will not on-lend or guarantee external credits to ZESCO.

these claims poses a risk to Zambia's adjustment effort. The staff is of the view that the authorities are making a good faith effort to settle its external commercial arrears.

B. Proposed Modifications to the Program

39. **The authorities have requested two modifications to the PRGF-supported program.** First, the authorities request that the end-December 2005 ceiling on net domestic financing be adjusted upward by up to K120 billion (0.3 percent of GDP) for the sole purpose of clearing a greater amount of domestic arrears to road contractors than initially budgeted (MEFP, para. 8). Combined with available budgetary resources, the additional borrowing (through the issuance of government securities) would clear the bulk of the arrears, depending on the discounts obtained from the contractors. The authorities established transparent procedures for seeking discounts from, and making payments to, the contractors. Staff supports this request. Clearance of the arrears would facilitate the issuance of new contracts for critical infrastructure projects and improve fiscal transparency. The operation is not expected to significantly crowd out bank credit to the private sector.

40. **The authorities also seek to reschedule the initiation of the IFMIS pilot to September 2006.** Ensuring compliance with the PEMFA/World Bank procurement guidelines in tendering the contract for the installation of IFMIS has, however, resulted in additional delays.[17] The contract has been retendered and selection of preferred bidders is expected to be completed in December 2005. It will thus not be feasible to meet the end-January 2006 performance criterion on the piloting of IFMIS. Rather, it is expected that a contractor can be selected and negotiations concluded by the second quarter of 2006. In the meantime, the authorities continue to install the infrastructure required by IFMIS and to strengthen the existing financial management system (FMS), including its computerization in all line ministries, the provinces, and government agencies and the production of monthly reports on budget execution, using activities-based budgeting (ABB) classification applied to the FMS.

C. Program for 2006

41. **In keeping with the authorities' medium-term objectives, as set out in the MTEF and draft NDP, the program for 2006 aims to promote macroeconomic stability and achieve robust economic growth.**[18] Real GDP is expected to grow by 6 percent, with the agricultural sector rebounding and mining output expanding markedly as the recent investments in the sector come on stream. The overall fiscal deficit is projected to remain roughly unchanged (2.6 percent of GDP), but domestic financing would be reduced modestly (1.6 percent of GDP)

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[17] In June 2005, the Executive Board agreed to move the test date on the piloting of IFMIS from end-June 2005 to end-January 2006 and indicated that the performance criterion on the report of a preliminary review of IFMIS would be set in the context of the third program review.

[18] The MTEF, which was approved by cabinet in November, serves as background to the 2006 budget proposal that is scheduled to be submitted to parliament in late January 2006. Parliament is expected to approve the budget by end-March 2006.

compared with the projected outcome for 2005.[19] The budget allocation for the 2006 elections has been cut by about two thirds with respect to the original estimate. To make room for this spending, administrative costs will be trimmed and spending on nonpriority programs curtailed or postponed. Transfers will increase by 0.9 percent of GDP, owing to an increase in statutory pension payments, an increase in poverty-related transfer programs, and a reclassification of some spending items. Sufficient resources will be allocated to achieve an increase of at least ½ percent of GDP in spending on poverty-reducing programs (PRPs). The budget provides additional scope for hiring new teachers and retaining core health workers, while maintaining the total government wage bill below 8 percent of GDP, and for the first time addresses the problem of paying outstanding arrears to the Public Sector Pension Fund. Donor support of 1 percent of GDP will be channeled through sector wide approach (SWAP) grants to the health and education sectors. In the area of infrastructure, capital expenditure on road development will be increased by 0.3 percent of GDP. In the wake of HIPC debt relief, the authorities are under pressure to cut taxes but they are committed to maintaining the ratio of tax revenue to GDP at least at current levels. In the first half of 2006 an overall review of tax policy will be undertaken, with the aim of broadening the tax base and rationalizing the tax system—the structure of rates, deductions, incentives and targeted reliefs.

42. **Monetary policy will aim at reducing end-year inflation to 10 percent.** The import coverage of foreign reserves is expected to rise slightly, while the current account deficit (excluding grants) is projected to narrow to 11 percent of GDP. The authorities remain committed to a flexible exchange rate regime, and to implementing measures that will reduce the cost of doing business in Zambia and expand and diversify the export base. External budget support is conservatively estimated to decline somewhat in 2006 relative to 2005. Based on commitments from donors under the Wider Harmonization in Practice (WHIP), external budget support is estimated to be about 1.6 percent of GDP, with more than four fifths coming in the form of grants. On the other hand, debt service charged to the budget is projected to decline to about 1 percent of GDP, from 1.9 percent in 2005, not taking into account potential relief under the MDRI. On this basis, the 2006 program is fully financed.

43. **The structural measures for 2006 build on the 2005 program and reflect the priorities in the draft NDP.** They seek to enhance public expenditure and debt management, transparency, and budget execution through both strengthening existing systems (for example, issuing regulations and new manuals for the new Finance Act and rules and procedures for enforcement of the cash-flow framework, reporting on budget execution, and improving government's monitoring of its onlending activities and contingent external liabilities), as well as implementing new systems (that is, IFMIS). The program includes follow-up measures for resolving government-owned nonbank financial institutions, the establishment of a credit

[19] The 2006 budget does not assume any debt-service relief under the MDRI. Potential savings on debt service to the AfDF and IDA in 2006 that accrue directly to the budget are estimated to be K 79 billion (0.2 percent of GDP), while savings on debt service to the Fund are estimated to be K 97 billion (0.25 percent of GDP). The authorities will consult with the Fund on the appropriate allocation of the savings on debt service at the time of the next review under the PRGF arrangement.

reference bureau, and, in the area of private sector development, provide for an assessment of ZESCO's performance under commercialization.

D. Program Monitoring

44. **Implementation of the PRGF arrangement will continue to be monitored quarterly, but the disbursement schedule will be converted to semi-annual disbursements that correspond with program reviews.** The fourth review of the program, which is expected to be completed by May 2006, will be based on the performance criteria and benchmarks for end-December 2005. The program for 2006 outlined in the MEFP sets quantitative benchmarks for end-March and performance criteria and benchmarks for end-June, which will be the basis for the fifth review expected to be completed by December 2006, and indicative targets for end-September and end-December 2006. At the time of the fourth review, the indicative targets will be re-evaluated and set as benchmarks for end-September 2006 and performance criteria and benchmarks for end-December 2006, which will be the basis for the sixth review expected to be completed by May 2007. In line with the schedule set out in Table 4 of the MEFP, performance criteria under the structural program will be part of the basis for completing program reviews. Financing assurance reviews would be completed prior to each disbursement so long as external arrears to private creditors remain outstanding.

IV. Staff Appraisal

45. **Staff commends the authorities for maintaining a policy framework that has enabled the economy to sustain robust growth in 2005, despite a number of adverse supply shocks.** Consolidation of the fiscal adjustment that began in 2004 and the tightening of monetary policy have positioned Zambia to achieve greater macroeconomic stability and extend its marked economic turnaround over the foreseeable future. The authorities' main challenge now is to seize the opportunity provided by debt relief and the prospect of rising external assistance to build upon the recent improvement in economic performance and to substantially reduce poverty. Sustained implementation of sound macroeconomic and structural policies will be crucial to avoid a repeat of the "stop-go" pattern that emerged from Zambia's faltering structural reform efforts and uneven macroeconomic management in the 1980s and 1990s.

46. **Prospects are favorable for significantly lowering inflation in 2006 and achieving single-digit inflation by 2007.** Attainment of this goal would mark a historic breakthrough in economic management in Zambia and would encourage financial intermediation, harmonious labor relations, and investment. To break entrenched expectations of inflation, the monetary authorities must maintain clear objectives for monetary policy. Close coordination of monetary and fiscal policy is necessary to ensure that the monetary program is consistently implemented. The staff welcomes the proposal to strengthen the operational independence of the BoZ.

47. **Increasing the efficiency and effectiveness of the public sector is critical for reorienting spending toward priority poverty reducing programs and obtaining greater donor support.** Staff welcomes the efforts made to contain expenditures for the elections and the constitutional review process in 2006 and 2007, thus permitting a further decline in government borrowing while providing scope for increased spending on poverty reduction programs.

48. **Progress has been made in advancing the reform agenda aimed at ameliorating public expenditure management systems**. This agenda has initially focused on developing and implementing a monitoring and evaluation framework, strengthening budget execution, and improving debt management. Introduction of IFMIS continues to encounter delays, however. While these have been largely beyond the authorities control, the staff urges the authorities to redouble efforts to prevent any further slippages. More generally, staff encourages the authorities to press ahead with the comprehensive PEMFA reform, with a view to strengthening existing financial management systems while introducing IFMIS in the coming years.

49. **The insolvent public pension system poses a serious risk to the public finances**. Staff urges the authorities to proceed expeditiously with reform of the pension system, and welcomes the allocation of budgetary resources to paying outstanding arrears on government contributions to the PSPF.

50. **A sound financial system is crucial to the authorities' private sector-led growth strategy.** The authorities should follow through on the plans to resolve the financially troubled nonbank financial institutions and ZNCB, improve financial sector supervision and regulation, and also give priority to strategies aimed at increasing the flow of credit to small- and medium-scale enterprises.

51. **The flexible exchange rate policy has served Zambia well.** The rapid growth of nontraditional exports in recent years suggests that Zambia has maintained its international competitiveness. In view of the recent real appreciation of the kwacha, brought on, at least in part, by a fundamental improvement in Zambia's longer term prospects, staff urges the authorities to step up implementation of the structural reform agenda, which aims at increasing both private and public sector productivity, removing impediments to business, and expanding access to credit. Improving infrastructure is also critical for maintaining competitiveness. Appreciation pressures also represent an opportunity for the BoZ to accumulate international reserves more rapidly than planned.

52. **Debt relief has greatly improved Zambia's external debt situation.** Moreover, the government is making good progress on improving its debt management capabilities. While Zambia's debt sustainability outlook is quite favorable, staff advises the authorities to exercise caution when taking on new debt. In this regard, ZESCO investment plan, which could lead to the accumulation of US$1-1½ billion of new debt, should be thoroughly scrutinized to assure that Zambia reaps the maximum benefits of its hydroelectricity resources.

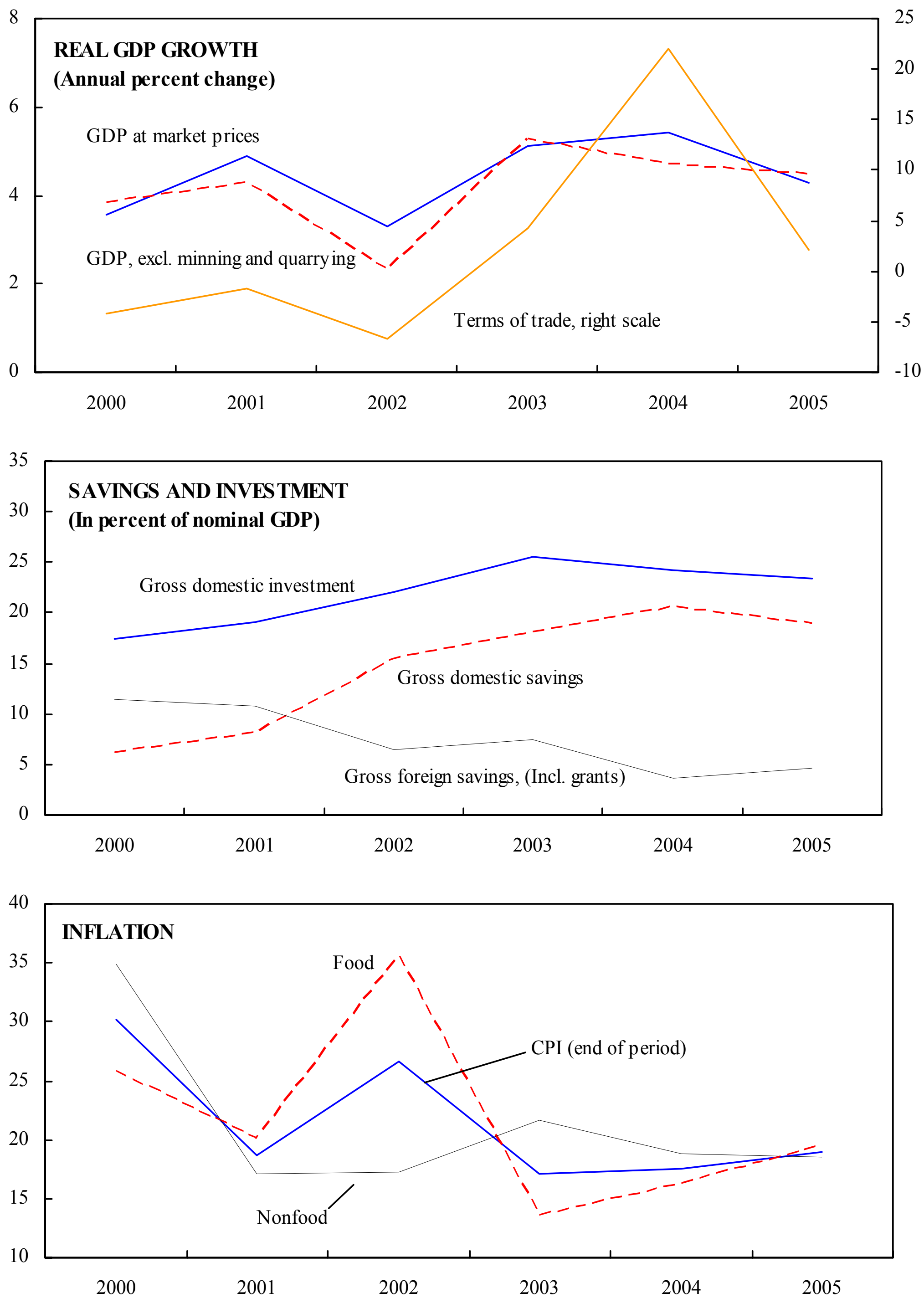
53. **While the economic outlook is broadly favorable, it is not without risks.** Election year pressures could threaten sound fiscal and monetary policies. In addition, Zambia remains vulnerable to climatic and terms of trade shocks. Debt relief has eased the risk of insufficient reserve coverage for meeting external debt service obligations. In this light, staff considers a gradual course for building up international reserves to be appropriate.

54. **Staff recommends that the third review under the PRGF arrangement be completed**. Staff further recommends that Zambia be granted a waiver for the nonobservance of one performance criterion for the sixth disbursement (based on performance under the quantitative program through September 2005), in view of the minor nature of the breach and the authorities' commitment to meet the end-year target. The staff also recommends that the

performance criterion for end-December 2005 net domestic financing and the end-January 2006 criterion with respect to IFMIS be modified as requested and that the financing assurances review be completed.

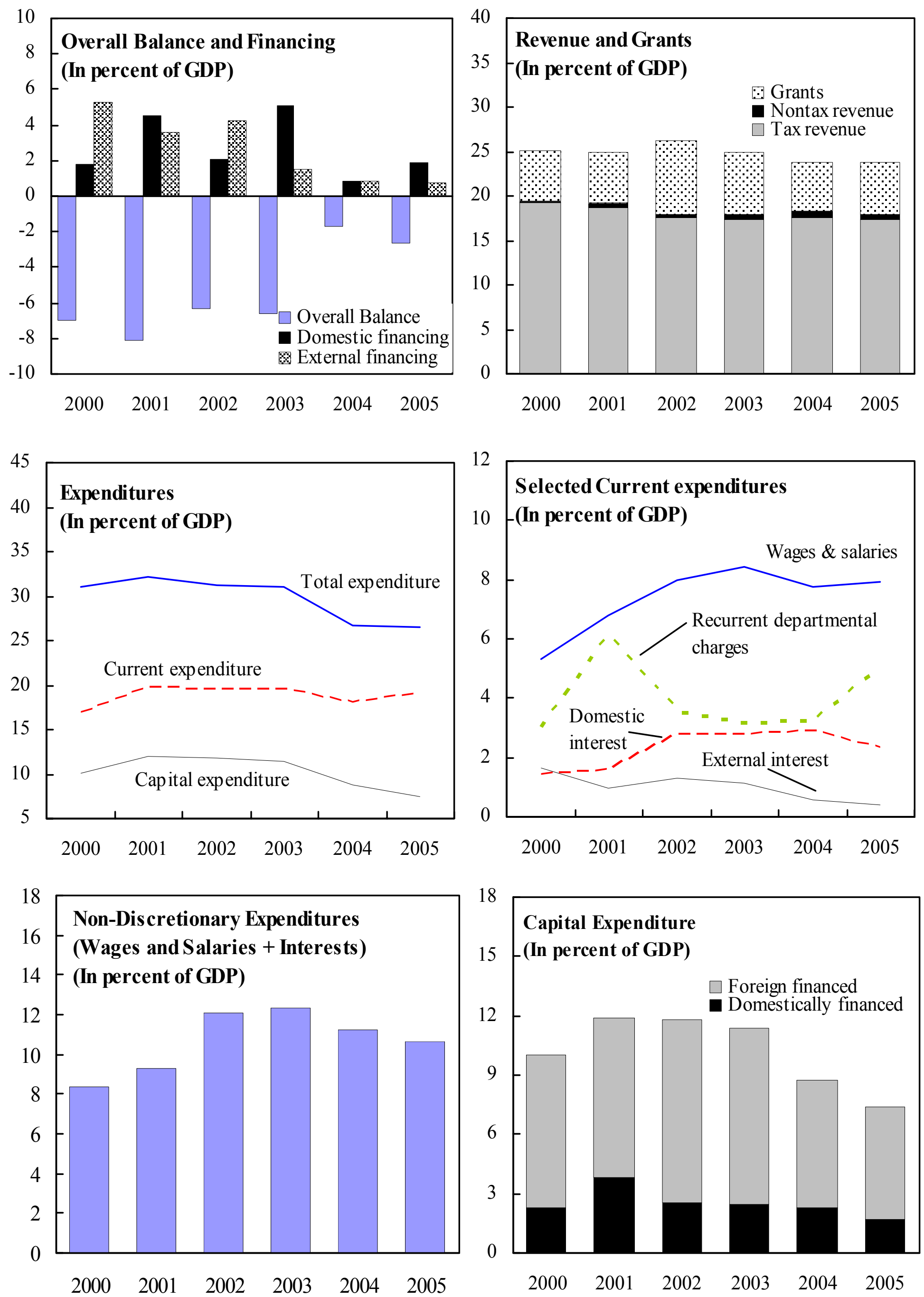
55. Regarding the exchange restriction evidenced by the existence of external arrears, the staff encourages the authorities to continue with their efforts to resolve the remaining arrears. It is proposed that the next Article IV consultation will be held on the 24-month consultation cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002.

Figure 1. Zambia: Real Sector Indicators and Inflation, 2000-05



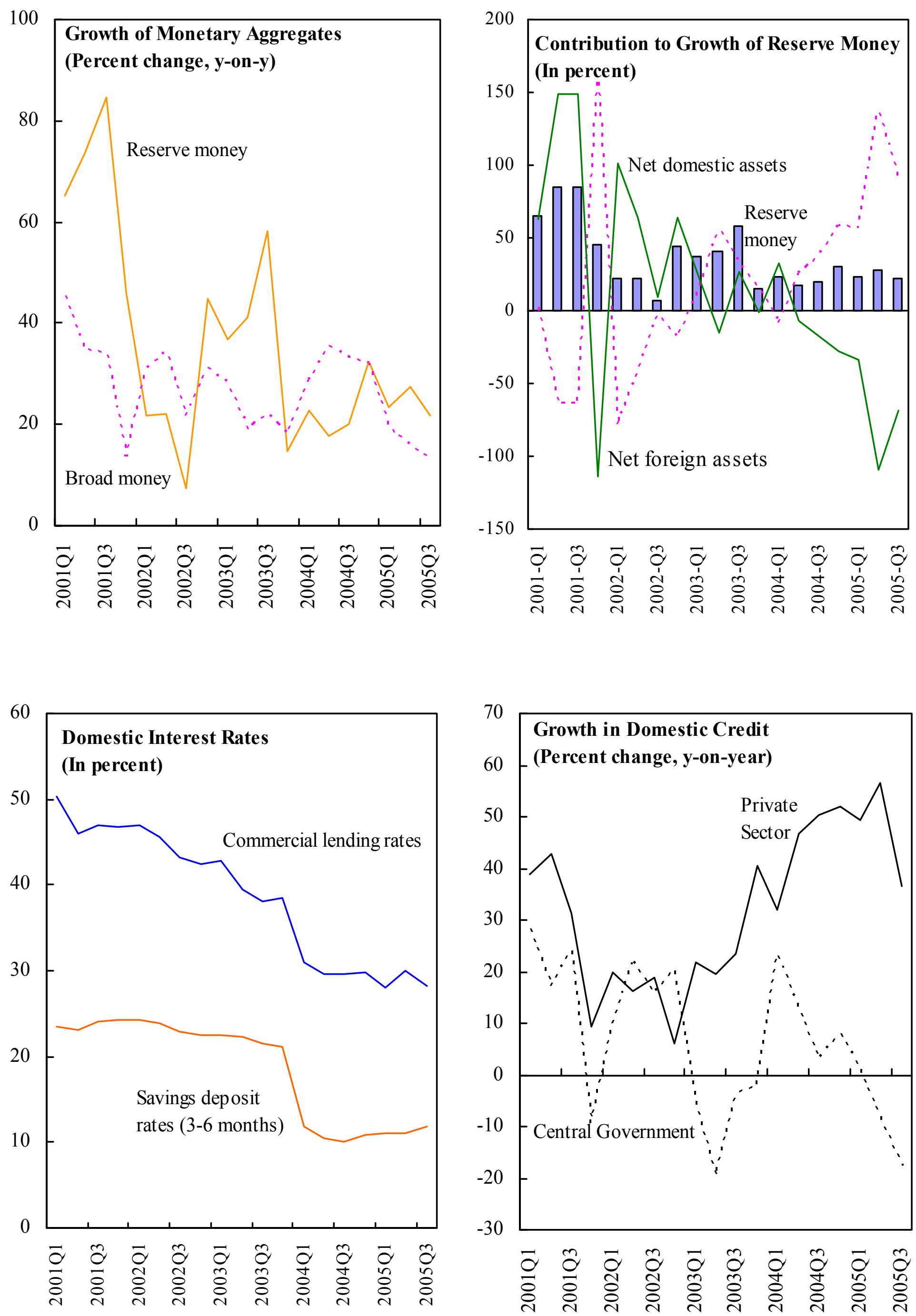
Source: Zambia Central Statistics Office; Bank of Zambia; and Fund staff estimates.

Figure 2. Zambia: Fiscal Sector Indicators, 2000-05



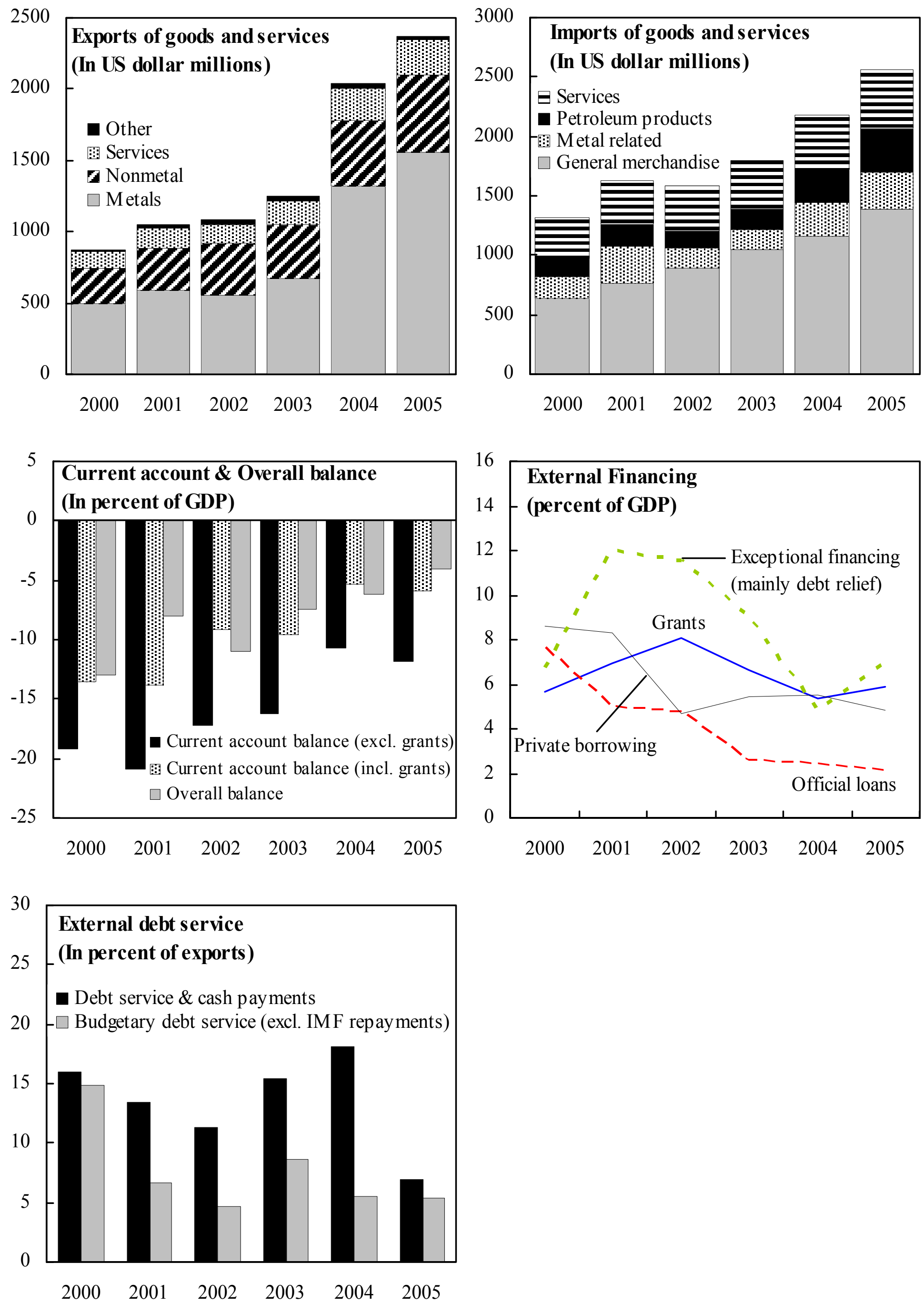
Source: Ministry of Finance and National Planning; and Fund staff estimates.

Figure 3. Zambia: Monetary and Financial Sector Developments, 2001Q1–2005Q3



Source: Bank of Zambia; and Fund staff estimates.

Figure 4. Zambia: External Sector Indicators, 2000-05



Source: Bank of Zambia; and Fund staff estimates.

Table 1. Zambia: Selected Economic and Financial Indicators, 2000-08

	2000	2001	2002	2003	2004	2005 Prog.	2005 Proj.	Projections 2006	Projections 2007	Projections 2008
	(Annual percentage change, unless otherwise indicated)									
National income and prices										
Real GDP	3.6	4.9	3.3	5.1	5.4	5.0	4.3	6.0	6.0	6.0
GDP deflator	30.0	24.3	19.9	19.8	20.1	15.2	18.9	11.5	4.6	4.1
Consumer prices (annual average)	26.1	21.4	22.2	21.4	18.0	16.2	18.4	14.4	6.3	4.9
Consumer prices (end of period)	30.1	18.7	26.7	17.2	17.5	15.0	17.0	10.0	5.0	5.0
External sector										
U.S. dollar value of exports of goods and services	2.3	19.4	2.4	15.4	63.7	8.6	16.3	10.2	7.0	-0.7
U.S. dollar value of imports of goods and services	12.8	23.3	-2.5	13.3	21.1	2.8	18.6	10.2	7.1	6.0
Export volume (goods)	-5.7	26.2	11.2	1.8	16.6	19.5	5.5	16.1	15.5	3.9
Import volume (goods)	2.7	34.3	-3.9	6.9	4.3	7.4	9.4	8.9	11.7	11.8
Copper export volume	-2.5	26.9	11.3	7.1	11.3	22.0	6.0	17.4	15.0	10.0
Nonmetal export volume	-9.4	22.0	20.3	-3.7	10.8	9.1	13.1	9.2	8.8	8.6
Copper export prices (average, U.S. dollars per pound)	0.82	0.77	0.70	0.78	1.20	1.09	1.52	1.42	1.28	1.18
Nominal effective exchange rate (annual average) 1/	-16.5	-7.7	-19.3	-14.1	-2.6	...	1.3	...	...	...
Real effective exchange rate (annual average) 1/	1.2	8.5	-5.8	-1.7	8.1	...	12.2	...	...	...
Terms of trade	-4.2	-1.7	-6.7	4.2	21.9	-1.0	2.1	-6.6	-3.6	-1.1
Money and credit (change in percent of beginning-of-year broad money)										
Net foreign assets	63.8	-53.5	68.5	-9.0	13.9	19.5	12.2	-1.2	6.6	3.9
Net domestic assets	10.3	64.3	-37.0	32.5	16.3	-4.7	-3.6	15.5	6.3	8.0
Net domestic credit	18.7	33.0	-29.4	36.6	16.4	-4.7	0.4	15.5	6.3	8.0
Net claims on government	18.1	36.0	3.1	27.0	1.0	5.9	6.7	6.7	2.2	1.6
Claims on nongovernment	28.6	6.7	6.1	9.6	15.4	8.8	13.1	8.9	5.7	7.2
Broad money	74.1	10.8	31.5	23.4	30.2	14.8	8.6	14.3	12.9	11.9
Velocity 2/	5.7	5.5	5.2	5.5	5.3	4.7	5.5	5.3	5.2	5.1
Central government budget										
Revenue (excluding grants)	47.5	28.4	16.0	26.5	28.8	21.1	21.0	19.2	12.3	11.9
Grants	-3.7	31.1	79.0	5.5	0.6	30.5	35.0	21.8	10.6	7.4
Expenditures 3/	42.2	34.9	20.7	24.6	9.2	21.0	23.3	19.4	8.5	8.9
Domestic expenditures 3/ 4/	52.9	39.2	11.3	27.1	18.8	24.4	10.2	16.2	10.4	9.2
	(In percent of GDP)									
Investment and savings										
Gross national savings 5/	3.9	5.1	12.8	16.0	18.9	18.5	17.5	17.3	18.5	17.9
Gross foreign savings	13.5	13.9	9.2	9.6	5.4	4.3	6.0	5.7	4.0	5.0
Gross domestic investment	17.4	19.0	22.0	25.6	24.3	22.8	23.5	22.9	22.5	22.9
Of which: public investment	10.0	11.9	11.8	11.4	8.7	7.1	7.4	8.4	8.5	8.0
Central government budget										
Revenue and grants	25.1	24.8	26.2	24.9	23.8	24.4	23.9	24.2	24.4	24.5
Revenue (excluding grants)	19.4	19.1	17.9	18.0	18.3	18.4	17.8	18.0	18.2	18.4
Expenditures (excluding interest) 3/	27.9	29.7	27.2	27.1	23.2	23.5	23.8	24.4	24.6	24.5
Interest due	3.0	2.5	4.1	3.9	3.5	3.4	2.7	2.4	1.6	1.4
Domestic expenditures 3/ 4/	21.7	23.1	20.7	20.9	19.6	20.2	19.9	20.0	19.9	19.7
Overall balance, cash basis	-7.0	-8.1	-6.3	-6.6	-1.7	-2.5	-2.7	-2.6	-1.8	-1.4
Domestic financing	1.8	4.5	2.1	5.1	0.8	1.6	1.9	1.5	0.7	0.5
External sector										
Current account balance, excluding grants	-19.2	-20.8	-17.3	-16.2	-10.7	-11.8	-11.9	-10.9	-9.4	-10.2
Current account balance, including grants	-13.5	-13.9	-9.2	-9.6	-5.4	-4.3	-6.0	-5.7	-4.0	-5.0
	(In percent of exports of goods and services)									
External debt										
External official debt service 5/	15.9	13.4	11.4	15.2	18.2	7.6	7.0	3.9	3.8	5.3
External program assistance 6/	21.5	7.1	12.8	4.4	3.2	6.7	5.7	4.7	5.6	5.4
	(In millions of U.S. dollars, unless otherwise indicated)									
Current account balance, including grants	-438	-506	-348	-414	-292	-268	-415	-466	-357	-481
Overall balance of payments	-420	-292	-414	-319	-332	-347	-279	-301	-249	-340
Gross official reserves (end of period)	114	114	283	194	222	246	312	358	444	586
In months of imports of goods and services	1.0	0.8	2.1	1.3	1.2	1.3	1.4	1.5	1.8	2.2

Sources: Zambian authorities; and IMF staff estimates and projections.

1/ Projection for 2005 reflects data for January-August.

2/ The 2005 program figure is based on the end-year stock of broad money. All other figures are based on the average stock during the year.

3/ Includes contingency reserve and payments of domestic arrears.

4/ Excludes external interest payments and foreign-financed project expenditure.

5/ After enhanced HIPC Initiative debt relief.

6/ Projections reflect trends based only on identified commitments.

Table 2. Zambia: Real Gross Domestic Product Growth, 2000-08

	2000	2001	2002	2003	2004	2005 Prog	2005 Proj	Projections 2006	Projections 2007	Projections 2008
	(Annual percentage change)									
GDP at market prices	3.6	4.9	3.3	5.1	5.4	5.0	4.3	6.0	6.0	6.0
(Excluding mining and quarrying)	3.8	4.3	2.3	5.3	4.7	4.4	4.5	5.0	5.1	5.6
Primary sector	1.1	2.0	3.8	4.5	7.5	6.8	2.7	9.4	8.2	6.4
Agriculture, forestry, and fishing	1.6	-2.6	-1.7	5.0	4.3	4.0	3.0	5.0	4.0	4.0
Mining and quarrying	0.1	14.0	16.4	3.4	13.9	12.0	2.2	17.5	15.0	10.0
Secondary sector	4.0	7.5	7.2	10.8	9.3	5.8	6.4	5.9	6.6	8.0
Manufacturing	3.6	4.2	5.7	7.6	3.8	5.0	2.6	5.0	6.0	7.0
Electricity, gas, and water	1.2	12.6	-5.2	0.4	-1.7	0.0	3.6	2.3	5.5	14.0
Construction	6.5	11.5	17.4	21.6	22.5	9.0	12.5	8.0	7.5	7.5
Tertiary sector	4.5	5.3	1.9	3.4	3.1	3.9	4.1	4.6	4.8	5.0
Wholesale and retail trade	2.3	5.4	5.0	6.1	4.8	5.0	5.1	5.0	5.2	5.4
Restaurants and hotels	12.3	24.4	4.9	6.9	6.4	5.5	10.9	7.0	6.0	6.0
Transport, storage, and communications	2.4	2.8	1.8	4.8	6.4	4.8	2.2	7.0	8.0	8.5
Financial intermediation and insurance	-0.6	0.1	3.5	3.5	3.5	3.5	3.5	3.5	4.0	4.5
Real estate and business services	17.0	3.5	4.4	4.0	4.0	4.0	5.0	5.0	5.0	5.0
Community, social, and personal services	-0.5	5.8	1.6	1.6	0.6	1.5	1.8	3.0	3.0	3.0
Other	7.5	10.6	-13.8	-7.5	-7.9	1.4	1.4	1.4	1.4	1.4
Population growth	1.0	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
GDP per capita	2.6	2.4	0.9	2.7	3.0	2.5	1.9	3.5	3.5	3.5
GDP deflator	30.0	24.3	19.9	19.8	20.1	15.2	18.9	11.5	4.6	4.1
CPI (period average)	26.1	21.4	22.2	21.4	18.0	16.2	18.4	14.4	6.3	4.9
CPI (end of period)	30.1	18.7	26.7	17.2	17.5	15.0	17.0	10.0	5.0	5.0
Terms of trade	-4.2	-1.7	-6.7	4.2	21.9	-1.0	2.1	-6.6	-3.6	-1.1
	(In percent of nominal GDP)									
Government consumption	9.5	10.2	11.9	14.6	14.4	...	14.0	13.2	12.2	12.2
Private consumption	87.4	87.1	86.8	81.1	63.8	...	70.3	69.2	69.6	72.3
Gross fixed capital formation	16.0	17.6	20.7	24.3	23.0	...	22.5	22.0	21.6	22.0
Increase in stocks	1.4	1.4	1.3	1.3	1.3	...	1.0	0.9	0.9	0.9
Exports of goods and services	27.1	28.1	26.1	24.7	37.6	...	34.1	31.9	31.5	28.9
Imports of goods and services	-41.5	-44.3	-46.8	-45.9	-40.0	...	-36.9	-34.5	-34.2	-33.4
Gross domestic investment	17.4	19.0	22.0	25.6	24.3	...	23.5	22.9	22.5	22.9
Public	10.0	11.9	11.8	11.4	8.7	...	7.4	8.4	8.5	8.0
Private	7.4	7.1	10.2	14.2	15.6	...	16.1	14.5	14.0	14.9
Gross national savings	3.9	5.1	12.8	16.0	18.9	...	17.5	17.3	18.5	17.9
Public	11.3	7.7	10.8	9.2	9.3	...	7.4	8.2	8.3	8.0
Private	-7.3	-2.6	2.0	6.7	9.6	...	10.1	9.1	10.2	9.9
Gross foreign savings (including grants)	13.5	13.9	9.2	9.6	5.4	...	6.0	5.7	4.0	5.0
Memorandum item										
Nominal GDP (in billions of Kwacha)	10,072	13,133	16,260	20,479	25,916	31,212	32,141	38,036	42,184	46,581

Sources: Zambian authorities; and Fund staff estimates and projections.

Table 3. Zambia: Central Government Overall Operations, 2000-08
(In billions Kwacha)

	2000	2001	2002	2003	2004	2005				2006	2007	2008
					Prel.	Prog. Q1-Q3	Prel. Q1-Q3	Prog.	Proj.	Proj.	Proj.	Proj.
Revenue and grants	2,528	3,262	4,259	5,104	6,173	5,605	5,610	7,608	7,671	9,192	10,282	11,391
Revenue	1,953	2,509	2,909	3,680	4,740	4,188	4,255	5,740	5,736	6,835	7,675	8,591
Tax revenue	1,931	2,449	2,849	3,548	4,546	4,056	4,149	5,523	5,578	6,654	7,482	8,368
Income taxes	634	977	1,244	1,622	2,032	1,800	1,834	2,436	2,469	2,935	3,347	3,707
Excise taxes	278	366	423	482	607	526	565	720	750	918	1,037	1,146
Value-added tax (VAT)	575	821	812	1,034	1,362	1,159	1,272	1,588	1,697	2,008	2,227	2,574
Domestic VAT	230	278	342	393	453	434	514	609	695	801	888	1,038
Import VAT	345	544	471	642	909	725	758	979	1,002	1,207	1,339	1,536
Customs duty	252	285	367	409	544	571	479	778	661	793	871	941
Nontax revenue 1/	22	60	60	132	194	132	106	217	158	180.6	193	223
Grants	575	754	1,350	1,424	1,433	1,416	1,355	1,868	1,934	2,357	2,606	2,800
Program	100	107	324	229	258	266	291	446	486	482	654	634
Sector Wide Approaches (SWAPS) Grants	...	...	...	...	...	...	...	...	...	386	349	400
Project 2/	476	647	1,026	1,195	1,175	1,151	1,065	1,423	1,448	1,489	1,604	1,767
Expenditures	3,122	4,212	5,086	6,337	6,919	6,177	6,076	8,373	8,528	10,180	11,047	12,031
Current expenditures	1,701	2,578	3,161	4,002	4,654	4,445	4,404	6,170	6,160	6,985	7,441	8,313
Wages and salaries	538	888	1,301	1,728	2,012	1,876	1,782	2,531	2,543	3,019	3,320	3,727
Public service retrenchment	74	19	80	10	20	66	22	66	66	75	80	78
Recurrent departmental charges (RDCs) 3/	300	801	584	648	835	1,012	1,018	1,513	1,621	1,476	1,700	2,181
Arrears clearance	0	117	147	52	84	82	100	141	169	138	153	95
Awards and Compensations (Court decisions)	...	...	0	15	35	54	46	54	54	60	60	60
Presidential Affairs	...	...	0	0	23	18	28	25	30	30	30	30
Elections & constitutional review	0	72	0	0	19	127	105	146	161	244	99	504
Other RDCs	300	562	426	564	673	731	739	1,147	1,207	1,004	1,358	1,491
Transfers and pensions	219	353	412	361	446	497	761	760	784	1,265	1,423	1,420
Of which: Foreign financed recurrent expenditure	...	...	...	...	...	0	0	126	115	...	...	...
Of which: Settlement of statutory pension payments	...	...	0	5	27	85	120	159	143	254	362	292
Domestic interest	140	207	450	563	746	633	531	850	747	777	491	463
External interest	167	124	210	229	152	144	113	200	135	130	170	171
Other current expenditures	88	178	95	456	430	211	167	243	248	234	245	252
Of which: financial restructuring	0	64	0	209	108	87	48	100	100	80	80	80
Contingency	82	8	29	6	13	5	10	8	16	10	12	20
Capital expenditure	1,009	1,557	1,925	2,335	2,265	1,732	1,673	2,203	2,367	3,195	3,606	3,719
Domestically financed	228	494	417	507	585	275	330	521	536	766	1,144	1,046
Foreign financed	781	1,063	1,508	1,828	1,681	1,456	1,342	1,681	1,831	2,429	2,462	2,672
Change in balances and statistical discrepancy (- = overfin.)	-114	-106	-204	-116	304	0	-39	0	0	0	0	0
Overall balance (cash basis)	-708	-1,056	-1,031	-1,349	-442	-494	-505	-765	-857	-988	-765	-640
Overall balance excluding grants	-1,283	-1,810	-2,381	-2,774	-1,875	-1,910	-1,860	-2,633	-2,792	-3,345	-3,371	-3,440
Domestic balance	-351	-606	-662	-716	-22	-169	-264	-565	-654	-787	-1,089	-996
Domestic primary balance	-211	-399	-212	-153	724	387	267	286	93	-10	-597	-533
Financing	708	1,056	1,031	1,349	442	571	505	765	857	988	765	640
Domestic 5/	177	589	337	1,041	212	301	498	500	621	589	295	224
Bank	139	483	90	979	45	186	197	343	391	424	162	134
Nonbank	38	106	247	62	167	115	301	157	230	165	133	89
External	531	467	693	308	230	270	7	265	236	399	470	416
Program loans	479	165	295	46	96	142	9	221	145	93	95	97
Project loans 2/	289	434	483	633	526	446	418	446	554	554	510	506
Amortization 4/	-237	-132	-84	-371	-392	-318	-421	-402	-463	-248	-135	-186
Memorandum items:												
HIPC-related poverty reducing spending	0	186	154	213	530	...	...	...	...	...	...	...
Poverty-reducing spending (wider definition) 6/	...	...	...	...	...	...	...	3,182	3,311	4,108	4,739	5,387
of which: domestically financed	...	...	...	...	...	...	...	1,538	1,607	2,092	2,569	2,982
External budget support	579	272	619	275	354	407	300	666	631	575	749	731
External debt service	404	256	294	600	544	462	534	603	598	377	305	358
Stock of domestic arrears (end period) 7/	...	346	602	747	675	594	575	534	386	248	95	0
Stock of Pension arrears PSPF (end period)	...	...	...	322	...	...	...	...	414	314	118	0
Stock of domestic debt (end period) 8/	773	2,891	3,408	4,481	4,693	4,994	5,191	5,193	5,314	5,903	6,199	6,422
GDP (annual)	10,072	13,133	16,260	20,479	25,916	31,212	32,141	31,212	32,141	38,036	42,184	46,581

Sources: Zambian authorities; and Fund staff estimates and projections.

1/ Includes medical levy collection by the Zambia revenue Authority. In 2004, nontax revenues include K 62 billion of additional proceeds due to the reconciliation of government accounts.

2/ In 2005, project grants and loans are also funding current expenditures. In 2006-2008, project grants include specific grants in Health and Education sectors (SWAPs).

3/ Include purchases of goods and services, some allowances, and training expenses.

4/ In 2004, authorized expenditure of about 0.3 percent of GDP which could not be spent in 2004 due to late funding will be executed in 2005. For this reason, projected domestic financing for 2005 is higher than programmed.

5/ Until 2003 at face value. From 2004 at cost value. Inconsistency in the past valuation of government securities has resulted in discrepancies with data from the banking system.

6/ From 2005, fiscal accounts identify poverty-reducing spending according to a wider definition consistent with the PRSP (MEFP, para. 14).

7/ Audited at end-June 2005 for K 593.5 billion by the Zambian authorities. It excludes the stock of statutory pension arrears, which was K 414 billion at end-September 2005.

8/ From 2004, at cost value. Includes bonds issued in 2001 in favor of BoZ (K 1,646 billion) and in 2002 in favor of the Zambia National Commercial Bank (K 248 billion).

Table 4. Zambia: Central Government Overall Operations, 2000-08
(In percent of GDP)

	2000	2001	2002	2003	2004	2005				2006	2007	2008
					Prel.	Prog. Q1-Q3	Prel. Q1-Q3	Prog.	Proj.	Proj.	Proj.	Proj.
Revenue and grants	25.1	24.9	26.2	24.9	23.8	18.0	17.5	24.4	23.9	24.2	24.4	24.5
Revenue	19.4	19.2	17.9	18.0	18.3	13.4	13.2	18.4	17.8	18.0	18.2	18.4
Tax revenue	19.2	18.7	17.5	17.3	17.5	13.0	12.9	17.7	17.4	17.5	17.7	18.0
Income taxes	6.3	7.5	7.6	7.9	7.8	5.8	5.7	7.8	7.7	7.7	7.9	8.0
Excise taxes	2.8	2.8	2.6	2.4	2.3	1.7	1.8	2.3	2.3	2.4	2.5	2.5
Value-added tax (VAT)	5.7	6.3	5.0	5.1	5.3	3.7	4.0	5.1	5.3	5.3	5.3	5.5
Domestic VAT	2.3	2.1	2.1	1.9	1.7	1.4	1.6	2.0	2.2	2.1	2.1	2.2
Import VAT	3.4	4.2	2.9	3.1	3.5	2.3	2.4	3.1	3.1	3.2	3.2	3.3
Customs duty	2.5	2.2	2.3	2.0	2.1	1.8	1.5	2.5	2.1	2.1	2.1	2.0
Nontax revenue 1/	0.2	0.5	0.4	0.6	0.8	0.4	0.3	0.7	0.5	0.5	0.5	0.5
Grants	5.7	5.8	8.3	7.0	5.5	4.5	4.2	6.0	6.0	6.2	6.2	6.0
Program	1.0	0.8	2.0	1.1	1.0	0.9	0.9	1.4	1.5	1.3	1.6	1.4
Sector Wide Approaches (SWAPS) Grants	...	...	...	...	... ..	...	...	...	...	1.0	0.8	0.9
Project 2/	4.7	4.9	6.3	5.8	4.5	3.7	3.3	4.6	4.5	3.9	3.8	3.8
Expenditures	31.0	32.2	31.3	30.9	26.7	19.8	18.9	26.8	26.5	26.8	26.2	25.8
Current expenditures	16.9	19.7	19.4	19.5	18.0	14.2	13.7	19.8	19.2	18.4	17.6	17.8
Wages and salaries	5.3	6.8	8.0	8.4	7.8	6.0	5.5	8.1	7.9	7.9	7.9	8.0
Public service retrenchment	0.7	0.1	0.5	0.0	0.1	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Recurrent departmental charges (RDCs) 3/	3.0	6.1	3.6	3.2	3.2	3.2	3.2	4.8	5.0	3.9	4.0	4.7
Arrears clearance	0.0	0.9	0.9	0.3	0.3	0.3	0.3	0.5	0.5	0.4	0.4	0.2
Awards and Compensations (Court decisions)	0.0	0.0	0.0	0.1	0.1	0.2	0.1	0.2	0.2	0.2	0.1	0.1
Presidential Affairs	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Elections & constitutional review	0.0	0.5	0.0	0.0	0.1	0.4	0.3	0.5	0.5	0.6	0.2	1.1
Other RDCs	3.0	4.3	2.6	2.8	2.6	2.3	2.3	3.7	3.8	2.6	3.2	3.2
Transfers and pensions	2.2	2.7	2.5	1.8	1.7	1.6	2.4	2.4	2.4	3.3	3.4	3.0
Of which: Settlement of statutory pension payments	0.0	0.0	0.0	0.0	0.1	0.3	0.4	0.5	0.4	0.7	0.9	0.6
Domestic interest	1.4	1.6	2.8	2.8	2.9	2.0	1.7	2.7	2.3	2.0	1.2	1.0
External interest	1.7	0.9	1.3	1.1	0.6	0.5	0.4	0.6	0.4	0.3	0.4	0.4
Other current expenditures	0.9	1.4	0.6	2.2	1.7	0.7	0.5	0.8	0.8	0.6	0.6	0.5
Of which: financial restructuring	0.0	0.5	0.0	1.0	0.4	0.3	0.2	0.3	0.3	0.2	0.2	0.2
Contingency	0.8	0.1	0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	10.0	11.9	11.8	11.4	8.7	5.5	5.2	7.1	7.4	8.4	8.5	8.0
Domestically financed	2.3	3.8	2.6	2.5	2.3	0.9	1.0	1.7	1.7	2.0	2.7	2.2
Foreign financed	7.8	8.1	9.3	8.9	6.5	4.7	4.2	5.4	5.7	6.4	5.8	5.7
Change in balances and statistical discrepancy (- = overfin.) 4/	-1.1	-0.8	-1.3	-0.6	1.2	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis)	-7.0	-8.1	-6.3	-6.6	-1.7	-1.6	-1.6	-2.4	-2.7	-2.6	-1.8	-1.4
Overall balance excluding grants	-12.7	-13.8	-14.6	-13.5	-7.2	-6.1	-5.8	-8.4	-8.7	-8.8	-8.0	-7.4
Domestic balance	-3.5	-4.6	-4.1	-3.5	-0.1	-0.5	-0.8	-1.8	-2.0	-2.1	-2.6	-2.1
Domestic primary balance	-2.1	-3.0	-1.3	-0.7	2.8	1.2	0.8	0.9	0.3	0.0	-1.4	-1.1
Financing	7.0	8.1	6.3	6.6	1.7	1.8	1.6	2.4	2.7	2.6	1.8	1.4
Domestic 5/	1.8	4.5	2.1	5.1	0.8	1.0	1.5	1.6	1.9	1.5	0.7	0.5
Bank	1.4	3.7	0.6	4.8	0.2	0.6	0.6	1.1	1.2	1.1	0.4	0.3
Nonbank	0.4	0.8	1.5	0.3	0.6	0.4	0.9	0.5	0.7	0.4	0.3	0.2
External	5.3	3.6	4.3	1.5	0.9	0.9	0.0	0.8	0.7	1.0	1.1	0.9
Program loans	4.8	1.3	1.8	0.2	0.4	0.5	0.0	0.7	0.5	0.2	0.2	0.2
Project loans 2/	2.9	3.3	3.0	3.1	2.0	1.4	1.3	1.4	1.7	1.5	1.2	1.1
Amortization 4/	-2.4	-1.0	-0.5	-1.8	-1.5	-1.0	-1.3	-1.3	-1.4	-0.7	-0.3	-0.4
Memorandum items:												
HIPC-related poverty reducing spending	0.0	1.4	0.9	1.0	2.0	...	...	...	...	...	...	...
Poverty-reducing spending (wider definition) 6/	...	...	...	...	...	...	...	10.2	10.3	10.8	11.2	11.6
of which: domestically financed	...	...	...	...	...	...	...	4.9	5.0	5.5	6.1	6.4
External budget support	5.7	2.1	3.8	1.3	1.4	1.3	0.9	2.1	2.0	1.5	1.8	1.6
External debt service	4.0	2.0	1.8	2.9	2.1	1.5	1.7	1.9	1.9	1.0	0.7	0.8
Stock of domestic arrears (end period) 7/	...	2.6	3.7	3.6	2.6	1.9	1.8	1.7	1.2	0.7	0.2	0.0
Stock of Pension arrears PSPF (end period)	...	...	...	1.6	...	...	...	...	1.3	0.8	0.3	0.0
Stock of domestic debt (end period) 8/	7.7	22.1	21.0	21.9	18.1	16.0	16.2	16.6	16.5	15.5	14.7	13.8
GDP (annual)	10,072	13,133	16,260	20,479	25,916	31,212	32,141	31,212	32,141	38,036	42,184	46,581

Sources: Zambian authorities; and Fund staff estimates and projections.

1/ Includes medical levy collection by the Zambia revenue Authority. In 2004, nontax revenues include K 62 billion of additional proceeds due to the reconciliation of government accounts.

2/ In 2005, project grants and loans are also funding current expenditures. In 2006-2008, project grants include specific grants in Health and Education sectors (SWAPs).

3/ Include purchases of goods and services, some allowances, and training expenses.

4/ In 2004, authorized expenditure of about 0.3 percent of GDP which could not be spent in 2004 due to late funding will be executed in 2005. For this reason, projected domestic financing for 2005 is higher than programmed.

5/ Until 2003 at face value. From 2004 at cost value. Inconsistency in the past valuation of government securities has resulted in discrepancies with data from the banking system.

6/ From 2005, fiscal accounts identify poverty-reducing spending according to a wider definition consistent with the PRSP (MEFP, para. 14).

7/ Audited at end-June 2005 for K 593.5 billion by the Zambian authorities. It excludes the stock of statutory pension arrears, which was K 414 billion at end-September 2005.

8/ From 2004, at cost value. Includes bonds issued in 2001 in favor of BoZ (K 1,646 billion) and in 2002 in favor of the Zambia National Commercial Bank (K 248 billion).

Table 5. Zambia: Monetary Survey, 2000-06
(In billions of Kwacha, unless otherwise indicated; end of period)

							2005								
							Q1		Q2		Q3		Q4		2006
	2000	2001	2002	2003	2004	Base 1/	Prog.	Prel.	Prog.	Prel.	Prog.	Prel.	Prog.	Proj.	Prog.
							(In billions of kwacha)								
Net foreign assets	-1,512	-2,843	-957	-1,454	-1,113	-1,543	-1594.5	-1,903.0	-1,154.0	-1,456.8	-991.6	-1,394.9	-405	-830.4	-905.8
Bank of Zambia	-2,440	-3,705	-1,954	-2,377	-2,518	-2,986	-3,035.8	-2,903.6	-2,593.4	-2,212.6	-2,429.0	-2,039.3	-1,841	-1,368.9	-1,377.4
Assets	772	588	1,692	892	1,189	1,254	1,223.9	1,315.6	1,091.4	1,431.5	1,281.6	1,590.1	1,295	1,681.9	1,831.6
Liabilities	-3,212	-4,294	-3,646	-3,269	-3,707	-4,240	-4,259.6	-4,219.2	-3,684.8	-3,644.1	-3,710.6	-3,629.4	-3,136	-3,050.8	-3,208.9
Commercial banks	927	863	997	922	1,405	1,443	1,441.3	1,000.6	1,439.3	755.8	1,437.4	644.4	1,436	538.5	471.6
Assets	996	956	1,081	1,030	1,592	1,635	...	1,230.0	...	1,211.3	...	1,095.4	...	1,029.3	...
Liabilities	-68	-94	-84	-108	-187	-192	...	-229.3	...	-455.5	...	-451.0	...	-490.8	...
Net domestic assets	3,998	5,596	4,577	5,922	6,930	7,359	7,514.4	7,400.0	7,232.3	7,354.7	7,370.2	7,455.0	7,083	7,147.5	8,128.8
Net domestic credit	1,772	2,593	1,784	2,323	2,685	2,629	2,784.0	2,923.6	2,501.9	2,889.7	2,639.8	2,924.4	2,353	2,651.5	3,632.8
Net claims on government	952	1,848	1,932	2,746	2,518	2,518	2,547.1	2,570.2	2,632.8	2,626.7	2,704.2	2,730.6	2,861	2,909.7	3,334.0
Claims on government	1,460	2,666	2,781	3,830	3,862	3,862	...	4,030.5	...	3,819.6	...	3,796.6	4,205	...	...
Government deposits	-508	-818	-849	-1,085	-1,344	-1,344	...	-1,460.3	...	-1,192.9	...	-1,066.0	-1,344	...	...
HIPC Initiative account (IMF)	-401	-643	-1,704	-1,929	-2,067	-2,123	-2,123.4	-2,123.4	-2,688.4	-2,688.4	-2,688.4	-2,688.4	-3,253	-3,253.3	-3,261.5
Claims on nongovernment	1,221	1,388	1,556	1,506	2,234	2,234	2,360.3	2,476.8	2557.4	2,951.4	2,624.0	2,882.2	2,745	2,995.1	3,560.3
Claims on private sector	862	946	1,019	1,390	2,059	2,059	2,094.9	2,217.6	2,287.6	2,716.2	2,364.1	2,648.3	2,517	2,759.1	3,320.3
Claims on public enterprises	359	442	537	116	175	175	265.4	259.2	269.8	235.2	259.8	233.9	228	236.0	240
Other items (net)	2,226	3,003	2,793	3,599	4,244	4,730	4,730.4	4,476.4	4,730.4	4,465.0	4,730.4	4,530.6	4,730	4,496	4,496.0
Broad money	2,486	2,754	3,620	4,468	5,817	5,817	5,919.9	5,497.0	6,078.2	5,898.0	6,378.6	6,060.1	6,678	6,317.2	7,223.0
Narrow money	761	1,015	1,323	1,696	2,041	2,041	...	1,961.3	...	2,222.4	...	2,298.9	…	2,362.6	2,534.9
Quasi money	1,725	1,738	2,296	2,772	3,775	3,775	...	3,535.7	...	3,675.5	...	3,761.2	…	3,954.5	4,688.1
Foreign exchange deposits	1,171	1,045	1,429	1,619	2,440	2,440	...	2,187.7	...	2,221.6	...	2,215.6	…	…	…
Other	554	693	867	1,153	1,336	1,336	...	1,352.9	...	1,453.9	...	1,545.6	…	…	…
						(Change in percent of beginning-of-year broad money)									
Net foreign assets	63.8	-53.5	68.5	-9.0	13.9	...	...	-6.2	...	1.5	...	2.5	19.5	12.2	-1.2
Net domestic assets	10.3	64.3	-37.0	32.5	16.3	...	...	0.7	...	-0.1	...	1.6	-4.7	-3.6	15.5
Net domestic credit	18.7	33.0	-29.4	36.6	16.4	...	...	5.1	...	4.5	...	5.1	-4.7	0.4	15.5
Net claims on government	18.1	36.0	3.1	27.0	1.0	...	...	0.9	...	1.9	...	3.6	5.9	6.7	6.7
Claims on nongovernment	28.6	6.7	6.1	9.6	15.4	...	...	4.2	...	12.3	...	11.1	8.8	13.1	8.9
Claims on private sector	21.5	3.4	2.7	9.0	14.1	...	...	2.7	...	11.3	...	10.1	7.9	12.0	8.9
Claims on public enterprises	7.1	3.3	3.5	0.6	1.3	...	...	1.4	...	1.0	...	1.0	0.9	1.0	0.1
Other items (net)	-8.4	31.3	-7.6	-4.1	-0.1	...	...	-4.4	...	-4.6	...	-3.4	0.0	-4.0	0.0
Broad money	74.1	10.8	31.5	23.4	30.2	...	...	-5.5	...	1.4	...	4.2	14.8	8.6	14.3
Velocity (GDP/M2)	5.7	5.5	5.2	5.5	5.3	...	...	...	...	...	...	...	4.7	5.5	5.3

Sources: Zambian authorities; and IMF staff estimates and projections.

1/ The base for the year *t* is obtained recalculating the figures for end-year *t*-1 on the basis of the program exchange rates assumed for the year *t*. Beginning in 2004, government securities are recorded at cost rather than at face value.

Table 6. Zambia: Assets and Liabilities of the Bank of Zambia, 2002-06
(In billions of kwacha, unless otherwise indicated; end of period)

	2002	2003	2004	2005									2006
				Base 1/	QI		QII		QIII		QIV		
					Prog.	Prel.	Prog.	Prel.	Prog.	Prel.	Prog.	Proj.	Prog
Net foreign assets	-1,954	-2,377	-2,518	-2,986	-3,036	-2,904	-2,593	-2,213	-2,429	-2,039	-1,841	-1,488	-1,377
Assets	1,692	892	1,189	1,254	1,224	1,316	1,091	1,432	1,282	1,590	1,295	1,563	1,832
Liabilities	-3,646	-3,269	-3,707	-4,240	-4,260	-4,219	-3,685	-3,644	-3,711	-3,629	-3,136	-3,051	-3,209
Of which : IMF (net)	-3,603	-3,242	-3,701	-4,234	-4,260	-4,219	-3,685	-3,644	-3,711	-3,629	-3,136	-3,051	-3,209
Net domestic assets	3,158	3,796	4,237	4,713	4,727	4,428	4,330	3,848	4,252	3,787	3,749	3,368	3,457
Net domestic credit	-189	-476	-516	-572	-558	-795	-955	-1,360	-1,033	-1,122	-1,536	-1,675	-1,683
Net claims on government	1,128	1,090	1,241	1,241	1,246	939	1,403	958	1,315	1,139	1,361	1,143	1,210
Claims on government	1,865	1,973	…	…	…	2,072	…	1,853	…	1,816	…	1,820	…
Government deposits	-737	-883	…	…	…	-1,133	…	-894	…	-677	…	-677	…
HIPC Initiative account (IMF)	-1,704	-1,929	-2,067	-2,123	-2,123	-2,123	-2,688	-2,688	-2,688	-2,688	-3,253	-3,253	-3,262
Claims on nongovernment	387	363	310	310	320	390	330	370	340	428	356	435	369
Of which: claims on banks	112	262	...	…	…		…	…	…	…	...	...	...
Other items (net)	3,347	4,272	4,753	5,285	5,285	5,222	5,285	5,208	5,285	4,909	5,285	5,042	5,042
Reserve money	1,205	1,419	1,719	1,727	1,691	1,524	1,737	1,635	1,822	1,748	1,908	1,879	2,064
Currency in circulation	479	670	816	816	…	773	…	914	…	946	…	1,049	…
Required reserves (kwacha deposits)	264	286	352	352	…	378	…	365	…	392	…	409	…
Required reserves (foreign exchange deposits)	234	224	295	303	…	291	…	282	…	326	…	338	…
Dollar denominated	86	224	295	303	…	291	…	282	…	326	…	…	…
Kwacha denominated	148	0	0	0	…	0	…	0	…	…	…		…
Current accounts	222	233	249	249	…	77	…	68	…	77	…	77	…
Nongovernment deposits	6	6	7	7	…	6	…	6	…	7	…	6	…
Memorandum items:													
Multiplier (broad money/reserve money)	3.0	3.1	3.4	…	3.5	3.6	3.5	3.6	3.5	3.4	3.5	3.4	3.5
Reserve money (percent change from end of previous year)	...	17.8	21.1	…	-2.1	-11.7	0.6	-5.3	5.5	1.2	10.5	8.8	9.8

Sources: Zambian authorities; and IMF staff estimates and projections.

1/ The base for the year *t* is obtained by recalculating the figures for end year *t*-1 on the basis of the program exchange rates assumed for the year *t*.
Beginning in 2004, government securities are recorded at cost rather than at face value. Base for 2004 revised in October 2004.

Table 7. Zambia: Financial Soundness Indicators, 2000- 2005
(In percent, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005 July
Capital adequacy						
Regulatory capital to risk-weighted assets	22.0	21.8	28.0	23.7	22.2	22.1
Tier 1 regulatory capital to risk-weighted assets	21.6	20.6	24.8	21.0	19.6	20.0
Capital to total assets	11.0	11.4	12.3	11.0	9.7	11.0
Asset quality						
Past due advances (NPL) to total advances 1/	26.5	23.6	11.4	5.3	7.6	10.8
Loan loss provisions to nonperforming loans	48.3	20.7	73.9	89.3	102.8	59.3
Bad debt provisions to advances	11.4	5.5	8.4	4.7	7.8	6.4
Loan concentration 2/						
Households	5.5	11.2	12.3	17.5	13.1	18.9
Government and parastatals	26.7	21.6	6.4	4.3	5.5	4.2
Agriculture	17.1	19.6	22.2	24.7	30.3	25.1
Mining	10.9	9.2	3.6	4.9	4.5	4.2
Manufacturing	12.4	10.6	14.0	12.7	13.0	10.6
Construction	1.1	1.2	1.6	2.2	2.0	1.7
Services	3.4	6.1	8.5	7.3	8.1	6.7
Others	55.1	53.4	49.9	45.1	42.0	51.7
Earnings and profitability						
Return on average assets	4.9	8.5	6.5	5.4	3.1	4.2
Return on equity	40.9	72.1	52.8	48.5	29.8	38.9
Gross interest income to total gross income	69.6	58.6	65.8	66.1	78.2	62.4
Gross noninterest income to total gross income	30.4	41.1	34.2	33.9	46.3	37.6
Net spread	...	...	...	...	...	86.2
Net interest margin	...	67.2	72.1	68.7	84.5	85.6
Liquidity						
Liquid assets to total assets	56.7	68.9	78.6	74.7	66.6	58.2
Liquid assets to total deposits	78.7	69.5	69.7	73.5	73.7	81.5
Advances to deposits ratio	39.7	44.9	29.9	33.3	37.3	50.7
Exposure to foreign currency						
Foreign currency loans to total gross loans	48.3	36.9	42.8	46.8	41.2	43.6
Foreign currency liabilities to total liabilities	67.1	59.9	62.2	58.4	64.6	59.0
Net open position in foreign exchange to capital	15.1	10.9	15.7	10.0	8.9	7.4
Exposure to household debt						
Household debt to GDP	0.01	0.01	0.01	0.01	0.01	0.02

Source: Bank of Zambia.

1/ Term loans that are in arrears for 30 days or more.
2/ Components do not add up to 100 because loans to households, government and parastatals are included in the loans classified by economic sectors below.

Table 8: Zambia: Balance of Payments, 2000-08

(In millions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003	2004 Prel.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Current account balance 1/	-622	-758	-652	-700	-583	-826	-891	-832	-975
Trade balance on goods and nonfactor services	-446	-570	-504	-549	-133	-206	-214	-231	-429
Metal	171	79	176	289	813	1,010	1,126	1,152	988
Nonmetal	-628	-676	-708	-867	-977	-1,249	-1,374	-1,419	-1,479
Merchandise trade balance	-221	-342	-259	-311	82	59	54	50	-137
Exports, f.o.b.	746	884	916	1,052	1,779	2,095	2,316	2,477	2,437
Metals	497	590	560	669	1,322	1,557	1,728	1,833	1,732
Nonmetal	249	295	357	383	457	538	588	644	705
Imports, f.o.b.	-978	-1,253	-1,204	-1,393	-1,727	-2,068	-2,295	-2,463	-2,611
Metal sector	-177	-310	-176	-169	-286	-309	-369	-432	-484
Nonmetal	-801	-943	-1,028	-1,224	-1,441	-1,759	-1,926	-2,031	-2,152
Of which : Petroleum	-158	-174	-141	-183	-280	-365	-441	-454	-466
Goods procured by airlines	11	27	28	29	31	32	34	35	37
Services, nonfactor (net)	-225	-228	-245	-238	-215	-265	-268	-281	-292
Receipts	115	144	136	165	232	246	265	285	304
Payments	-340	-372	-381	-403	-447	-512	-533	-566	-596
Income (net)	-158	-168	-155	-148	-424	-592	-645	-562	-504
Of which: Official interest payments	-155	-144	-137	-131	-121	-110	-101	-95	-89
Current transfers (net)	-18	-20	7	-3	-25	-28	-33	-38	-43
Capital and financial accounts	202	466	238	380	251	547	590	583	635
Project grants	153	222	236	240	246	306	321	337	364
Financial account	49	245	2	140	5	241	269	246	271
Official loan disbursement (net)	-140	-96	-122	-141	-205	-113	-42	-74	-69
Disbursement	93	136	111	101	110	120	119	99	104
Amortization (-)	-233	-233	-234	-242	-315	-233	-161	-173	-173
Change in NFA of commercial banks (-increase)	-89	40	-53	48	-90	17	-10	-10	-10
Private capital (net)	278	301	178	233	299	337	321	330	350
Foreign direct investment	122	72	178	172	239	259	240	239	268
Private borrowing (net)	156	229	0	61	60	78	81	91	82
Errors and omissions, short-term capital	111	-107	31	-2	47	0	0	0	0
Overall balance	-420	-292	-414	-319	-332	-279	-301	-249	-340
Financing	309	399	383	321	285	279	301	249	124
Change in net int. reserves of BoZ (-increase)	-155	-124	-225	-161	-44	-336	-20	-109	-211
Gross official reserves of BoZ (-increase)	-68	0	-169	89	-28	-90	-47	-86	-142
IMF (net)	-80	-119	-50	-244	-10	-240	27	-23	-69
Disbursements	26	94	173	0	248	16	48	16	0
Repayments	-106	-213	-222	-244	-257	-256	-21	-39	-69
Debt relief	217	436	437	389	264	480	197	200	184
Non-HIPC 2/	217	170	171	154	245	152	70	64	67
HIPC, including IMF	...	266	266	235	19	328	127	137	117
Of which : IMF	...	150	153	169	2	219	2	1	0
Of which : Paris Club	...	65	64	16	-2	38	51	56	61
Program support	185	75	138	55	65	134	124	158	151
Grants	32	31	69	45	44	105	104	138	131
Loans	154	44	69	10	21	29	20	20	20
Unidentified financing (+ deficit)	0	0	0	0	0	0	0	0	216
Memorandum items:									
Current acc't bal. excl. grants (percent of GDP)	-19.2	-20.8	-17.3	-16.2	-10.7	-11.9	-10.9	-9.4	-10.2
Current acc't bal. incl. grants (percent of GDP)	-13.5	-13.9	-9.2	-9.6	-5.4	-6.0	-5.7	-4.0	-5.0
Merchandise trade balance (percent of GDP)	-6.8	-9.4	-6.9	-7.2	1.5	0.8	0.7	0.6	-1.4
Terms of trade (percentage change)	-4.2	-1.7	-6.7	4.2	21.9	2.1	-6.6	-3.6	-1.1
Copper export volume (thousands of metric tons)	234	297	330	353	393	417	489	563	619
Copper eport price (U.S. dollars per pound)	0.82	0.77	0.70	0.78	1.20	1.52	1.42	1.28	1.18
Oil price (U.S. dollars per barrel)	28	24	25	29	38	54	62	60	58
Gross official reserves 3/	114	114	283	194	222	312	358	444	586
(in months of imports)	1.0	0.8	2.1	1.3	1.2	1.4	1.5	1.8	2.2
Official debt service, cash payments	139	142	123	189	371	166	101	108	148
(in percent of exports)	15.9	13.4	11.4	15.2	18.2	7.0	3.9	3.8	5.3
Official budget debt service, cash payments	130	70	50	108	114	129	81	64	74

Sources: Bank of Zambia (BoZ); and Fund staff estimates and projections.

1/ Excludes grants.

2/ Indicates debt relief that would have been available under traditional debt relief mechanisms.

3/ Reserves at current exchange rates.

Table 9. Zambia: External Financing, 2000-08
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004 Prel.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Current account deficit (excl. official transfers and interest	-467	-614	-543	-589	-461	-717	-790	-736	-886
Change in n.f.a. of commercial banks	-89	40	-53	48	-90	17	-10	-10	-10
Private capital (net)	278	301	178	233	299	337	321	330	350
Gross reserves (-, increase)	-68	0	-169	89	-28	-90	-47	-86	-142
BoZ liabilities	-7	-5	-6	-6	-6	-6	0	0	0
Other foreign assets of the BoZ	30	...	...	...	...	...	...	...	...
Debt service, scheduled 1/	-494	-590	-593	-616	-694	-599	-283	-308	-332
Interest	-155	-144	-137	-131	-121	-110	-101	-95	-89
Multilaterals	-39	-37	-31	-33	-34	-31	-28	-26	-30
of which : IMF	-9	-8	-3	-6	-6	-5	-4	-5	-5
Bilaterals	-116	-107	-105	-98	-85	-75	-69	-64	-63
of which : Paris Club	-114	-105	-104	-97	-82	-73	-67	-63	-63
Amortization	-340	-446	-456	-486	-572	-490	-182	-213	-243
Multilaterals	-41	-260	-270	-295	-347	-348	-114	-142	-122
of which : IMF	0	-213	-222	-244	-257	-256	-21	-39	-69
Bilaterals	-192	-186	-186	-191	-259	-172	-97	-97	-96
of which : Paris Club	-173	-167	-169	-180	-211	-136	-81	-84	-93
Financing gap before debt relief and donor disbursements	-785	-856	-1153	-804	-979	-1057	-810	-810	-1020
Debt relief	217	436	437	389	264	480	197	200	184
Before HIPC-Paris Club 2/	217	170	171	154	245	152	70	64	67
HIPC debt relief	...	266	266	235	19	328	127	137	117
of which : IMF	…	150	153	169	2	219	2	1	0
of which : Paris Club	…	65	64	16	-2	38	51	56	61
Gross official assistance	457	527	685	416	668	577	613	610	619
Official creditors, excl. IMF	431	433	512	416	421	560	565	594	619
Budgetary support	185	75	138	55	65	134	124	158	151
World Bank	140	44	56	20	21	20	20	20	20
AfDB	13	0	13	0	0	9	0	0	0
Other	32	31	69	35	44	105	104	138	131
Project financing	246	358	347	341	356	426	441	436	468
Grants	153	222	236	240	246	306	321	337	364
Loans	93	136	111	101	110	120	119	99	104
Commodity support	0	0	27	20	0	0	0	0	0
IMF (PRGF)	26	94	173	0	248	16	48	16	0
Errors and ommissions	111	-107	31	-2	47	0	0	0	0
Unidentified financing (deficit -)	0	0	0	0	0	0	0	0	-216
Memorandum items:									
Official debt service, cash payments, incl IMF	-139	-142	-123	-189	-371	-166	-101	-108	-148
Official debt service, cash payments, excl IMF	-130	-70	-50	-108	-114	-129	-81	-64	-74
of which : Paris Club	-38	-26	-5	-69	-50	-19	-27	-27	-28
Net resource inflows, incl. IMF	212	385	563	227	239	458	526	502	471
Percent of GDP	6.5	10.6	14.9	5.3	4.4	6.6	6.4	5.7	4.9
Net resource inflows, excl. IMF	195	363	462	308	252	484	502	530	545
Percent of GDP	6.0	10.0	12.2	7.1	4.6	7.0	6.1	6.0	5.7
Gross official external reserves (end-year)	114	114	283	194	222	312	358	444	586
Months of imports	1.0	0.9	2.2	1.3	1.2	1.4	1.5	1.8	2.1
Percent of next year's annual official debt service	80	93	150	52	134	309	333	301	423

Sources: Bank of Zambia (BoZ); and IMF staff estimates and projections.

1/ Scheduled, before debt relief.

2/ Indicates debt relief that would have been available under the traditional debt relief mechanisms.

Table 10. Zambia: Projected Medium-Term Outlook, 2005-10

	2005	2006	2007	2008	2009	2010
	(Annual percentage change)					
National income and prices						
Real GDP	4.3	6.0	6.0	6.0	6.0	6.0
GDP deflator	18.9	11.5	4.6	4.1	3.6	4.4
Consumer prices (annual average)	18.4	14.4	6.3	4.9	5.0	5.0
Consumer prices (end of period)	17.0	10.0	5.0	5.0	5.0	5.0
	(In percent of GDP)					
Investment and savings						
Gross national savings	17.5	17.3	18.5	17.9	17.8	18.3
Gross foreign savings 1/	6.0	5.7	4.0	5.0	5.2	4.8
Gross domestic investment	23.5	22.9	22.5	22.9	23.0	23.0
Of which: public investment	7.4	8.4	8.5	8.0	9.4	9.4
Central government budget						
Revenue and grants	23.9	24.2	24.4	24.5	24.6	24.6
Revenue	17.8	18.0	18.2	18.4	18.5	18.5
Grants	6.0	6.2	6.2	6.0	6.1	6.1
Expenditures	26.5	26.8	26.2	25.8	26.1	26.2
Current expenditures	19.2	18.4	17.6	17.8	16.7	16.8
Of which:						
Wages and salaries	7.9	7.9	7.9	8.0	8.0	8.0
Interest due	2.7	2.4	1.6	1.4	1.3	1.3
Capital expenditures	7.4	8.4	8.5	8.0	9.4	9.4
Overall balance, cash basis	-2.7	-2.6	-1.8	-1.4	-1.5	-1.6
Domestic financing (net)	1.9	1.5	0.7	0.5	0.5	0.5
External financing (net)	0.7	1.0	1.1	0.9	1.0	1.1
	(Annual percentage change)					
Money and credit						
Broad money	8.6	14.3	12.9	11.9	11.2	11.2
Claims on the private sector	34.0	20.3	12.3	15.0	14.7	14.8
	(Annual percentage change)					
External sector						
U.S. dollar value of exports of goods and services	16.3	10.2	7.0	-0.7	1.5	4.9
U.S. dollar value of imports of goods and services	18.6	10.2	7.1	6.0	6.0	6.0
Export volume (goods)	5.5	16.1	15.5	3.9	7.5	7.4
Import volume (goods)	9.4	8.9	11.7	11.8	10.7	9.9
Terms of trade	2.1	-6.6	-3.6	-1.1	-3.3	-0.9
	(In percent of GDP)					
Current account balance, excluding grants	-11.9	-10.9	-9.4	-10.2	-10.4	-9.9
Current account balance, including grants and debt relief 2	-6.0	-5.7	-4.0	-5.0	-5.2	-4.8
Overall balance of payments	-4.0	-3.7	-2.8	-3.5	-3.3	-2.7
	(In percent of exports of goods and services)					
External official debt service	7.0	3.9	3.8	5.3	4.9	5.9
External program assistance 2/	5.7	4.7	5.6	5.4	5.8	5.9
	(In millions of U.S. dollars)					
Gross official reserves (end of period)	312	358	444	586	712	882
In months of imports of goods and services	1.4	1.5	1.8	2.2	2.5	2.9

Sources: Zambian authorities; and IMF staff estimates and projections.

1/ Includes program and budget grants and debt relief on interest payments.

2/ Projections are based on current trends in identified commitments.

Table 11. Zambia: Schedule of Disbursements Under the PRGF Arrangement, 2004-07

Amount		Availability Date	Conditions Necessary for Disbursement
(In millions of SDRs)	(In percent of quota)		
82.5356	16.88	June 16, 2004	Board approved the three-year arrangement and endorsed the annual program.
82.5356	16.88	December 15, 2004	Board completed the first review based on observance of performance criteria for September 30, 2004.
5.5020	1.13	April 6, 2005	Observance of performance criteria for December 31, 2004, and completion of the second review.
5.5024	1.13	June 16, 2005	Observance of performance criteria for March 31, 2005.
5.5024	1.13	September 13, 2005	Observance of performance criteria for June 30, 2005, and completion of the third review.
5.5024	1.13	December 13, 2005	Observance of performance criteria for September 30, 2005.
5.5024	1.13	May 31, 2006	Observance of the performance criteria for December 31, 2005, and completion of the fourth review.
11.0045	2.25	December 15, 2006	Observance of the performance criteria for June 30, 2006 and completion of the fifth review.
11.0045	2.25	March 15, 2007	Observance of performance criteria for December 31, 2006. and completion of the sixth review
5.5024	1.13	May 31, 2007	Observance of performance criteria for March 31, 2007.

December 9, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D. C.

Dear Mr. de Rato:

Since June 2004, the Government of Zambia has been implementing a financial and economic program with support from the Fund under the Poverty Reduction and Growth Facility (PRGF). The second review of the program was completed on April 8, 2005. The attached Memorandum of Economic and Financial Policies (MEFP) and Technical Memorandum of Understanding (TMU) reviews progress in implementing the program during 2005 and outlines the policies that the Government of Zambia will pursue in 2006. In the context of the new National Development Plan, scheduled to be launched in early 2006, the government's development strategy and policies will continue to focus on achieving high rates of pro-poor economic growth through the maintenance of sustainable macroeconomic policies and acceleration of the pace of structural reforms to support private sector growth, improve public expenditure management and accountability and the delivery of public services, and enhance competitiveness.

The Government requests the completion of the third review and the fifth and sixth disbursements under the PRGF arrangement in the amounts of SDR 5.502 million each. With regard to the sixth disbursement, the Government requests the IMF Executive Board to grant a waiver for the nonobservance of the end-September 2005 performance criterion on net domestic financing (NDF). The ceiling on NDF was breached by a small amount owing to emergency outlays for food relief in drought-affected areas, and higher-than-programmed expenditures on preparations for elections and the constitutional review process. The Government is making every effort to contain its net domestic financing requirements within program limits, in part, by soliciting additional external support for food relief.

The Government also requests two modifications to the program under the PRGF arrangement. First, the Government requests an upward adjustment to the end-December 2005 ceiling on NDF of up to K120 billion for the sole purpose of clearing domestic arrears to road contractors and consultants. These additional resources, combined with available resources from the 2005 budget allocation for arrears and a supplementary allocation financed from identified budgetary savings, would allow the Government to clear the bulk of the outstanding arrears to road contractors. This would facilitate the completion of ongoing contracts and the implementation of new contracts for essential infrastructure projects.

Second, the piloting of the Integrated Financial Management and Information System (IFMIS) has encountered further delays owing to difficulties in the procurement process. The contract for the installation of IFMIS had to be retendered after serious flaws with the preferred bidder emerged. The time table for selecting the winning bidder, signing the contract, and piloting the project is now expected to extend beyond that envisaged in the program. The Government thus requests that the IMF Executive Board modify the end-January 2006 performance criterion on the piloting of the IFMIS. The Government plans to undertake the piloting of the IFMIS by end-September 2006. Notwithstanding this delay, the Government has continued to strengthen current public expenditure management systems, including the computerized Commitment Control System and the Financial Management System (FMS). Site preparations are also being done at various ministries to facilitate the fast introduction of the IFMIS when it is ready for implementation.

The Government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. Zambia will consult with the IMF on the adoption of these measures, and in advance of revisions to policies contained in the MEFP, in accordance with Fund policies on such consultation.

The Government of Zambia authorizes the IMF to make this letter and attached memoranda available to the public, including through the placement of these documents on the IMF website, subject to the removal of market sensitive information, following the IMF Executive Board conclusion of the review.

Sincerely yours,

Ng'andu P. Magande, MP
Minister of Finance and National Planning
Ministry of Finance and National Planning

Attachment

ZAMBIA

Memorandum of Economic and Financial Policies of the Government of Zambia for 2006

I. Performance Under the Program Supported by the Poverty Reduction and Growth Facility (PRGF) in 2005

1. The Zambian economy has continued to perform well overall in 2005, although supply-side shocks have resulted in lower real GDP growth and higher inflation than was projected under the program. Real GDP growth is projected to be 4.3 percent, compared with 5.0 percent under the program (and 5.4 percent in 2004). A strong expansion in construction—driven by a robust demand for housing and large-scale investment in the copper sector—and solid growth in the tourism and cash crop sectors has been only partly offset by a drought-related shortfall in maize production and a relatively weak performance in mining. Zambia's copper production capacity increased significantly with the start-up of the Kansanshi mine in 2005, however its initial production was lower-than–expected. In addition, output growth in the sector was weakened by a variety of temporary setbacks, including a serious mine accident, labor disputes, and a fuel shortage caused by an extended shutdown of the country's oil refinery (Indeni). More broadly, Indeni's production problems and the ensuing severe fuel shortages disrupted activity throughout the economy during the second half of the year. Inflation has increased somewhat during 2005, owing in part to strong pressure on food and fuel prices. End-year inflation is expected to be 19.0 percent, compared with 17.5 percent in 2004 and the program objective of 15 percent.

2. **Fiscal performance has been broadly satisfactory through September 2005.** Government revenue collection was above the program target, with buoyant tax revenue collection largely offsetting a shortfall in nontax revenue. In October, to alleviate the impact of the fuel shortages, the Government reduced import and excise duties on petroleum products for the remainder of the year, which is expected to lower tax revenue by K 35 billion (about 0.1 percent of GDP). Nevertheless, for the year as a whole, revenues are expected to be in line with the program target. Through September, total recurrent expenditure was lower than programmed because of savings realized in domestic and external interest payments. However, government has had to resort to a bridge loan from the BoZ to cover a recurring mismatch in liquidity. Repayment of this loan and supplementary budget expenditures suggest a significantly tighter fiscal position in the fourth quarter of the year.

3. **The growth of broad money has decelerated steadily, in line with the objectives of containing inflation pressures.** On a year-on-year basis, the increase in broad money declined from 30.2 percent in December 2004 to 9.1 percent in August 2005. Owing largely to the difficulty in coordinating the management of liquidity, progress in slowing down the growth of reserve money was uneven. The control of liquidity was complicated by the sharp reduction by commercial banks of their holding of foreign assets to avoid balance sheet losses associated with the appreciation of the kwacha.

4. **On the external side**, record high world copper prices and expanding non-traditional exports of goods and services, including tourism, have contributed to strong growth in export receipts. Imports have grown even more strongly, in part because of high world petroleum prices and strong investment activity in the mining sector. On balance, however, the current account deficit (including grants) is expected to widen from 5.4 percent of GDP in 2004 to 6 percent in 2005. External budget support is expected to double between 2004 and 2005, to US$134 million, or 1.9 percent of GDP.

5. **All quantitative PRGF program targets were met for June and all but one for September (Table 1).** Of note, the floor on gross international reserves and the ceiling on net domestic assets of the Bank of Zambia (BoZ) were met by wide margins. The ceiling on government domestic financing was met by a comfortable margin in June, owing to a delay in the conclusion of wage negotiations with public sector labor unions, but it was narrowly missed in September. Similarly, the Government's wage bill was well below the benchmark ceiling for June, while the September benchmark was met by a narrower margin.[1]

6. **Under the structural program, both performance criteria were observed and, despite some delays, most benchmarks were implemented (Table 2).** In August, the Investment and Debt Management Department (IDM) of the Ministry of Finance and National Planning (MoFNP) produced the first quarterly update of debt-service projections based on the validated end-second quarter debt stock. Also, the Government continued to refrain from extrabudgetary expenditures that were not legally binding. In August, a list of supplementary expenditures (of about 0.5 percent of GDP) was approved by Cabinet. These expenditures, which included supplementary spending on emergency food relief, were limited to resources available from the contingency account and identified budgetary savings—mainly lower-than-budgeted interest payments on domestic and external debt. While there have been delays, all but one of the measures related to Public Expenditure Management and Financial Accountability (PEMFA) were implemented. With regard to the outstanding measure, new financial regulations and revised accounting manuals for the new Finance Act are being prepared and are expected to be issued by end-March 2006. The quarterly report on budget execution was published in a timely manner, but it was incomplete because some ministries had not yet provided the necessary information. All ministries have since reported.

7. **In the financial sector,** the government adopted the Bank of Zambia's (BoZ) proposed action plan for the Zambia National Building Society (ZNBS) in August, and the National Savings and Credit Bank (NSCB) and Development Bank of Zambia (DBZ) submitted initial drafts of their plans for incorporation under the Companies Act to the BoZ in April and May, respectively. The BoZ is working with the NSCB, DBZ, and Government (the principal shareholder), to finalize the action plans, including necessary resource allocations in the 2006 budget. The amendments to the acts governing the building societies, NSCB, and

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[1] Agreements were reached in June 2005, which provided for a 25 percent wage increase retroactive to April 1, 2005, and 13 percent effective April 1, 2006. The wage bill in 2005 is expected to slightly exceed budget projections.

DBZ, which align these acts with the Banking and Financial Services Act and gives the BoZ clear supervisory responsibility for these institutions, were enacted in October. Furthermore, the Zambia Privatization Agency (ZPA), has selected Rabobank as the favored bidder for a controlling 49 percent stake in the Zambia National Commercial Bank (ZNCB) and negotiations are expected to begin before the end of the year. The Government will make another 25.8 percent of the shares in ZNCB available for purchase by the general public through the Stock Exchange.

II. Proposed Modification to the Program for 2005

8. **While fiscal and monetary developments have largely been in line with program objectives through the first three quarters of the year, the Government may exceed the end-year program ceiling on domestic financing in order to pay down a larger amount of arrears to domestic road contractors and consultants (RCCs) than envisaged in the budget.** Re-establishing a good payments record with the RCCs is essential to assure the smooth implementation of road development, which is a key element of the draft National Development Plan (NDP) and for reducing poverty. The Government intends to borrow up to K 120 billion (0.3 percent of GDP) through the issuance of government securities during the fourth quarter that will be combined with other available budgetary resources for immediate payment of the bulk of these outstanding arrears.[2] Government will seek significant discounts in the claims to be paid off and the selection of RCCs to be paid will be done in a transparent manner. Given the availability of credit in the banking system and the demand for government securities from the non-bank public, the issuance of additional government securities is not expected to greatly impinge upon credit to the private sector. Government therefore will seek an adjustor to the December 2005 program ceiling on its domestic financing of up to K 120 billion for the sole purpose of clearing arrears beyond the amount possible with currently available resources.[3]

III. Medium-Term Objectives

9. **In line with the forthcoming National Development Plan (NDP), expected to be finalized in early 2006, and the medium-term expenditure framework (MTEF), Government aims to implement a macroeconomic policy framework and an agenda of structural reforms that will support strong economic growth and a substantial reduction in poverty.** While the NDP considers policy alternatives to accelerate growth and poverty reduction, which would require additional resources, the MTEF is based on current projections

[2] Arrears to road contractors and consultants stood at K 298 billion as of end-March 2005.

[3] The adjustor is defined in paragraph 7 of the technical memorandum of understanding. Available resources amount to K 108 billion from a budget allocation of K 35 billion and identified savings of K 73 billion.

and resource commitments. Under this current scenario for the MTEF period, 2006–2008, Government aims to:

- Achieve real GDP growth of 6 percent a year;
- Bring down end-year inflation to 10 percent in 2006 and 5 percent in 2007 and 2008;
- Reduce domestic borrowing to 1.6 percent of GDP in 2006, 0.7 percent of GDP in 2007, and 0.5 percent of GDP in 2008 to strengthen the domestic debt position and limit the crowding out of credit to the private sector;
- Increase the coverage of official gross international reserves to at least 1.5 months of imports in 2006, 1.8 months in 2007, and 2.2 months in 2008; and
- Remain current with foreign debt service.

10. **Raising economic growth is a key government objective and a precondition for poverty reduction.** In addition to sound macroeconomic and financial policies, raising economic growth to 6 percent a year would be supported by strong private sector investment, an expansion of energy supplies, and pro-poor growth policies to encourage labor-intensive sectors including small-scale mining, agriculture, manufacturing, and tourism. Recent and ongoing large-scale investment in the copper sector is expected to greatly boost mining sector output over the medium term, while strong growth in both residential and infrastructure construction is expected to continue. Monetary policy—supported by prudent fiscal policy—will focus on achieving price stability. External policies will be centered on maintaining a liberal trade regime, while ensuring a competitive, expanded and diversified export base.

11. **The reduction in Government's domestic borrowing over the medium term is the anchor to Zambia's macroeconomic stabilization effort.** That reduction will be achieved by gradually raising government revenues—by improving tax administration and widening the tax base by further bringing in the informal sector into the tax base—while exercising strict control on government expenditures. In addition, Government will explore the scope for revising the taxation of mining, without violating existing agreements. Expected increases in donor assistance, including in the form of budget support, would provide room for a greater expansion of government spending. A strengthening of budget execution will not only be critical to enable donors to increase budget support, but also to improve public sector service delivery and investment. The government has a large outstanding stock of arrears to the Public Service Pension Fund (PSPF). Over 2006-2008, about 1.5 percent of GDP will be allocated to reducing the stock of pension arrears.

12. **The structural reform agenda is mainly aimed at increasing productivity.** Implementation of the Financial Sector Development Plan (FSDP) and the Private Sector Development (PSD) action plan will be instrumental in addressing the main credit and administrative constraints on the private sector in Zambia. The structural reform agenda will also include measures to improve the quality, efficiency, cost effectiveness, and delivery of public services. Increasing productivity in the public sector will rely on continued progress with ongoing reforms to strengthen public expenditure management and financial

accountability (PEMFA), public service management, including rightsizing of the civil service, and decentralization.

IV. The Program for 2006

A. Fiscal Policy

13. **A reduction in the Government's net domestic financing to 1.6 percent of GDP in 2006, while allocating sufficient resources to achieve an increase of at least ½ percent of GDP in spending on PRPs, will be the anchor of the Government's macroeconomic stabilization effort.**[4] Government will conduct an overall review of tax policy during the first half of 2006, with the aim of rationalizing the tax system and expanding the tax base. In this context, Government is committed to maintaining revenues at a minimum of 17.5 percent of GDP in 2006, which is the projected collection under current policies (that is, excluding the temporary reduction in duties and excises on petroleum products). In addition, the Government will explore options to increase revenues from the mining sector, without violating any existing agreements.[5] Any tax measures and business incentives that may be introduced during the forthcoming budget deliberations will be accompanied by offsetting revenue measures. On the spending side, Government will seek to contain expenditures associated with an election year, including limiting spending on the general election itself in line with recent experience in neighboring sub-Saharan African countries. In addition to the PRPs, other spending priorities include (i) staying current with pension contributions and paying down outstanding arrears to the Public Sector Pension Fund (PSPF); (ii) net recruitment of [2000] teachers and retention of core health workers; (iii) financial restructuring of parastatals, including the NSCB and DBZ; (iv) timely payment of current terminal benefits. Moreover, it will be important to ensure that spending outcomes reflect budget intentions. In this regard, supplementary spending will continue to be limited to the contingency account and identified additional budgetary resources. The total wage bill in 2006 will respect the indicative ceiling of 8 percent of GDP.

B. Monetary and Exchange Rate Policies

14. **The BoZ will maintain an appropriately tight monetary policy in 2006.** Reserve money growth will be held to 9.8 percent during the year, while broad money, defined to include foreign currency deposits, is expected to expand by 14.3 percent.[6] The monetary authorities recognize that consistent implementation of the reserve money program is necessary in order to curb entrenched expectations of high inflation. In this regard, a return to

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[4] Government net domestic financing in 2005 could reach 2.2 percent of GDP, if the adjuster for clearance of arrears to road contractors and consultants is fully utilized.

[5] The expiration at the end of March 2005 of the tax concessions given to Konkola Copper Mines and new mining operations from Kansanshi Mines will increase the revenues from the mining sector.

[6] As measured using the program exchange rate.

normal conditions in the agriculture and fuel sectors would ease inflation pressures. The monetary program is projected to accommodate an expansion of credit to the private sector of about 20 percent in 2006. In addition, the BoZ expects to continue its buildup of gross international reserves (to at least 1.5 months of imports).

15. **The Bank of Zambia has been successful in maintaining the growth of broad money at below the target under the 2005 program.** However, this has not been without difficulty. In the face of, at times, significant upward pressure on the kwacha, the conduct of policy required a balancing act that was not always successful in achieving of the monetary policy objective. In particular, short-term interest rates came down noticeably in the first half of the year and were increasingly negative in real terms. In the second half of the year, the Bank of Zambia has been pursuing a more clearly tighter monetary stance consistent with the objective of lowering inflation. The recent introduction of long term bonds, in part to help define the yield curve, and efforts to foster the development of the interbank money market, as spelled out in the draft NDP, will form the basis for strengthening the conduct of policy. Close coordination between the BoZ and the MoFNP is important for improving liquidity management and will be intensified. The Government also recognizes the need for operational independence for the BoZ, if the BoZ is to successfully pursue the objective of price stability.

16. **The government remains committed to a flexible exchange rate regime**. The government is cognizant of the potential impact of exchange rate appreciation—caused by a combination of rising export receipts, growing aid inflows, and actual and prospective debt service relief—on the international competitiveness of nontraditional exports and domestic manufacturers. However, competitiveness needs to be secured through the establishment and maintenance of a business environment that is conducive to productivity growth. The government is, therefore, committed to implementing measures—including under the FSDP and the PSD action plan—that will reduce the cost of doing business in Zambia and contribute to the expansion and diversification of the export base, as well as allow domestic manufacturers to flourish.

C. External Prospects and Policies

17. **The external outlook for 2006 is favorable**. Notwithstanding an anticipated easing of copper prices from their record levels of 2005, metals exports are expected to rise by 11 percent, owing to stepped up production from Chambishi and Kansanshi mines. Nontraditional exports, including tourism, are also expected to continue to record healthy growth, resulting in total growth of goods and services exports of 10 percent in U.S. dollar terms. The oil import bill is also likely to rise further as a result of continued high oil prices and the need to restore inventories drawn down in 2005, including the possible initiation of a strategic petroleum reserve to guard against temporary supply shocks. Total goods and services imports are therefore projected to rise by 10 percent in U.S. dollar terms. On this basis, the current account deficit (including grants) is projected to remain steady at about6 percent of GDP in 2006.

18. **Somewhat lower external budget support is programmed for 2006 than was received in 2005, while external debt service is projected to decline sharply**. Based on

commitments from donors under the Harmonization in Practice (HIP) program, external budget support is conservatively estimated to be US$121 million (1.5 percent of GDP), with more than four-fifths in the form of grants. On the other hand, external debt service charged to the budget is projected to decline to US$81 million (1 percent of GDP), from US$129 million (1.9 percent of GDP) in 2005 with the full implementation of the debt-service relief under the HIPC Initiative. On this basis, the program for 2006 is fully financed.

19. **The government is committed to an open trade regime that is supportive of export development and diversification of the economy**.

D. Structural Measures

20. **Structural reforms in 2006 will continue to focus on public expenditure management and financial accountability (PEMFA), debt management, financial sector development, and governance and transparency.** These reforms are critical to support macroeconomic stability and growth. Table 4 presents the specific measures proposed for inclusion in the PRGF-supported program for 2006 as structural performance criteria and benchmarks

Public Expenditure Management

21. **Important advances in the PEMFA reform program will be implemented in 2006.** In addition to hiring a contractor for installation of and training for an integrated financial management and information system (IFMIS), Government will take steps to strengthen existing expenditure management systems. The Accountant General will issue rules and procedures for implementing and enforcing the new cash management system and will prepare reports for Cabinet on compliance with the commitment control system by ministry, province, and spending agency. To enhance transparency with regard to proposed budgetary allocations, starting with the 2006 budget, the MoFNP will issue summary tables using the activities based budgeting classification and identifying poverty-reducing programs. To strengthen planning and budget preparations the MoFNP will submit the initial draft of the 2007–2009 MTEF ("Green Paper") to Cabinet by end-August 2006. Also, Government will issue new regulations and revised accounting manuals for the new Finance Act by end-March 2006, which would improve procedures for treasury management at the MoFNP.

22. **Progress is being made toward implementation of IFMIS, albeit with some delays.** In line with the World Bank's procurement guidelines, the Government has re-tendered the contract for installation and training of IFMIS, including the piloting of the system in at least three line ministries by end-September 2006. It is expected that a list of pre-qualified bidders will be submitted to the World Bank in December 2005, and that negotiations with a preferred contractor could be concluded by end-April 2006. However, this is a complex process, involving a series of reviews by Government, bilateral donors, and the World Bank, and is subject to delays. The Government anticipates that a report on the findings of a preliminary review of the piloting exercise will be available by end-March 2007.

Debt Management

23. **The government will continue to strengthen its debt management capacity**. With the support of the World Bank, the government is implementing a multi-year debt management reform and capacity building program. The initial focus of the program is on strengthening back office functions in the IDM Department of the MoFNP. Major progress has been achieved in the validation of the external debt database and the initiation of the preparation of quarterly projections of debt service for the coming three years. The Government will validate the stock of onlending agreements by end-June 2006, with a view to ensuring that these agreements are effectively enforced, and will validate the stock of contingent external liabilities by end-December 2006. The Government will also prepare by end-June 2006 an annual report on external debt management operations during 2005. In addition, the IDM Department will strengthen the data base on Government's outstanding domestic obligations, beginning with the quarterly reporting of outstanding obligations to the Public Service Pension Fund (PSPF).

Financial Sector Development

24. **The government has continued to make progress in implementing the action plans for the problem nonbank financial institutions (NBFIs).** With the necessary legal framework in place, the way is now clear to pursue the resolution options for which preliminary work has been done. As regards the DBZ, the Government will, in accordance with understandings reached with the World Bank, explore options for expanding the lending resources of the DBZ in the light of the coming in of a new investor and the offer of a substantial line of credit. The Government expects that progress in this regard will pave the way for the registration of the DBZ under the Companies act and subsequent licensing under the Banking and Financial Services Act. The Government remains firm in its commitment to reduce its shareholding in the DBZ to 25 percent. As for the NSCB, the immediate tasks are to conclude the ongoing account reconciliation exercise, and implement the bank's Institutional Development Plan (IDP) involving the installation of a new computer system, with the IFAD's assistance. It is expected that with the completion of the review of the IDP, IFAD will formalize its participation in the bank and release funds to the NSCB. To this end Government in September, paid in its counterpart funds to the NSCB. This will open the way for registration and subsequent licensing of NSCB. Regarding the ZNBS, the Government has made a decision on the resolution of the institution and the BoZ is working on the modalities for its implementation. The resolution of the ZNBS will be effected by end-June 2006.

25. **A key element of the Government's Financial Sector Development Plan is the establishment of credit reference bureaux (CRB), to foster the availability of credit to support growth**. In this regard, the government will submit to cabinet a proposal for the legal framework establishing a credit reference bureau. The BoZ has completed preliminary studies and expects to issue interim guidelines for CRBs by the end of the year. These guidelines will serve as the basis for regulating CRBs until a legal framework is established.

26. **Outstanding pension liabilities pose a significant risk to fiscal balances over the medium term.** With support and technical assistance from the World Bank, the Government has initiated a pension reform aimed at providing sustainable benefits for retirees. In this

regard, Cabinet has approved a proposal to amend the constitution with the aim of ensuring the financial sustainability of the pension system. At the same time, Government will ensure that the investment and asset management capabilities are strengthened at the National Pension Scheme Authority NAPSA. To address the anticipated cash flow deficit in the Public Service Pension Fund, Government will paydown its outstanding balance on past contributions during 2006–2008.

Private sector development

27. **The Government has taken steps to accelerate the implementation of the Private Sector Development Programme (PSDP).** Most recently, following the fourth meeting of the Zambian Investors Business Advisory Council (ZIBAC) in September 2005, the Ministry of Labour and Social Security is preparing a reform proposal for Statutory Instruments Nos. 1 and 2 of 2002 on separation packages, aimed at reducing the burden of Zambia's costly terminal benefits. Also, the Ministry of Commerce, Trade, and Industry is preparing a cabinet memorandum on the liberalization of the telecommunications international gateway. A decision on the gateway is planned for early-December 2005. With the establishment of the PSD Steering Committee, assisted by a dedicated programme coordinating unit, it is expected that further progress will be achieved throughout the six areas of the PSDP: (i) reform of labor regulations and laws; (ii) business facilitation and economic diversification; (iii) infrastructure; (iv) local empowerment; (v) trade expansion; and (vi) policy environment and institutions.

28. **The electricity sector will play an integral role in supporting the country's economic growth in the years ahead, both through expanded production and contribution to increasing productivity and competitiveness.** At present, Zambia's electricity company (ZESCO), which is in the midst of implementing the first year of its business plan as a commercialized government-owned company, is planning a number of large-scale investments primarily to expand its generation and transmission capacity. Under the plan, ZESCO would incur external debt obligations of about US$1.5 billion. For Zambia to benefit from this expansion, without exposing the Government to potentially large liabilities, ZESCO's management must demonstrate the highest level of expertise in all aspects of the electricity sector. Upon completion of its fiscal year ending March 31, 2006, ZESCO's management will provide all the necessary financial, technical, and managerial information to the World Bank and the IMF for an assessment of ZESCO's performance under the commercialization process. The information will be provided by end-April 2006. Moreover, to ensure ZESCO's independent operations, the Government will not on-lend or guarantee any external credits to ZESCO.

Strengthening data

29. **The Government will take steps to expand Zambia's capacity to collect and report quality economic data.** At present, there are serious shortcomings in the data for the national accounts, consumer price index, and the balance of payments. To strengthen the role of the Central Statistics Office (CSO) in collecting and compiling data, the Minister of Finance and National Planning will submit to Cabinet a proposal for the revision of the 1964 Census and Statistics Act, with a view to reorganizing the CSO so as to make it more efficient and

effective. The CSO will also prepare a comprehensive strategy for improving its data collecting and reporting services.

V. Technical Assistance Needs

30. Over the past year, Zambia has received technical assistance from the IMF in the areas of banking sector statistics, liquidity management, government finance statistics, legislation governing nonbank financial institutions, public sector financial regulations, and tax policy for the mining sector. It is expected that further technical assistance will be requested for follow-up on liquidity management and the payments system, public sector financial regulations, and for training in reporting government finance statistics. In addition, the CSO will likely request assistance on rebasing the consumer price index and the national accounts. When making these requests, the Zambian authority will identify a senior officer who will oversee the technical assistance and a counterpart team that will work directly with IMF staff and the technical experts. The identified senior officer will also participate in the formulation of technical recommendations and be responsible for their implementation.

VI. Program Monitoring

31. Progress in implementing the PRGF-supported program will continue to be monitored quarterly, with semi-annual reviews, based on the quantitative and structural performance measures indicated in Tables 3 and 4. Performance criteria are now proposed through the end of June 2006, as well as indicative targets through the end of December 2006. The fourth review of the program, which is expected to be completed by May 31, 2006, will be based on the performance criteria and benchmarks for end-December 2005. The fifth review of the program, which is expected to be completed by December 15, 2006, will be based on the performance criteria and benchmarks for end-June 2006. In addition, the government requests modification of the performance criterion for end-December 2005 on the ceiling on net government domestic financing, through the introduction of an adjustor related to clearance of arrears to road contractors and consultants. The government further requests that the performance criterion envisaging initiation of the piloting of IFMIS in at least three line ministries by end-January 2006 be modified to envisage initiation by end-September 2006. The quantitative and structural performance criteria and benchmarks are defined in the attached technical memorandum of understanding.

Table 1. Zambia: Quantitative Performance Criteria (PC), Benchmarks and Indicative Targets Under the PRGF Program 1/
(In billions of Kwacha, unless otherwise indicated)

	2004	2005									2005	
	Dec. Stocks	March Prog.	March Actual	Status	Jun. Prog.	Jun. Actual	Status	Sep. Prog.	Sep. Actual	Status	Dec. Prog.	Dec. Actual
Performance Criteria												
1 Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia 2/ 3/ 4/ 5/	6,836	14	-185	**Met**	182	-41	**Met**	104	-306	**Met**	166	...
Adjusted ceiling		94			296			286				
2 Ceiling on the cumulative increase in net domestic financing (NDF) 2/ 5/	3,305	60	168	**Met**	217	319	**Met**	301	513	**Not met**	500	...
Adjusted ceiling		190			374			496				
3 Floor on the stock of gross international reserves (GIR) of the Bank of Zambia (In millions of U.S. dollars) 2/	238	232	251	**Met**	204	275	**Met**	244	308	**Met**	246	...
Adjusted floor		225			192			194				
4 Ceiling on new external payment arrears		0	0	**Met**	0	0	**Met**	0	0	**Met**	0	...
5 Ceiling on the stock of short-term debt and on contracting or guaranteeing of nonconcessional debt (In millions of U.S. dollars) 6/		0	0	**Met**	0	0	**Met**	0	0	**Met**	0	...
6 Ceiling on cumulative new concessional loans collateralized or guaranteed by the central government or the Bank of Zambia for ZESCO.		20	0	**Met**	20	0	**Met**	20	0	**Met**	20	...
7 Floor on the cumulative payment of domestic arrears of the government 5/		62	65	**Met**	100	144	**Met**	151	220	**Met**	284	...
Quantitative Benchmarks												
8 Cumulative ceiling for the Central Government wage bill 5/		593	508	**Met**	1,236	1,090	**Met**	1,876	1,782	**Met**	2,531	...
9 Ceiling on the cumulative arrears on the Central Government wage bill		0	0	**Met**	0	0	**Met**	0	0	**Met**	0	...
Memorandum items:												
10 Cumulative net balance of payments support (In millions of U.S. dollars)		-8	-14		-29	-41		4	-45		13	...
Balance of payments assistance		31	36		41	41		98	64		133	...
Central Government debt service obligations (excl. IMF)		-39	-51		-78	-83		-93	-109		-120	...
Shortfall (-)/Excess (+) net BOP support			-6			-12			-49			
Program exchange rates												
Kwacha/US$	4,771											
US$/SDR	1.5478											

1/ The definitions of the indicative targets are contained in the Technical Memorandum of Understanding (TMU).
2/ Adjustors, including for balance of payments support are defined in the TMU.
3/ Excludes HIPC debt relief from the IMF.
4/ The ceiling will be adjusted for changes in the legal reserve requirements.
5/ Cumulative from the end of 2004.
6/ Nonconcessional loans are defined as having a grant element of less than 40 percent.

Table 2. Zambia: Status of Structural Benchmarks and Performance Criteria 1/

Benchmarks and Performance Criteria	Timing	Status
1. Public expenditure management and financial accountability (PEMFA)		
The government will refrain from paying any amounts for which it is not legally liable and which are not included in the budget. 2/	Continuous	Observed
Publication of quarterly budget execution reports using the activity-based budgeting classification, within 45 days of the end of each quarter.	Continuous	Observed. A summary table was prepared for the report for 2005:Q2; however, data from many line ministries were not included in the report. Data for all 46 line ministries were later reported.
In consultation with the PEMFA Technical Working Group, design a cash-flow framework for all line ministries.	May 2005	Completed late. The cash-flow framework was implemented in all line ministries in August. The framework has also been implemented in provinces and spending agencies. Implementation of the framework was done without consultation with the PEMFA Joint Technical Working Group (JTWG), but user mauals were later sent to lead donors in the JTWG.
In consultation with the PEMFA Technical Working Group, finalize a framework for monitoring and evaluating the PEMFA program.	May 2005	Completed late. The framework was completed in July and approved by the PEMFA Steering Committee in August.
Prepare and publish the first draft ("Green Paper") of the Medium-Term Expenditure Framework (MTEF) for 2006-08.	August 2005	Completed late. Cabinet discussed the first draft of the MTEF in early November, after which the MTEF was made public.
Issue new regulations and revised accounting manuals for the new Finance Act.	September 2005	Not completed. An initial draft of the regulations was prepared with technical assistance from an IMF-supported expert in July-August, and was circulated for comments. The MoFNP is drafting the corresponding manual detailing operational procedures. With further assistance from the expert, the regulations and manuals will be finalized in early 2006.
Complete review of the implementation of the PEMFA program.	November 2005	Observed
2. Debt management		
Beginning with the second quarter of 2005, validate end-quarter external debt stock data and, within 45 days, provide updated 3-year schedule of debt service falling due. 2/	Continuous from August 2005	Observed
3. Financial sector reform		
Adoption by the government and the Bank of Zambia of an action plan, finalized in consultation with the World Bank and IMF staff for the resolution of the Zambia National Building Society.	April 2005	Completed late. The Minister of Finance and National Planning approved the BoZ's recommended plan in August.
The National Savings and Cred Bank (NSCB) and the Development Bank of Zambia (DBZ) submit to the BoZ plans for their incorporation in 2006 under the Companies Act.	December 2005	Observed. The BoZ is working with the NSCB and DBZ to finalize the plans and Government has proposed allocating the necessary resources in the 2006 budget to prepare the institutions for incorporation. Both institutions have found investors to help shore up their financial positions and strengthen management.
4. Governance and transparency		
Unbudgeted expenditure requirements will be funded only to the limits of the contingency resources indicated in the budget or only after the cabinet has approved any changes by finding compensatory funding within the approved budget resources.	Continuous	Observed

1/ The definitions of the prior actions, structural benchmarks, and performance criteria are contained in the Technical Memorandum of Understanding (TMU).

2/ Performance criteria.

Table 3: Zambia: Quantitative Performance Criteria (PC), Benchmarks and Indicative Targets Under the PRGF Program 1/
(In billions of Kwacha, unless otherwise indicated)

	2006	2006			
	Base	March Prog.	Jun. Prog.	Sep. Prog.	Dec. Prog.
Performance Criteria					
Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia 2/ 3/ 4/ 5/	6,428	-37	65	-68	128
Adjusted ceiling					
Ceiling on the cumulative increase in net domestic financing (NDF) 2/ 5/	2,910	136	226	206	589
Adjusted ceiling					
Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (In millions of U.S. dollars) 2/	312	8	17	61	47
Adjusted floor					
Ceiling on new external payment arrears		0	0	0	0
Ceiling on the stock of short-term debt and on contracting or guaranteeing of nonconcessional debt (In millions of U.S. dollars) 6/		0	0	0	0
Floor on the cumulative payment of domestic arrears of the government 5/ 7/		50	89	155	238
Quantitative Benchmarks					
Cumulative ceiling for the Central Government wage bill 5/		654	1,431	2,242	3,019
Ceiling on the cumulative arrears on the Central Government wage bill		0	0	0	0
Memorandum items:					
Cumulative net balance of payments support (In millions of U.S. dollars)		1.3	6.9	60.5	45.6
Balance of payments assistance		17.8	47.8	118.4	127.0
Central Government debt service obligations (excl. IMF)		-16.5	-40.9	-57.9	-81.4
Shortfall (-)/Excess (+) net BOP support					
Program exchange rates					
Kwacha/US$	4,550				
US$/SDR	1.436				

1/ The definitions of the items in the quantitative program are contained in the Technical Memorandum of Understanding (TMU). Targets for September and December are indicative. All targets for March are benchmarks.
2/ Adjustors, including for balance of payments support are defined in the TMU.
3/ Excludes HIPC debt relief from the IMF.
4/ The ceiling will be adjusted for changes in the legal reserve requirements.
5/ Cumulative from the end of 2005.
6/ Nonconcessional loans are defined as having a grant element of less than 40 percent.
7/ This includes K100 billion for the payment of arrears to the Public Service Pension Fund.

Table 4. Zambia: Structural Performance Criteria and Benchmarks for 2006[1]

Measure	Timing
Performance Criteria	
The government will refrain from paying any amounts for which it is not legally liable and which are not included in the budget.	Continuous
The Investment and Debt Management Department (IDM) of the MoFNP will validate the stock of onlending agreements with a view to effectively enforcing these agreements. The IDM will report to the Secretary of Treasury on the validation of these agreements.	end-June 2006
Initiate the piloting of an integrated financial management and information system (IFMIS) in at least three line ministries.	end-September 2006
The IDM will validate the stock of government contingent external liabilities, including loan guarantees, and pension obligations. The IDM will report to the Secretary of Treasury on the validation of these liabilities.	end-December 2006
Report on the findings of a preliminary review of the piloting of the IFMIS in at least three line ministries.	end-March 2007
Benchmarks	
Public expenditure management and financial accountability (PEMFA)	
Issue summary tables, developed in consultation with the PEMFA Joint Technical Working Group (JTWG), using activities based budgeting classification and identifying poverty reducing programs.	end-March 2006
Issue new regulations and revised accounting manuals for the new Finance Act.	end-March 2006
In consultation with the PEMFA JTWG, issue (i) accountability rules and procedures under the new cash management framework and (ii) corresponding administrative procedures for enforcement, to ensure the timely release of funds by the Ministry of Finance and National Planning.	end-March 2006
Submit to Cabinet the first draft ("Green Paper") of the Medium-Term Expenditure Framework (MTEF) for 2007-2009.	end-August 2006
Debt management	
Validate end-quarter external debt stock data and, within 45 days, provide updated 3-year schedule of debt service falling due to the Budget Director.	Continuous

[1] The definitions of the prior actions, structural benchmarks, and performance criteria are contained in the Technical Memorandum of Understanding (TMU).

Table 4. Zambia: Structural Performance Criteria and Benchmarks for 2006[1]

Measure	Timing
The MoFNP will issue an annual report on external debt management operations during 2005.	end-June 2006
Financial sector development	
Execute the action plan adopted by the Government on the resolution of the Zambia National Building Society.	end-June 2006
Submit to cabinet a proposal for the legal framework establishing a credit reference bureau, including the necessary amendments to [privacy laws].	end-June 2006
Incorporate the National Savings and Credit Bank and the Development Bank of Zambia under the Companies Act.	end-December 2006
Private sector development	
ZESCO's management will provide all the necessary financial, technical, and managerial information to the World Bank and the IMF for an assessment of ZESCO's performance in line with the conditions for reaching the evaluation point under the commercialization process.	end-April 2006
Governance and transparency	
Unbudgeted expenditure requirements will be funded only to the limits of the contingency resources indicated in the budget or only after the cabinet has approved any changes by finding compensatory funding within the approved budget resources.	Continuous
Publication of quarterly budget execution reports using the activity-based budgeting classification, within 45 days of the end of each quarter, including summary tables developed in consultation with the PEMFA JTWG.	Continuous

Zambia: Technical Memorandum of Understanding for The Poverty Reduction and Growth Facility (PRGF) Arrangement

I. INTRODUCTION

1. This memorandum sets out the understandings between the Zambian authorities and the International Monetary Fund (IMF) regarding the definitions of the quantitative and structural performance criteria and benchmarks for the program for 2006 supported by the PRGF arrangement, as well as the related reporting requirements. The definitions are valid at the start of the program, but may need to be revisited to ensure that the memorandum continues to reflect the best understanding of the Zambian authorities and IMF staff to monitor the program. The memorandum also introduces an adjustor on the end-2005 ceiling on net domestic financing related to the clearance of arrears to road contractors and consultants (paragraph 7).

II. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS: DEFINITIONS AND DATA SOURCES

A. Net Domestic Assets (NDA) of the BoZ

2. Net domestic assets (NDA) of the BoZ are defined as the monthly average (based on daily data) of reserve money less net foreign assets calculated at Kwacha 4,550.0 per U.S. dollar (program exchange rate).[1] Reserve money consists of currency issued, required reserves on Kwacha deposits, required reserves on foreign currency deposits (at the program exchange rate), positive current account balances of banks with the BoZ, and deposits in the BoZ of non-central government institutions. Net foreign assets of the BoZ are defined as gross international reserves (defined below) plus any other foreign assets, including the US$25 million blocked reserves at the former Meridien Bank (MBZ), minus foreign liabilities (defined below). The Kwacha values are derived from the U.S. dollar values using the program exchange rate.

3. Foreign reserve liabilities are defined as short term (one year or less in original maturity) foreign currency-denominated liabilities of the BoZ to nonresidents and outstanding use of IMF credit.

4. The ceilings on NDA will be adjusted upward by the amount of the shortfall of balance of payments support net of debt service as indicated in Table 3 (item 10) of the Memorandum of Economic and Financial Policies (MEFP), up to a maximum of US$20 million for the period end-December 2005 to end-December 2006. External disbursements that occur anytime during

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[1] Unless otherwise defined, program exchange rates for 2006 between the U.S. dollar and other (non-Kwacha) currencies will be equal to the end-September 2005 rates. The U.S. dollar/SDR rate for program purposes is 1.4360. Any other assets (e.g. gold) would be revalued at their end-September 2005 market prices.

the month of the test date will be treated as if they were disbursed on the first day of the month.[2] In the event of excess balance of payments support net of debt service, the ceiling on NDA will be adjusted downward by 100 percent of the additional excess support. However, if part of the excess support is used to reduce the stock of Treasury bills or bonds held by commercial banks and the non-bank sector, then the programmed NDA will be adjusted upward by that amount. In the event of implementation of the MDRI, the ceiling on NDA will be adjusted downwards by 100 percent of the amount of debt to the IMF that is cancelled. The Kwacha value of the cumulative shortfall/excess will be calculated at the program exchange rate.

5. The ceiling on NDA will be adjusted downward/upward to reflect decreases/increases in the legal reserve requirements on deposits in commercial banks. The adjustor will be calculated as the percent change in the reserve requirement multiplied by the actual amount of reserves (Kwacha and foreign-currency denominated) at the end of the previous calendar month.

B. Net Domestic Financing (NDF)

6. Net domestic financing is defined as the Central Government's net borrowing from the banking and non-banking sectors (See table 1).[3] All government-issued securities will be recorded at cost (face value less discount). NDF will be defined as:

(a) the net position of the Government with commercial banks, including: (i) Treasury bills; (ii) government bonds; (iii) loans and advances; less (iv) support to MBZ; and (v) central government deposits (defined to include account balances under the authority of controlling officers); plus

(b) BoZ holdings of: (i) Treasury bills; (ii) government bonds; (iii) the Kwacha bridge loan (overdraft facility); less (iv) the government's position at the BoZ; and (v) the donor suspense account; plus (vi) the long-term non-transferable security issued against the government's total indebtedness to BoZ as at end-2002.

(c) Nonbank holdings will include: Treasury bills; and government bonds.

7. The end-December 2005 ceiling on NDF will be adjusted upward by up to K 120 billion solely for the purpose of clearance of government arrears to road contractors and consultants, audited at end-March 2005 at K 298 billion, in excess of the K 108 billion provided for this purpose in the 2005 budget allocation and a supplementary allocation financed from identified budgetary savings.

8. The NDF ceiling will be adjusted upward by the amount of the shortfall in balance of payments support net of debt service as indicated in Table 3 (item 10) of the MEFP, up to a

[2] This implies that, for purposes of monitoring the NDA, the targeted NDA will be increased by the amount of the disbursement divided by the number of business days in the month and multiplied by the number of business days from the beginning of the month to the day prior to the disbursement.

[3] The Central Government includes all the administrations identified by the budget heads listed in the 2006 Yellow Book.

maximum of US$20 million for the period end-December 2005 to end-December 2006. In the event of excess balance of payments support net of debt service, the ceiling on NDF will be adjusted downward by 100 percent of the additional excess support. The ceiling on NDF will be adjusted downward by 100 percent of the amount of debt-service payments foregone to IDA and AfDF under the MDRI. The Kwacha value of the cumulative shortfall/excess will be converted at the program exchange rate.

9. The data source for the above will be the "Net Domestic Financing" Table produced by the BoZ Economics Department, submitted on a weekly basis, and reconciled with the monthly monetary survey.

C. Gross International Reserves of the BOZ

10. Unless otherwise noted here, gross international reserves of the BoZ will be defined as reserve assets of the BoZ (See Table 2). Reserve assets are defined in the IMF BOP manual (5th edition) and elaborated in the reserve template of the IMF's special data dissemination standards (SDDS). They exclude, for example, foreign assets not readily available to or controlled by the monetary authorities, and foreign currency claims on Zambian residents.

11. Gross international reserves consist of (i) monetary gold; (ii) foreign currency in cash; (iii) unencumbered foreign-currency deposits at non-resident banks; (iv) foreign securities and deposits; (v) SDR holdings and Zambia's reserve position with the IMF; and (vi) balances in the BIS account related to debt service to Paris Club creditors. Gross reserves exclude non-convertible currencies, pledged, swapped, or any encumbered reserve assets including but not limited to reserve assets used as collateral or guarantees for third-party external liabilities, commercial bank reserve requirements in foreign currency, and the US$25 million deposit in MBZ (in liquidation).

12. The floor on gross international reserves will be adjusted: (i) downward by the amount in U.S. dollars of the shortfall in balance of payments support net of debt service as indicated in Table 3 (item 10) of the MEFP, up to a maximum of US$20 million for the period end-December 2005 to end-December 2006; (ii) upward by 100 percent of the cumulative excess balance of payments support net of debt service. However, if part of the excess support is used to reduce the stock of Treasury bills or bonds held by commercial banks or the non-bank sector, then the programmed reserves buildup will be adjusted downward by that amount; (iii) downward/upward for any shortfall/excess in the U.S. dollar value of disbursements from the IMF under the PRGF arrangement; (iv) downward for any increase in BoZ short-term foreign currency denominated debt (to residents and nonresidents), using the definition of short-term debt below; and (v) upward by 100 percent of the amount of debt-service payments to the IMF foregone under the MDRI.

13. For the purpose of this target, as well as those for external debt and arrears, valuation will be in U.S. dollars using the program exchange rate.

14. Data on gross international reserves, including its components, will be reported by the BoZ on a weekly and end-month basis.

D. External Payment Arrears

15. The performance criterion on the non-accumulation of new external arrears is continuous. Official external payment arrears are defined as unpaid debt service by the Central Government and BoZ, beyond the due date and/or the grace period, if any. This definition excludes arrears subject to rescheduling.

16. Data on arrears are compiled jointly by the Ministry of Finance and National Planning (MoFNP) and BoZ and will be reported by the MoFNP on a quarterly basis.

E. Official Medium- and Long-Term Concessional External Debt

17. Official medium- and long-term concessional external debt is defined as all forms of official debt with original maturity of more than one year contracted or guaranteed by the Central Government and BoZ having a grant element of no less than 40 percent, but excludes debts subject to rescheduling. The grant element is to be calculated by using currency-specific commercial interest reference rates (CIRRs) reported by the OECD; for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs, and for maturities longer than 15 years, the grant element will be calculated based on 10-year averages. Adjustment lending from the IMF will be excluded.

18. This target applies not only to debt as defined in Point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) of August 24, 2000; see Annex), but also to commitments contracted or guaranteed for which value has not been received. This excludes non-concessional loans stemming from the rescheduling of external arrears.

19. Detailed data on all new concessional and non-concessional debt contracted or guaranteed will be provided by the MoFNP on a monthly basis.

F. Official External Short-Term Non-concessional External Debt

20. Official external short-term non-concessional external debt is defined as the outstanding stock of external debt with original maturity of less than one year owed or guaranteed by the central Government or the BoZ. For this purpose short-term debt will include forward commodity sales but will exclude normal trade credit for imports. There will be no new official external short-term debt during the program period. The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) of August 24, 2000; see Annex).

21. The data will be reported by the MoFNP and BoZ on a monthly basis.

G. Domestic Arrears of Government

22. Domestic arrears are defined as: (i) any bill that has been received by a spending ministry from a supplier for goods and services delivered (and verified) and for which payment has not been made within 30 days after the due date of payments; (ii) wage, salary and any

payment to government employees, including all forms of housing allowances, that were due to be paid in a given month but remained unpaid on the 15th of the following month; and (iii) interest or principal obligations which remain unpaid 30 days after the due date of payment. Included in the quarterly program floors for payment of domestic arrears in 2006 is payment of K 25 billion each quarter toward Government's arrears on contributions to the Public Sector Pension Fund.

23. Information regarding domestic arrears is to be compiled through audits of the accounts of spending Ministries and agencies, conducted by the Internal Audit division of the MoFNP. The audits will be completed and data submitted to IMF staff by the Secretary of the Treasury within six weeks of the end of each quarter.

H. The Central Government's Wage Bill

24. For the purposes of the wage bill, the definition of Central Government includes all heads covered in the 2006 Yellow Book. The Central Government's total wage bill will include payments on wages, salaries, allowances, and all other items specified as personal emoluments in the Yellow Book, and any direct or indirect payments of housing allowances to employees. The Government will provide, on a monthly basis and by budget head, the following data: (i) the number of all employees in the Central Government for each budget head; (ii) the basic salary, the allowances and any other personal emoluments released during the month; (iii) the arrears incurred during the month on the basic salary, on the allowances, and on any other personal emoluments; (iv) the number of employees retrenched and the corresponding retrenchment costs.

25. All the data will be submitted to the IMF staff by the MoFNP within three weeks of the end of each month.

III. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

A. Performance Criteria

Continuous Criterion

26. The Government will refrain from making payments for which it is not legally liable and which are not included in the budget.

Public Expenditure Management

27. By September 30, 2006, the Government will initiate the piloting of the Integrated Financial Management and Information System (IFMIS) in at least three ministries.

28. By March 31, 2007, the government will report on the findings of a preliminary review of the piloting of the IFMIS in at least three line ministries.

Debt Management

29. The Investment and Debt Management Department (IDM) of the MoFNP will validate the stock of onlending agreements with a view to effectively enforcing these agreements. The

IDM will report to the Secretary of Treasury on the validation of these agreements by June 30, 2006.

30. The IDM will validate the stock of government contingent external liabilities, including loan guarantees and pension obligations. The IDM will report to the Secretary of Treasury on the validation of these liabilities by December 31, 2006.

B. Benchmarks

Continuous Benchmarks

31. Unbudgeted expenditure requirements will be funded only to the limits of the contingency resources indicated in the budget or only after the Cabinet has approved any changes by finding compensatory funding within the approved budget resources.

32. The MoFNP will publish quarterly budget execution reports using the classification system of activity-based budgeting within 45 days of the end of each quarter, including summary tables developed in consultation with the PEMFA JTWG and an annex on compliance with the commitment controls system (CCS) by ministry.

33. The MoFNP will validate end-quarter debt stock data and, within 45 days, provide to the Budget Director an three-year updated schedule of debt service falling due.

Public Expenditure Management

34. By end-March 2006, the Government will include in the budget proposal submitted to parliament ("Yellow Book") summary tables, developed in consultation with the PEMFA Joint Technical Working Group (JTWG), using activities based budgeting classification and identifying poverty related expenditure.

35. By end-March 2006, in consultation with the PEMFA JTWG, the government will issue (i) accountability rules and procedures under the new cash management framework and (ii) corresponding administrative procedures for enforcement, to ensure the timely release of funds by the MoFNP.

36. By March 31, 2006, the MoFNP will issue the new regulations and the revised accounting manual needed for the complete and effective operations of the Finance Act approved by parliament in December 2004.

37. The Government will prepare and submit to Cabinet, by end-August 2006, a first draft of the Medium-Term Expenditure Framework ("Green Paper") for the period 2007-2009.

Debt Management

38. Before end-June 2006, the MoFNP will issue an annual report on external debt management operations during 2005.

Financial Sector Development

39. Before end-June 2006, the authorities will execute the action plan adopted by the Government and Bank of Zambia on the resolution of the Zambia National Building Society.

40. Before end-June 2006, the MoFNP will submit to Cabinet a proposal for the legal framework establishing a credit reference bureau, including the necessary amendments to privacy laws.

41. Before end-December 2006, the government will incorporate the National Savings and Credit Bank and the Development Bank of Zambia under the Companies Act.

Private Sector Development

42. By April 30, 2006, ZESCO’s management will provide all the necessary financial, technical, and managerial information to the World Bank and the IMF for an assessment of ZESCO’s performance in line with the conditions for reaching the evaluation point under the commercialization process.

ANNEX

Guidelines on Performance Criteria with Respect to Foreign Debt

Excerpt from Executive Board Decision No. 6230-(79/140), as revised on August 24, 2000

9. (a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

Table 1. Net Domestic Financing

	2005		2006
		Program Base	
	End-Dec.	End- Dec.	
Total domestic financing (program)			
Adjustment			
Adjusted program financing			
Excess/shortfall (-= excess)			
Total domestic financing			
Bank financing			
Commercial banks			
Treasury bills 1/			
Bonds 1/			
Loans and advances			
less: Support to MBZ			
less: Deposits			
Bank of Zambia			
Treasury bills 1/			
Bonds			
Kwacha bridging loan			
GRZ position			
Donor suspense balance			
GRZ long-term security IFO BoZ			
Other			
Nonbank financing			
Treasury bills 1/			
Bonds 1/			

Source: BoZ net domestic financing table
1/Measured at cost (face value less discount) starting from end-December 2003

Table 2. Zambia: Gross International Reserves
(In millions of U.S. dollars)

	2005 December			2006 March, June, September, December				
	12/31/2005 = Base			Current			31/12/05	
	Amount	Exch rate or price	U.S. dollar	Amount	Exch rate or price	U.S. dollar	Exch rate or price	U.S. dollar
Official Reserve assets 2/								
Foreign Currency Reserves								
Securities								
In U.S. dollars								
In U.K. pounds								
In Euro								
Other currencies								
Deposits 3/								
In U.S. dollars								
In U.K. pounds								
In Euro								
In South African Rand								
Other currencies								
IMF reserve position								
SDR (excludes IMF interim assistance under the HIPC initiative)								
Monetary gold								
Other reserve assets								
Memo: Other foreign currency assets 4/								
Predetermined short-term net drains 5/								
Liabilities to IMF								
Other foreign currency loans and securities								
In U.S. dollars								
In U.K. pounds								
In other currencies								
Aggregate short and long positions in forwards, futures and swaps								
Other								
Contingent short-term drains								
Contingent liabilities								
Securities with embedded options								
Undrawn, unconditional credit lines								
Aggregate short & long term positions of options								
Memorandum items:								
Short-term domestic currency debt indexed to the exchange rate								
Financial instruments denominated in foreign currency settled by other means								
Pledged assets								
of which: Balance of IMF interim HIPC assistance								
Securities learnt on repo								
Financial derivatives (net, marked to market)								
Derivatives w/residual maturity >1 year, subject to margin calls								

1/ As defined in the TMU or IMF, "Data Template on Int'l Reserves and Foreign Currency Liquidity: Operations Guidelines."
2/ Corresponds to gross international reserves for program monitoring.
3/ Excludes deposits at resident banks, unless assets held abroad by the bank are explicitly connected to the foreign exchange deposits of the BoZ and are totally and effectively controlled by the BoZ and are available for balance of payments needs.
4/ Includes foreign currency deposits at resident banks.
5/ The program target for gross international reserves will be adjusted as described in the TMU.

Zambia: Fund Relations
(As of October 31, 2005)

I. **Membership Status:** Joined: September 23, 1965; Article VIII

II. **General Resources Account:**	**SDR Million**	**Percent Quota**
Quota	489.10	100.0
Fund holdings of currency	489.10	100.0
Reserve position in Fund	0.2	0.0

III. **SDR Department:**	**SDR Million**	**Percent Allocation**
Net cumulative allocation	68.30	100.0
Holdings	26.22	38.4

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent Quota**
PRGF arrangements	473.26	97.2
SAF loans	18.18	3.7

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
PRGF	06/16/2004	06/15/2007	220.10	170.57
PRGF	03/25/1999	03/28/2003	278.90	237.52
PRGF	12/06/1995	12/05/1998	701.68	661.68

VI. **Projected Obligations to Fund (Without HIPC Assistance):**
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	83.34	10.49	26.95	47.50	54.76
Charges/interest	1.51	3.25	3.17	3.00	2.67
Total	84.85	13.74	30.12	50.51	57.43

Projected Obligations to Fund (With Board-approved HIPC Assistance):
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	13.71	9.29	26.45	47.50	54.76
Charges/interest	1.51	3.25	3.17	3.00	2.76
Total	15.22	12.54	29.62	50.51	57.52

VII. **Implementation of HIPC Initiative**:

	Enhanced Framework
Commitment of HIPC assistance	
Decision point date	Dec. 2000
Assistance committed (1999 NPV terms)[1]	
Total assistance (US$ million)	2,499.20
Of which: Fund assistance (SDR million)	468.80
Completion point date	April 2005
Delivery of Fund assistance (SDR million)	
Amount disbursed	468.80
Interim assistance	351.60
Completion point balance	117.20
Additional disbursements of interest income[2]	39.47
Total disbursements	508.27

VIII. **Safeguards Assessment:**

Under the Fund's safeguards assessment policy, the Bank of Zambia (BOZ) is subject to an assessment with respect to the PRGF arrangement, which was approved on June 16, 2004 and is scheduled to expire on June 15, 2007. A safeguards assessment of the BOZ was completed on October 20, 2004.

The assessment identified certain weaknesses. The authorities have taken the following steps in the light of the recommendations made:

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[1] Net present value (NPV) terms at the decision point under the enhanced framework.

[2] Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point but not disbursed during the interim period.

(i) in December 2004, the BoZ's board adopted the International Financial Reporting Standards as the basis for financial reporting;

(ii) in December 2004, the BoZ's board also adopted a policy for the appointment of external auditors (three year-term appointment, renewable only once);

(iii) pending the approval of an amendment to the Bank of Zambia Act the BoZ and the MoFNP have adopted a Memorandum of Understanding for the exclusion of unrealized gains from profits available for distribution to government; and

(iv) the Finance Department of the BoZ and the Economics Department of the BoZ have established a data monitoring committee for the purpose of jointly reconciling the data reported to the Fund. Reconciliation reports for the first two quarters of 2005 have been submitted to the Fund.

(v) proposed amendments to the BoZ Act to strengthen the operational independence of the BoZ have been submitted for consideration as part of the ongoing review of the country's constitution.

IX. **Exchange Rate Arrangement**:

The currency of Zambia is the kwacha. The exchange rate for the kwacha is determined in the inter-bank foreign exchange market, in a managed float with no pre-announced path. On August 31, 2005, the Bank of Zambia mid-rate was K 4,364 per U.S. dollar. On April 19, 2002, Zambia accepted the obligations of Article VIII, Section 2, 3, and 4 of the Articles of Agreement. However, the Fund urged the authorities to eliminate the exchange restriction evidenced by the accumulation of external payments arrears, which is subject to approval by the Fund under Article VIII, as soon as possible.

X. **Article IV Consultations**:

Zambia is on the 24-month Article IV consultation cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002. The last Article IV consultation was concluded by the Executive Board on April 7, 2004.

XI. **FSAP Participation and ROSC**:

Zambia has participated in the financial sector assessment program (FSAP), and an FSAP mission from the Fund and the World Bank conducted a comprehensive external assessment of the financial system. The two FSAP missions visited Zambia during April 30-May 15 and July 15-26, 2002.

A fiscal transparency module of a Report on Observance of Standards and Codes (ROSC) assessing compliance with the IMF's Code of Good Practices on Fiscal Transparency—Declaration of Principles was completed and issued to the Executive Board on October 31, 2001. A ROSC-Data Module was completed and issued to the Executive Board on January 18, 2005.

XII. **Technical Assistance (since 2000)**:

Resident advisors

Department	**Dates**	**Position**
FAD	1997-2001	Advisor on Budget Management
	2002-2003	Advisor on Public Expenditure Management

Technical assistance missions

Department	**Dates**	**Purpose**
MFD	November 2000	Bank supervision
	June 2001	Bank supervision
	November 2001	Monetary policy, financial sector issues, and payments system
	September 2002	Foreign exchange market
	January and May 2003	Development of foreign exchange interbank market, monetary operations, and reform of the financial system
	September 2003	Monetary operations, reform of the financial system, government securities market, and payments system.
	April–October 2004	Resolution of nonbank financial institutions (three missions)
	April–May 2005	Liquidity management operations
STA	May 2000	Balance of payments
	June 2002	General Data Dissemination System (GDDS)
	June 2002	Government Finance Statistics (GDDS)
	June 2002	Real Sector (GDDS)
	July 2002	Monetary Statistics (GDDS)
	June 2004	Data ROSC
	April–May 2005	Monetary Statistics (GDDS)
	May 2005	Government Finance Statistics (GDDS)
FAD	March 2000	Budget management
	January 2001	Public expenditure management
	May-June, 2001	ROSC—fiscal transparency module
	August 2001	Tax policy issues
	December 2002	Inspection mission to review the progress in public expenditure management reform
	July–August 2005	Regulations for the Public Finance Act

	November 2005	Fiscal Regime for Copper Mining
LEG	August-December 2004	Assistance on amending legislation on nonbank financial institutions
	February–May 2005	Proposal for amending acts of various nonbank financial institutions

XIII. **Resident Representative**:

A Fund Resident Representative first took up the position in Lusaka in June 1990. Mr. Joseph Kakoza has been the Resident Representative since October 2004.

Zambia: Relations with the World Bank Group

A. Partnership for Development

1. The IDA and IMF Boards endorsed the Government's Poverty Reduction Strategy, covering the period 2002-2004[1], embodied in its first full PRSP, in May of 2002. An Interim Poverty Reduction Strategy Paper (I-PRSP) had been presented to the Board in July 2000. The PRSP was substantially complete when the new Government took office in January 2002. The new Government endorsed the PRSP and went further to expand the PRSP in the Transitional National Development Plan (TNDP) that was published in October 2002 and covers the period 2002-2005. The first and the second Annual Progress Report on the implementation of the PRSP were presented to the IDA and IMF Boards in May 2004 and April 2005, respectively.

2. ***Strategic focus of the PRSP.*** The PRSP /TNDPhighlights the following barriers to poverty reduction: lack of economic growth, high inequality, excessive dependence on foreign aid, poor prioritization of public resources, inadequate safety nets, and HIV/AIDS. Therefore, the PRSP seeks to achieve poverty reduction through promoting (i) economic growth and diversification of production and exports; (ii) improved access and quality in the provision of social services; and (iii) the mainstreaming of crosscutting issues of governance, HIV/AIDS, gender, and the environment. Targets and indicators are provided for each sector and sub-sector. For example, by 2004 the poverty headcount is to be reduced to 65 percent, the same as in 1996. Even though the MDGs are not explicitly mentioned in the PRSP, given that the MDGs were not widely discussed when Zambia prepared its PRSP, some of the targets for improvements in the social indicators are similar to the MDGs.

3. ***Joint staff assessment of the PRSP and the Progress Reports.*** Bank and IMF staffs are in agreement with the major objectives set out in the PRSP and confirmed in the Annual Progress Reports. The strengths of the PRSP are: a participatory process that involved civil society, the private sector, and the donors; a poverty analysis that draws from available quantitative and qualitative data, looks at multiple dimensions of poverty, and provides data broken down by socio-economic group, gender, and region; an appropriate macroeconomic framework and financing plan; identification of priority sectors likely to contribute most to pro-poor growth; and the emphasis placed on the need to improve governance and reduce corruption.

4. Since 1995, the Fund has supported by ESAF and PRGF arrangements Zambia's economic reform program. During December 2003-May 2004, the authorities have implemented an extended Staff Monitoring Program (SMP), which has formed the basis of a new Fund-supported program under the Poverty Reduction and Growth Facility which was endorsed by the IMF Board on June 14, 2004. The PRGF focuses on (i) fiscal consolidation; (ii) inflation reduction, and (iii) maintaining an adequate level of foreign reserves. Successful performance

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[1] Subsequently the PRSP was extended to cover also 2005 as to fully overlap with the Transitional National Development Plan. A new PRSP/National Development plan is currently being formulated and will cover the 2006-10 period.

under the PRGF is a key condition for reaching the completion point under the Enhanced HIPC Initiative.

B. World Bank Group Strategy

5. In March 2004, the Bank's executive Board discussed the Bank's current Country Assistance Strategy (CAS), which outlines the roadmap for the Bank's country support for the period 2004-2007. The CAS is explicitly rooted in a result-based framework, which links overall goals of the PRSP/TNDP to specific strategic objectives. Paying attention to cause-and-result linkages, the main focus of the planned Bank's activities is to remove obstacles to longer-term strategic development outcomes. Where appropriate, quantitative targets to be reached during the CAS period have been specified. For the CAS period, the Bank will track progress on specific outcomes and intermediate indicators directly affected by Bank interventions.

6. World Bank activities focus on three strategic priorities:

1. Strategic Priority 1: Sustained Economic Growth Anchored in a Diversified and Export-Oriented Economy;
2. Strategic Priority 2: Improved Lives and Protection of the Vulnerable;
3. Strategic Priority 3: Efficiently and Effectively Managed Public Sector.

In addition to ongoing Bank's lending operations in the areas of public sector reform, privatization, HIV/AIDS, education, social service delivery, infrastructure, support for diversification, and the environment, the base case of the new CAS includes adjustment lending, i.e., the Economic Management and Growth Credit, approved in December 2004. The CAS also continues project support (in particular, for public sector reforms, infrastructure, and sanitation), pursues a reengagement in the agricultural sector and to assist in the governments fight against malaria.

7. The Bank continues to undertake substantive country diagnostics providing a solid base for policy dialogue, design, and implementation of its lending operations in Zambia. A combined Public Expenditure Review (PER), Country Procurement Assessment Review (CPAR), and Country Financial Accountability Assessment (CFAA), was completed in 2003 and forms the basis for the Public Expenditure and Financial Accountability TA work jointly undertaken with cooperating partners. The main economic sector works recently completed are a Country Economic Memorandum (CEM), an Investment Climate Assessment (ICA), an Administrative Barriers study (AB), and a Strategic Country Gender Assessment (SCGA). In addition, a collaborative Poverty and Vulnerability Assessment (PVA), an integrated framework study for trade (DTIS), and Public Expenditure Review for the education sector are currently being finalized and a Public Expenditure Review for the Health sector and an assessment of competition and regulation in Zambia's infrastructure sectors initiated. In addition, a review of labor market regulations, a rural development strategy, and a post privatization copper strategy, have been planned for the upcoming two FYs.

8. To support the implementation of the PRSP, IDA prepared a results-based CAS for the period FY04-Fy07, which was discussed by IDA's Executive Board in March 2004. IDA's active portfolio as of November 2005 contains 14 credits and grants for a total initial commitment of US$462 million. During FY05 2 projects were approved i.e. SEED (US$32.2 mil.) to support economic diversification in July 2004 and the Economic Management

and Growth Credit (US$40 mil.) in Dec 2004. In FY06 one project, the Malaria Booster Project (US$20 mil.) was approved by IDA's Board. It is expected that two additional projects will be submitted for Board approval before the end of June 2006 i.e. the Public Sector Management Project (US$30 mil.) and Agricultural Development Support Program (US$40 mil.). Note that 4 projects are expected to close by the end of 2005 (see table 1).

9. The International Finance Corporation (IFC) is very much aligned with the Bank's policy agenda in Zambia. The IFC currently has a small portfolio of 12 projects totaling US$15 million outstanding. These are a mix of financial sector, agribusiness, telecommunications (mobile telephone), and tourism projects. The IFC's most prominent project was for US$30 million in the equity of Konkola Copper Mines (KCM) with Anglo-American in 2000. The IFC exited in 2002 along with Anglo, in accordance with the terms of the investment agreement.

10. Zambia is currently a group 3 country for the IFC (as defined in the recently board approved IFC strategic initiative for Africa) and thus assessed as a relatively poor investment climate, with limited prospects for stimulating new private investment and limited progress on reforms to improve the investment climate. In this environment, the IFC seeks to be responsive to individual projects where IFC can play a role, and in which there is strong development impact, but does not invest significant resources in upstream project development. The IFC is exploring, jointly with the Bank, how to support the Bank Group's activities on improving the investment climate in Zambia.

11. MIGA's outstanding portfolio in Zambia consists of four contracts of guarantee in the agribusiness and manufacturing services sector with a US$36.1 million gross exposure and a US$35.7 million net exposure as of December 2003. The projects are for the privatization, modernization, and expansion of a foundry, and for cobalt and copper facilities. They benefit the Zambian economy by saving production costs and by providing training to personnel working on projects. The estimated total amount of foreign direct investment facilitated to date is US$155.5 million

Table 1: Projects under Supervision

(As of 02/06/05)
(in US$ Millions)

Project Name	Strategic Focus	Date, Approval	Date, Rev Closing	Net Comm Amt	Tot Disb	Undisbursed
Totals *				**461.7**	**283.9**	**212.3**
ZM-Econ Mgmt & Growth SAC (FY05)	Pillar 1	12/14/2004	12/31/2005	40.0	19.1	21.3
ZM-SEED SIL (FY05)	Pillar 1	07/29/2004	11/30/2009	28.2	3.0	25.4
ZM-GEF SEED Biodiversity SIL (IDA GRANT)	Pillar 2	07/29/2004	05/31/2009	4.0	0.3	3.8
3A Southern Africa Power Market	Pillar 1	07/09/2004	12/31/2007	1.1	0.8	0.4
ZM-Road Rehab Maintenance Prj (FY04)	Pillar 1	03/09/2004	06/30/2007	50.0	5.7	43.7
Copperbelt Environment	Pillar 1	03/20/2003	08/01/2008	19.0	1.9	18.9
HIV/AIDS (ZANARA) (IDA GRANT)	Pillar 2	12/30/2002	02/28/2008	42.0	17.2	32.5
ZM-TEVET SIM (FY01)	Pillar 2	06/14/2001	12/30/2006	25.0	11.7	17.1
Regional Trade Fac. Proj. – Zambia	Pillar 1	04/03/2001	06/30/2011	15.0	8.3	8.9
MINE TOWNSHIP SERVICES PROJECT	Pillar 2	06/20/2000	12/31/2005	37.7	35.4	6.2
Social Investment Fund (ZAMSIF)	Pillar 2	05/25/2000	12/31/2005	64.7	70.5	0.7
Basic Ed. Subsect. Inv. Pgr	Pillar 3	04/08/1999	06/30/2006	40.0	32.4	9.7
ZM POWER REHABILITATION	Pillar 1	02/19/1998	12/31/2005	75.0	77.6	3.7
Malaria-Booster	Pillar 1 & 2	11/15/2005		20.0	0.0	20.0

*Note that Total disb plus Undisbursed amounts do not necessarily add up to total commitments due to exchange rate movements

C. IMF-World Bank Collaboration in Specific Areas

12. A summary of IMF-World Bank collaboration in Zambia is provided in Table 2. There are a number of areas where the Fund leads and its analysis serve as inputs into the World Bank policy formulation and advice, including policies to maintain macroeconomic stability, fiscal, monetary, and exchange rate policies. There are other areas in which the Fund and the Bank share responsibility and are coordinating closely their policy advice to the Zambian authorities, such as trade, financial sector, public expenditure management, including debt management, and economic governance. The Bank has taken the lead in the social sectors, including health, education, social protection, water and sanitation, agriculture and rural development, private sector development including regulatory issues and the environment.

13. The Fund and the Bank shared joint responsibility in supporting the Government in the preparation of the PRSP and its annual progress reports on the implementation of the PRSP. The Fund and the Bank have also jointly provided assistance to Zambia for evaluating progress to reach the Completion Point under the Enhanced HIPC Initiative. In addition, the Bank and the Fund are jointly assisting GRZ to improve its debt and cash management practices.

C.1. Areas in which the World Bank leads and there is no direct IMF involvement

14. Areas in which the Bank leads and there is no direct involvement of the IMF are support for social sectors, agriculture and rural development, economic diversification, infrastructure, and the environment. In light of the complex and crosscutting nature of risk and vulnerability in Zambia, the Bank is assisting Government in developing a cross-sectoral **Social Protection Strategy**. The strategy will extend beyond traditional ex post risk-coping measures (e.g. safety nets) to include a better understanding of the role of ex ante risk-prevention and risk-mitigation measures. The strategy is being prepared in a highly participatory fashion, with the aim of integrating it within Zambia's next poverty-reduction strategy. For the same purpose, the Bank has undertaken a Poverty and Vulnerability Assessment, which is to be discussed with GRZ in Winter 2005.

15. **HIV/AIDS, Malaria, and health.** At this time, IDA is assisting the Ministry of Health with a US$12 million project under a multi-sectoral AIDS program (ZANARA) and US$20 million under its Malaria Booster project. In addition, IDA has carried out an ESW on human resources in the health sector (FY04) and plans a health sector PER in FY06. Building on this, IDA will provide support, but not necessarily financially for the Health Sector Support Program (SWAP) beginning in FY07. The improvement of water supplies under the Mine Township Services Project will also contribute to health outcomes in the areas served.

16. **In education**, the Bank is currently supporting the Ministry of Education's efforts through Adaptable Program Lending (APL). The APL1 Credit enables IDA funds to be devoted to a wide range of purposes in basic education and, following an amendment, to construct two high schools in the Eastern Province. The Bank is supporting expenditure effectiveness and efficiency in the sector through a public expenditure review (currently underway).

17. In the area of technical education, vocational, and entrepreneurship training (TEVET), the Government is carrying out reforms aimed at improving the quality of training, making it more responsive to labor market demand and financially sustainable. Reforms also aim at increasing the participation of female trainees and trainees from socio-economically disadvantaged groups. The Government's efforts in this area are being supported by an IDA Credit committed in FY01 and by several other partners.

18. **In agriculture and rural development**, the Bank's focus is two fold: improvement of productivity of the sector and increase of overall food security. The Bank is reengaging in the agricultural sector given the priority Zambia attaches to this sector, as set out in the PRSP/TNDP. Indeed, in a stable macroeconomic environment, if supporting infrastructure and adequate agricultural policy are in place, a major effort could be launched to unleash growth and poverty reduction potential of the sector, in particular through well-targeted interventions for both smallholders and commercial agriculture.

19. Analytical and Advisory Activities (AAA) are planned to support the formulation of an agricultural policy consistent with the planned and ongoing projects in related sectors, such as roads and electricity, to remove bottlenecks that prohibit and or make difficult for farmers to produce for the market. Hence, the policy dialogue with the Government on reforms and priorities of public spending for agriculture and rural development will address both short run policy issues, as well as a long run strategy to tap the large agricultural export potential of the

country, focusing on investment in land development, irrigation, and infrastructure. A balanced treatment of smallholders and commercial agriculture is important for growth and poverty reduction. As a follow-up to the AAA work, an Agricultural Support Project is planned to assist the Government with these challenges in FY06.

20. In addition, the Bank has assisted Zambia in developing an Integrated Framework for Disaster Relief and Mitigation–intended as multi-sectoral response to anticipate and address the impacts of climate shocks–under the recently closed Emergency Drought Recovery Project (EDRP). The aim was to increase food security and protect living conditions for the poorest and most vulnerable in targeted districts. Pilot programs are being designed to manage and protect against climate shocks, including dams and local irrigation, labor intensive public works, and agriculture input distribution programs. Feeding programs will be implemented in primary schools in a subset of districts; young children in Zambia are particularly at risk to high and rising levels of malnutrition.

21. The Bank supports **economic diversification** directly through its SEED project, which will assist implementation of a diversification strategy in the tourism, agribusiness, and gemstone sectors. In the initial phase, the SEED project will focus on supporting the design and establishment of appropriate policy and legal frameworks to encourage private investments in these three sectors, as well as investments, primarily in tourism-related infrastructure. The tourism component will work toward making Livingstone the flagship tourism destination in Zambia and strengthening management of national parks, which underpin Zambia's medium-term tourism development strategy. The interventions in the gemstones and agribusiness subsectors are focused to strengthen the supply chain that links rural/small-scale producers to local and export markets.

22. **Private sector development.** To improve Zambia's investment climate, the Bank and the IFC have assisted the Government with analytical work, notably an Investment Climate Assessment and a FIAS-led Administrative Barriers to Investment study. These studies are geared to facilitate the adoption of a new and more business friendly Investment Act and result in regular consultations between business and Government to discuss how to strengthen Zambia's business climate. As a result of this dialogue, the Government, with support from the Bank and the IFC, prepared a private sector development strategy. The strategy was developed through an interactive process, which included intensive consultations with the private sector and other donors and coordination within the Government itself. Implementation of some of the reform actions identified in the strategy has already started through analytical support by the Bank and through programs funded by other donors.

23. In the **infrastructural sectors**, the Bank is assisting the authorities in the commercialization of ZESCO. Analytical work aims at identifying the main bottlenecks with regard to competition and effective service delivery. The policy recommendations and institutional changes would be supported through adjustment operations. In particular, the ongoing and proposed investment projects (Road Rehabilitation and Maintenance Project and the Water Sector Reform Project) would provide the financial resources needed for investments. Zambia will also benefit from the Southern African Power Pool Project.

24. **Environmental concerns** are addressed as part of each individual project as laid down in the Bank's safeguard policies. They are also addressed through the Bank's environmental

project in the Copperbelt, which will assist Government with the cleanup of several hazardous sites in the Copperbelt and Kabwe area. The SEED project will assist the Government in making environmentally sustainable tourism in protected areas.

C.2. Areas in which the World Bank leads and its analysis serves as input into the IMF program

25. The Bank leads the dialogue on institutional dimensions of public expenditure management and financial accountability as well as public sector reform and restructuring and privatization. The Bank program will support these areas through a combination of lending and analytical work. In the area of **institutional dimensions of public expenditure management and financial accountability**, the Bank's long-term objective is to encourage a more transparent and accountable public sector by improving budget management, procurement systems, and the accountability for public funds. **The public sector reform and restructuring agenda** centers on instilling a more productive and efficient public service. To achieve this goal, reform efforts aim at promoting a more qualified and motivated civil service, developing a strategic management orientation in line ministries, improving policy coordination and implementation, and lastly, strengthening local government's capacity to participate in the development process.

26. While the Bank has taken the lead in **privatization**, the IMF has also a strong interest in these areas since many of the reforms are critical to achieving macroeconomic stabilization and enhancing Zambia's growth prospects. Accordingly, there is a high degree of consultation and coordination between the two institutions on these matters.

C.3. Areas of shared responsibility

27. The Fund and the Bank are working jointly in the following five areas (i) trade policy; (ii) financial sector reform; (iii) debt management and domestic debt market development; (iv) PRSP monitoring and evaluation; and preparation of a LIC debt sustainability analysis.

28. In the area of **trade policy,** the Bank, with collaboration from other partners, will undertake an integrated framework exercise. The Fund and the Bank jointly reviewed the Financial Sector Development Plan (FSDP). Follow ups on the FSAP and the FSDP will guide the Bank's policy dialogue and interventions in the **financial sector** in close collaboration with the IMF. The PRGF and the Economic Management and Growth Credit assist the Government on the resolution of three state-owned Non-Bank Financial Institutions and the strengthening of the operational independence of the Bank of Zambia.

29. Assistance in the areas of central government **debt management and domestic debt market development** will focus on reducing vulnerability and the cost of and the need for domestic financing. This work will draw from the Guidelines for Public Debt Management (published in March 2001) and the Handbook on Developing Government Bond Markets (published in July 2001). It will also benefit from an accompanying document to the Guidelines (prepared by the World Bank and the IMF), containing case studies from a range of countries at different stages of economic and financial development. The Bank, through its Treasury department, has under taken a debt management assessment and currently assists the Government in putting the recommended institutional changes in place.

30. The Fund and the Bank are working closely to review progress with Zambia's PRSP. The Bank and the Fund jointly prepared the Joint Staff Assessment (JSA) of the full PRSP (published in May 2002), the JSA of the first annual progress report (May 2004), and the Joint Staff Advisory Note on the second annual progress report (March 2005). Zambia reached its decision point in December 2000. Finally, the Fund and the Bank jointly prepared the HIPC-AAP document, monitored progress towards the completion point under the Enhanced HIPC Initiative, and prepared a debt sustainability analysis.

C.4. Areas in which the Fund leads and its analysis serves as input into the World Bank program

31. The Fund leads the dialogue on **macroeconomic framework,** in particular with regard to fiscal policy, advising the Government on the overall envelope for public expenditures, tax policy, as well as monetary and exchange rate policy. In these areas the Bank takes into account the policy recommendations of the Fund and ensures that its own policy advice, embedded in its adjustment operation (the Economic Management and Growth Credit), is consistent.

Table 2: IMF-World Bank Collaboration in Zambia

CAS Component	Specialized advice from Fund	Specialized advice from World Bank	*Key Instruments*
Goal: A growth conducive macro economic environment			
Subject: Economic Framework/ Management	Monetary policy; Financial sector reforms, exchange rate, fiscal policy and wage bill, debt management, balance of payments, economic statistics	Debt management; payroll management; Financial sector reforms	***IMF***: PRGF performance criteria and benchmarks on key monetary and fiscal targets and structural reforms ***Bank***: Ongoing portfolio: Public Sector Capacity Building Project (PSCAP) (FY00); EMGC (FY05) New Lending : EMGC II (DPL) (FY07) ESW: Debt Management Assessment ***Jointly***: JSAN on PRSP progress report and debt sustainability analysis
Goal: A diversified and export oriented economy			
Subject: Private sector development; Trade and export diversification	Financial sector reform; trade policy; exchange rate policy	Economic growth, investment climate for private sector (infrastructure services, reforms of financial sector and pension funds, power and telecommunication sector reforms, vocational training), trade policy for export diversification, rural development, environmental regulations for the mining sector	***IMF***: PRGF performance criteria and benchmarks on key monetary and fiscal targets and structural reforms. ***Bank***: On-going Portfolio: ERIPTA, Copperbelt Environment Program, ROADSIP, Mine Township Services Project (FY00), Regional Trade Facilitation Project (FY00), Railways Restructuring Project (FY00), TEVET (FY00) Zambia Power Rehabilitation, SEED (FY05), EMGC (FY05). New Lending: EMGC II (DPL-FY06), EMGC III (FY07), PMSP (FY05), Increased Access to Electricity, South Africa Power Pool. ESW: Country Economic Memorandum (FY04), Investment Climate Assessment (FY04), ICT Options Study (FY06), Energy Services Delivery. ***Jointly***: FSAP (FY02) and follow up, JSAN of PRSP progress report
Goal: Better health and long-term survival, with particular focus on at risk and vulnerable groups			
Subject: Health		Health Sector Expenditure Management. Provision of sustainable water services in provinces and districts	***Bank:*** On-going Portfolio: ZANARA (FY03), ZAMSIF (FY00), Mine Townships Project (FY00) New Lending: PRSC Health (FY07) (high case only) ESW: Health Sector PER (FY06), Strategic Country Gender Assessment (FY04)
Goal: Reverse the spread of HIV/AIDS: decrease prevalence among			

Subject: HIV/AIDS		Behavioral change; education; prevention, care and risk mitigation services.	***Bank:*** On-going Portfolio: ZANARA (FY03), ZAMSIF (FY00), Aids Component BESSIP(FY00) New Lending: HIV/AIDS Corridor Project (Sub-regional project) (FY07) ESW: Social Safety Nets and Protection Strategy Note (FY04), Strategic Country Gender Assessment (FY04)
Goal: Better educated populace, with relevant job skills as well as academic training			
Subject: Education		Provision and quality of primary education	***Bank:*** On-going Portfolio: BESSIP I (SWAP)(FY99), TEVET(FY01) ZAMSIF (FY00) New Lending: PRSC (education) FY06 (high case only) ESW: Education Sector PER(FY05)
Goal: Improved living conditions for poor/vulnerable households in drought prone areas			
Subject: Social Protection/ Risk Mitigation		Social protection and risk management systems	***IMF***: PRGF ***Bank:*** Ongoing Portfolio: Emergency Drought Recovery Project, SEED New Lending: Health/Nutrition Project, Agriculture Project. ESW: Poverty and Vulnerability Assessment, Strategic Country Gender Assessment, Social Safety Nets and Social Protection Strategy Note, Health Sector Review
Goal: Good governance and public sector management			
Subject: Public Expenditure	Medium-term budget framework, tax policy and administration. Arrears and commitment control	Public expenditure analysis, Capacity building in financial management and accountability	***IMF***: PRGF measures to put in place the IFMIS and to ensure timely reporting on budget execution ***Bank:*** On-going Portfolio: PSCAP I (FY00), EMGC (FY05) New Lending: PSMP(FY05); EMGC II (FY06); EMGC III (FY07) ESW: PEMFAR (FY03) ***Jointly***: HIPC AAP expenditure tracking assessment (FY04)
Goal: A productive and efficient public service			
Subject: Public Sector Reform and Restructuring		Pay reform, public sector restructuring	***Bank:*** On-going Portfolio: PSCAP I; EMGC (FY05) New Lending: PSMP (FY05), EMGC II (FY06), EMGC III (FY07) ESW: PEMFAR(FY03), Governance Survey

Questions may be referred to Jos Verbeek (202-473-5539).

Zambia: Statistical Issues

Zambia is one of fifteen countries participating in the Fund's General Data Dissemination System (GDDS) Project for Anglophone African Countries. Zambia's GDDS metadata were posted on the Fund's Dissemination Standards Bulletin Board on November 1, 2002 and were partially updated in July 2004.

Zambia's data provision is generally adequate, but there are shortcomings in the data for the national accounts, consumer prices, and balance of payments remain. The present arrangements for the compilation of macroeconomic statistics involve duplication of effort and insufficient coordination among the Bank of Zambia (BoZ), the Ministry of Finance, and the Central Statistical Office (CSO). The situation largely reflects resource constraints and organizational weakness within the CSO that have affected its ability to produce economic statistics on a timely basis.

A data module ROSC for Zambia, using the July 2003 DQAF methodology, was published on January 18, 2005 and is available on the IMF website.

Real sector

An IMF/DFID GDDS mission visited Lusaka from June 24 to July 5, 2002 to provide technical assistance to the CSO on national accounts, focusing on improving the source data (surveys); introducing a phased implementation of the 1993 System of National Accounts *(1993 SNA)*; and developing quarterly GDP estimates. The mission's main findings are summarized below.

The national accounts estimates are compiled according to the conceptual guidelines of the *1968 SNA*, but a phased approach to the introduction of the *1993 SNA* is planned. The estimates are released in accordance with a well-established schedule and cover, on the production side, 11 industry groups and 23 subgroups, and, on the expenditure side, the 6 main components, at both constant and current prices. For the production approach, 1994 is the latest benchmark year for value-added ratios. For many important industry areas, such as wholesale and retail trade, construction, business services and many other service industries consisting mainly of small-scale private service providers, there are no appropriate indicators. In addition, the data currently available are mostly quarterly volume or quantity indicators of production. Data that would permit the compilation of the more comprehensive real sector indicators, such as data on total production and intermediate consumption of establishments, are not available. On the expenditure side, there are no current indicators of household consumption, and private final consumption expenditure is derived residually. Source data to estimate gross fixed capital formation and changes in stocks are incomplete.

Current price estimates for both the production and the expenditure sides have been derived from the constant price indicators by using wholesale price indices (WPIs) and consumer price indices (CPIs) as deflators. However, for the most recent period, the WPI was no longer available and the CPI components were used throughout the system.

A rapid erosion of the range of basic source data for national accounts estimates in recent years and at a time when the economy was subject to major structural changes has increasingly detracted from the quality of the GDP estimates. Moreover, even some major methodological improvements within national accounts, such as the adoption of the commodity flow approach to estimate some of the aggregates, have not been adopted. Further, the CSO has not used the results of the input-output table constructed for the period 1994-1999, to improve the estimation process. The authorities' plan to implement the economic census project for 2002 constitutes a major breakthrough in the development of source data for the national accounts.

A follow-up mission during March 3-19, 2003 noted that the short-term recommendations made during the first mission had not been implemented due to lack of staff resources. The 2004 Data ROSC mission also confirmed the lack of progress in the compilation process.

Government finance

Zambia's GFS data have not been updated since 2000. Last information available and published in the *GFS Yearbook 2004* is preliminary for 1998 and forecast for 1999. The coverage of the data is limited to budgetary central government. No monthly or quarterly fiscal data are reported for publication in *International Financial Statistics* (*IFS)*.

The authorities report monthly budget data for the Fund's operational use in a timely manner. However, data are often subject to substantial revisions later in the year. Local government fiscal data are not available.

An IMF/DFID GDDS mission visited Lusaka from March 13 to 26, 2003 to provide technical assistance to the Ministry of Finance and National Planning on fiscal issues. The expert provided advice on the initial steps toward migration to the methodology of the *Government Finance Statistics Manual 2001 (GFSM2001).* An IMF GDDS mission visited Lusaka again on April 18-29, 2005 to assess the overall quality, coverage, and timeliness of fiscal data. The main conclusions and recommendations of the mission were:

- With regard to the accounting data, the mission reviewed and made proposals to improve the chart of accounts that would be introduced in the 2006 budget cycle, but indicated that the implementation of Integrated Financial Management and Information System (IMFIS) is a long-term project (full implementation is only expected towards 2009). Capacity constrains with regards to companies that are capable to implement the system as well as human resources were noted.

- Decentralization of government activities in earlier years has led to the creation of numerous extra-budgetary institutions. While the majority of these entities follow international accounting practices, they are not obliged to report to the Ministry of Finance. Currently an estimated 35 percent of government activities are not captured in the data.

Monetary accounts

There has been progress made in the compilation of monetary statistics, and the monetary survey is published on a monthly basis. The BoZ has also eliminated discrepancies between its own records of IMF accounts and data from the Finance Department of the IMF.

In April 2003, the BoZ switched fully to a new computing system for generating its monthly trial balance, which enables the production of monetary accounts on a timely basis. A July 2003 STA monetary and financial statistics mission recommended the recording of deposits on a gross, rather than on a net basis; the reporting of central government securities at cost, rather than at face value; and the reclassification of some accounts.

Data reported by commercial banks are adequate, but the other depository corporations' survey should be expanded to cover four nonbank deposit-taking institutions. Furthermore, the BoZ should include in the survey the accounts of all the banks currently in the process of liquidation, classifying their deposits as restricted deposits and excluding them from broad money. A STA mission in May 2005 noted that the authorities had implemented most of the recommendations of the July 2003 mission. However, the BoZ was still recording deposits on a net rather than gross basis. There were also problems with the sectorization of public sector deposits reported by commercial banks.

Balance of payments

In May 2000, a STA mission found compilation of data on imports, exports, and foreign direct investment to be inadequate and made a number of recommendations to improve the coverage of the data. Since then, the authorities have prepared a work plan to implement the recommendations of the mission, and some improvements have been made in the coverage of the customs data and the methodology for compiling some balance of payments components. However, the quality of balance of payments data continues to be problematic, as data sources are poor and unreliable, and the methodology inadequate.

Data sources on private sector foreign assets and liabilities are insufficient to compile an international investment position statement.

Zambia: Table of Common Indicators Required for Surveillance

As of December 7, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	Nov. 2005	Nov. 29, 2005	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov. 2005	Nov. 24, 2005	W	W	M		
Reserve/Base Money	Nov. 2005	Nov. 24, 2005	W	W	F	LO, LO, LO, LO	LO, O, O, O, O
Broad Money	Sep. 2005	Oct. 29, 2005	M	M	M		
Central Bank Balance Sheet	Sep. 2005	Oct. 2005	M	M	M		
Consolidated Balance Sheet of the Banking System	Sep. 2005	Oct. 29, 2005	M	M	M		
Interest Rates[2]	Nov. 2005	Nov. 28, 2005	W	W	F		
Consumer Price Index	Nov. 2005	Nov. 28, 2005	M	M	M	O, LO, O, LO	LNO, LO, LO, LNO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						LO, LNO, LNO, LO	LNO, LO, O, O, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Sep. 2005	Oct. 12, 2005	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sep. 2005	Oct. 12, 2005	M	M	A		
External Current Account Balance	2004	Oct., 2005	A	A	A	LO, LNO, LNO, O	LNO, O, LNO, LO, LNO
Exports and Imports of Goods and Services	Jun. 2005	Oct. 2005	Q	Q	A		
GDP/GNP	2004	Jun., 2005	A	A	A	LO, LO, LO, LO	LNO, LO, LNO, LNO, LNO
Gross External Debt	Jun. 2005	Oct., 2005	Q	I	I		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); or Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on January 2005 and based on the findings of the mission that took place during May 18-June 3, 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of i..

Progress Towards Achieving the Millennium Development Goals

Two reports have been prepared in recent years—the first in 2003 and the second in 2005—which assess Zambia's progress towards achieving the MDGs.[1] These reports were prepared in collaboration with Government, Civil Society Organizations, academia, political representatives and the U.N. Country Team. Both reports highlight the efforts being made in achieving the MDGs and the challenges ahead. In the 2003 report, only one MDG target out of ten—viz, gender equality—was judged likely to be achieved. Six other targets were considered potentially achievable, while three targets were judged as unlikely to be achieved by 2015. In 2005, five targets were judged likely to be achieved (those relating to eradicating extreme hunger and poverty, universal primary education (UPE), gender equality, and halting the spread of HIV/AIDS), three potentially achievable (reducing child mortality, halving the incidence of malaria, and halving the proportion of people without access to drinking water), and only two unlikely to be achieved by 2015 (improving material health and ensuring environmental sustainability). Reasons for the more positive assessment in 2005 included attainment of the HIPC completion point and the Multilateral Debt Relief Initiative. It is expected that the additional resources provided by debt relief would go into poverty reduction programs and the social sectors.

Status of Achieving the MDGs

Goals/Targets	Will Target be Met		State of National Support	
	2003	2005	2003	2005
MDG 1. Eradicate extreme poverty and hunger				
Target 1. Halve, between 1990 and 2015, the proportion of people living in extreme poverty	Unlikely	Likely	Weak	Strong
Target 2. Halve, between 1990 and 2015, the proportion of people who suffer from hunger	Unlikely	Likely	Weak	Good
MDG 2. Achieve universal primary education				
Target 3. Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling	Potentially	Likely	Strong	Strong
MDG 3. Promote gender equality				
Target 4. Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015	Likely	Likely	Good	Good
MDG 4. Reduce child mortality				
Target 5. Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate	Potentially	Potentially	Good	Good
MDG 5. Improve maternal health				
Target 6. Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio	Unlikely	Unlikely	Weak	Weak
MDG 6. Combat HIV/AIDS, malaria and other diseases				
Target 7. Have halted by 2015, and begun to reverse, the spread of HIV/AIDS	Potentially	Likely	Good	Good
Target 8. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases	Potentially	Potentially	Good	Good
MDG 7. Ensure environmental sustainability				
Target 9. Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources	Potentially	Unlikely	weak	Good
Target 10. Halve, by 2015, the proportion of people without sustainable access to safe drinking water	Potentially	Potentially	weak	Good

Source: Zambia MDG Progress Reports 2003 and 2005.

1/ Millennium Development Goals Progress Report 2003: Zambia, Government of the Republic of Zambia and United Nations System (2003) and Millennium Development Goals Progress Report 2005: Zambia, Government of the Republic of Zambia and United Nations System (2005).

The more favorable recent assessment is supported by improvements in some indicators measuring progress in achieving of the MDGs. For instance, according to the preliminary results of the 2004 Living Conditions Monitoring Survey, the incidence of extreme poverty has dropped to 53 percent from 58 percent in 1998. There has also been progress with respect to achieving UPE and general equality.

Trends in Millennium Development Goals Indicators

Indicator	1990/91/92	2002/03	2004	2015 MDG Target
MDG 1. Eradicate extreme poverty and hunger				
Proportion of people living in extreme poverty	58.2%		53%	29.1%
Percentage of underweight children (under 5 years of age)	25%		20%	12.5%
MDG 2. Achieve universal primary education				
Net Enrollment ratio in Primary schools	70%	76%	78%	100%
Girls	69%	75%	77%	
Boys	71%	71%	79%	
Pupils Reaching Grade 7	64%	73%	82%	100%
Girls	57%	66%	75%	
Boys	71%	80%	95%	
Literacy Rates (15-24 year olds)	75%	75%	70%	100%
Female	71%	80%	66%	
Male	79%	75%	75%	
MDG 3. Promote gender equality				
Ratio of girls to boys				
Primary	0.98	0.98	0.95	1.00
Secondary	0.92	0.90	0.84	1.00
Tertiary		0.71	0.63	1.00
MDG 4. Reduce child mortality				
Under 5 Mortality Ratio per 1000 births	191	168	...	63
Infant Mortality Ratio per 1000 births	107	95	...	36
MDG 5. Improve maternal health				
Maternal Mortality Rate (per 100,000 live births) (earliest data for 1996)	649	729	...	162
MDG 6. Combat HIV/AIDS, malaria and other diseases				
Trends of HIV infection among Ante-natal Clinic Attendees (earliest data for 1994)	20	19	...	19
HIV prevalence rate Male & Female		16	...	16
New malaria cases per 1000 (latest data is for 1999)	255	377	...	Less than 121
MDG 7. Ensure environmental sustainability				
Percentage of land covered by forest	59.8	45	...	
Percentage of Land protected to maintain biological diversity	38.8	39.6	39.6	
Consumption of ozone depleting chlorofluorocarbons (CFCs) in ODP tons (earliest data for 1996)	95.6	44.5	43.0	
Percentage of population using solid fuels	86	80	...	

Source: Zambia MDG Progress Reports 2003 and 2005, and 2004 Living Conditions Monitoring Survey.

The reports also indicated an improvement in the national environment for reaching the MDGs. The 2005 report concluded that national support for achieving the MDGs was generally good. This was an improvement on 2003, when national support was perceived to be weak for five out of ten targets. For its part, for instance, government has been released the resources committed in the national budget to poverty reduction and social sector programs.

Notwithstanding the progress made, Zambia faces a number of challenges in her efforts to achieve the MDGs. To reduce poverty and hunger, Zambia needs to achieve higher pro-poor economic growth and increase employment opportunities. In addition, more resources, both financial and human resources, are required in the social sectors to achieve the targets in the education and health sectors.

Zambia: Debt Sustainability Assessment

Introduction

1. **This appendix reports the results of a debt sustainability assessment for Zambia conducted jointly by Fund and World Bank staff using the LIC DSA framework.** The baseline scenario extends the medium-term macroeconomic framework of the PRGF-supported program to 2025. In addition to standard alternative scenarios and stress tests two scenarios were considered: one that involves additional borrowing from power sector investment over 2008-11 and another that incorporates potential debt relief under the MDRI. In addition to external debt, the assessment also takes into account the implications of the outlook for domestic debt for fiscal sustainability.

2. **Zambia's external debt sustainability outlook has greatly improved with the attainment of the HIPC Initiative completion point in April 2005.** With the full delivery of HIPC Initiative assistance, as well as additional bilateral debt relief, Zambia's external debt is estimated at $3.8 billion in nominal terms at end-2004, corresponding to $1.5 billion in NPV terms, or 75 percent of exports. The bulk of this debt—almost 90 percent—is owed to multilateral institutions, in particular the Fund, IDA and the African Development Bank. Domestic debt, at 22 percent of GDP in NPV terms at end-2004, represents an additional element of risk to debt sustainability in Zambia, but this risk is mitigated by the government's commitment to limiting domestic financing to 0.5 percent of GDP per year over the long term. Fund and World Bank staff are of the view that Zambia is at low risk of debt distress going forward.

Baseline Scenario

3. **Policy-based indicative thresholds for debt burden indicators are a key feature of the LIC DSA framework**. The thresholds are based on the empirical finding that low-income countries with stronger policies and institutions tend to have higher debt carrying capacity. Zambia is classified as a medium performer in regard to policies and institutions, for which the relevant thresholds for debt burden indicators are 40 percent for the NPV of debt-to-GDP ratio, 150 percent for the NPV of debt-to-exports ratio, and 20 percent for the debt service-to-exports ratio.

4. **Zambia's external debt burden indicators are well below the policy-based thresholds of the LIC DSA framework in the baseline scenario and gradually improve over time.** The baseline scenario is based on an extension of the macroeconomic framework of the PRGF-supported program (Box A1). It assumes a continuation of Zambia's relatively strong recent performance, but incorporates a projected deterioration in the terms of trade as copper prices ease from their recent historic highs and a tapering off of output growth in the mining sector. In this scenario, the NPV of debt-to-GDP ratio is projected to decline gradually from 23 percent at end-2005 to 16 percent by 2010 and 10 percent by 2025 (Table A1 and Figure A1). The NPV of debt-to-exports ratio is also projected to decline, although somewhat more slowly, from 66 percent at end-2004 to 59 percent by 2010 and 45 percent by 2025, reflecting the slower growth of exports than of GDP. The debt service-to-exports ratio is

projected to fluctuate between 3-5 percent until 2010 and thereafter decline to 1 percent. In the baseline, the debt burden indicators remain significantly below their CPIA-linked thresholds for a medium performer on the quality of policies and institutions such as Zambia—40 percent for the NPV of debt-to GDP ratio, 150 percent for the NPV of debt-to-exports ratio, and 20 percent for the debt service-to-exports ratio—throughout the projection period.

Box 1. Macroeconomic Assumptions for Baseline Scenario, 2005-06

The baseline scenario is an extension of the macroeconomic framework that underlies the PRGF-supported program. It assumes that the government will continue to pursue sound macroeconomic and structural policies and that economic performance will be favorable.

- Real GDP grows by 6 percent per year on average.
- Inflation declines to 5 percent by 2007 and remains stable thereafter.
- The real effective exchange rate appreciates gradually—by about 2 percent per year.
- Exports growth is projected to be strong over the medium term, but to then moderate for a few years as metals output growth slows. Thereafter, export growth averages about 8 percent a year in dollar terms, supported by a rising share of nontraditional exports.
- Import growth is assumed to be strongly linked to GDP growth over the long run.
- Following the sharp recent improvement, the terms of trade are assumed to deteriorate gradually over the medium-term and then stabilize.
- The current account deficit (excluding grants) declines to 10 percent of GDP by 2010 and to about 8 percent by 2025.
- Government revenues remain stable over the medium term at about 18.5 percent of GDP, and thereafter rise gradually to 20 percent of GDP. External grants, both project and program, are stable at around 6 percent of GDP. Expenditures rise to 25 percent of GDP and remain stable thereafter. Domestic financing falls to ½ percent of GDP by 2008 and remains at that level.
- Foreign direct investment declines somewhat from its recent level of around 5 percent of GDP, associated with strong investment in the mining sector, to about 2 percent over the long run.
- External borrowing rises in nominal terms but declines gradually, relative to GDP, from its current level of about 2 percent to about 1 percent over the long run. All external borrowing is assumed to be concessional.

Standard Alternative Scenarios and Stress Tests

5. **Zambia's favorable external debt sustainability outlook is fairly robust to a deterioration in economic performance and exogenous shocks**. In a scenario that sets key variables equal to their averages over 1994-2004, and therefore takes into account the relatively poor performance of the Zambian economy during the earlier part of that period, the NPV of debt-to-GDP ratio declines throughout the projection period, albeit at a slower pace than in the baseline (Table A2). The NPV of debt-to-exports ratio, however, rises initially to 74

percent by 2010 and the declines gradually to 65 percent by 2025. The debt service-to-exports ratio is marginally higher than in the baseline.

6. **All but one of the standardized stress tests exhibit relatively benign debt dynamics**: all debt burden indicators remain well below relevant thresholds throughout. The exception is a shock to exports in 2006-07—modeled as export value growth at its historical average less one standard deviation, to allow for the possibility that copper prices fall sharply from their current elevated levels. In this scenario, the NPV of debt-to-exports ratio rises sharply in 2007, to above 150 percent where it stays through 2010. However, by 2015 the NPV of debt-to-exports ratio is projected to fall to 137 percent and to 94 percent by 2025. The NPV of debt-to-GDP and the debt service-to exports ratio also rise temporarily to peaks of 28 percent and 10 percent, respectively, well below the relevant thresholds.

Power Sector Investment Scenario

7. **Substantial investment in power generation financed by external borrowing on commercial terms has only a limited impact on Zambia's debt burden indicators**. As discussed in the staff report, ZESCO aims to expand its power generating capacity significantly over the medium term, with investment needs possibly financed on commercial terms. An alternative scenario that assumes external borrowing on nonconcessional terms—8 percent interest rate, 5 year grace, 17 year maturity—of 1 billion over 2008-2011 was prepared. The impact of this borrowing on debt and debt service ratios relative to the baseline is similar in magnitude to that of the historical scenario. Debt burden indicators never come close to their respective threshold.

MDRI Scenario

8. **Implementation of the MDRI would further improve Zambia's debt sustainability outlook**. The MDRI would cancel Zambia's obligations to the Fund, IDA, and the AfDF as of end-2004. This would lower Zambia's projected end-2006 nominal external debt from $3.6 billion to $0.5 billion. The reduction in the NPV of external debt-to-GDP ratio would be equally marked with the end-2006 value declining from 20 percent to 4 percent, while the NPV of external debt to export ratio would fall from 63 percent to 14 percent. These ratios would rise gradually over the long run as new borrowing comes to dominate the debt dynamics. The debt ratios remain low throughout relative to the relevant debt burden thresholds. The debt service-to-export ratio declines quickly to 2 percent and thereafter settles around 1 percent.

Fiscal Sustainability

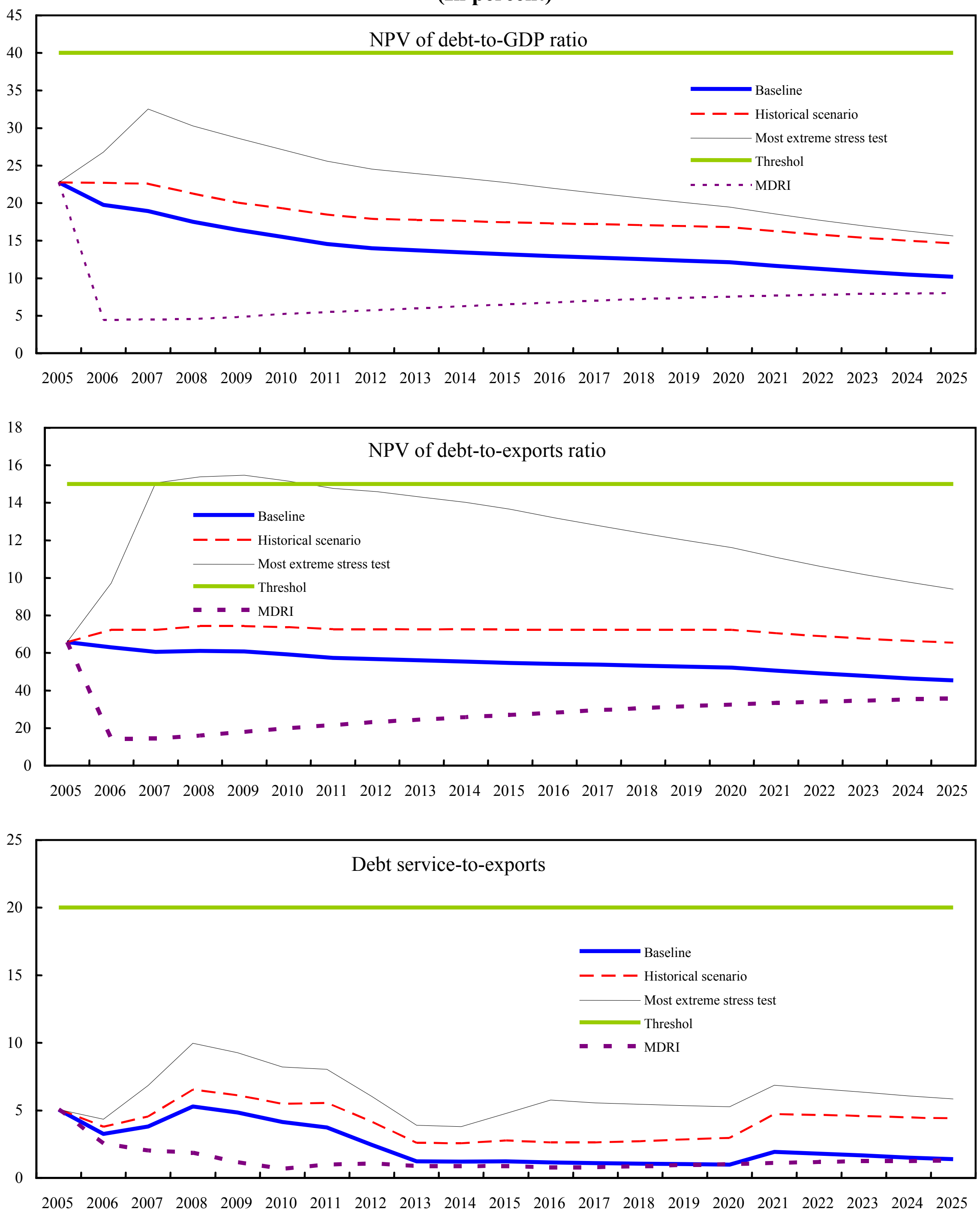
9. **Domestic debt accounts for a substantial share of overall public debt in Zambia**. Domestic debt is projected to be about 19 percent of GDP at end-2005, a sizable portion of which is in short-term treasury bills (Table A3 and Figure A2). Under the baseline scenario, which builds on the successful fiscal adjustment that the government has undertaken in recent years and incorporates its objective of limiting domestic financing to ½ percent of GDP per year over the long run, domestic debt is projected to decline to 12 percent of GDP by 2010 and 6 percent by 2025. The domestic debt-to-revenue ratio is projected to decline from 80 percent in 2005 to 50 percent by 2010 and 24 percent in 2025. Thus, in the baseline, the share of domestic debt in total public debt is projected to decline over time.

10. **Domestic debt is an additional element of risk to fiscal sustainability in Zambia.** Under standard alternative scenarios and stress tests, the projected debt dynamics are less favorable, sometimes significantly so (Table A4). The least favorable case is represented by a scenario in which key variables, including real GDP growth and the primary balance, are set at their historical averages, and the resulting financing requirement is met by additional domestic borrowing. In this scenario, the ratio of domestic debt to GDP is stable at 16-17 percent of GDP until 2010 before rising to 23 percent of GDP by 2015 and 26 percent by 2025. Relative to government revenue, the NPV of domestic debt is projected to ease from 70 percent in 2005 to 65 percent in 2010 before rising to 85 percent in 2015 and 123 percent in 2025. Moreover, the cost of servicing overall public debt in this scenario rises from a low of 13 percent of revenue in 2006-07 to 18 percent by 2010, 25 percent by 2015 and 39 percent by 2025.

Conclusion

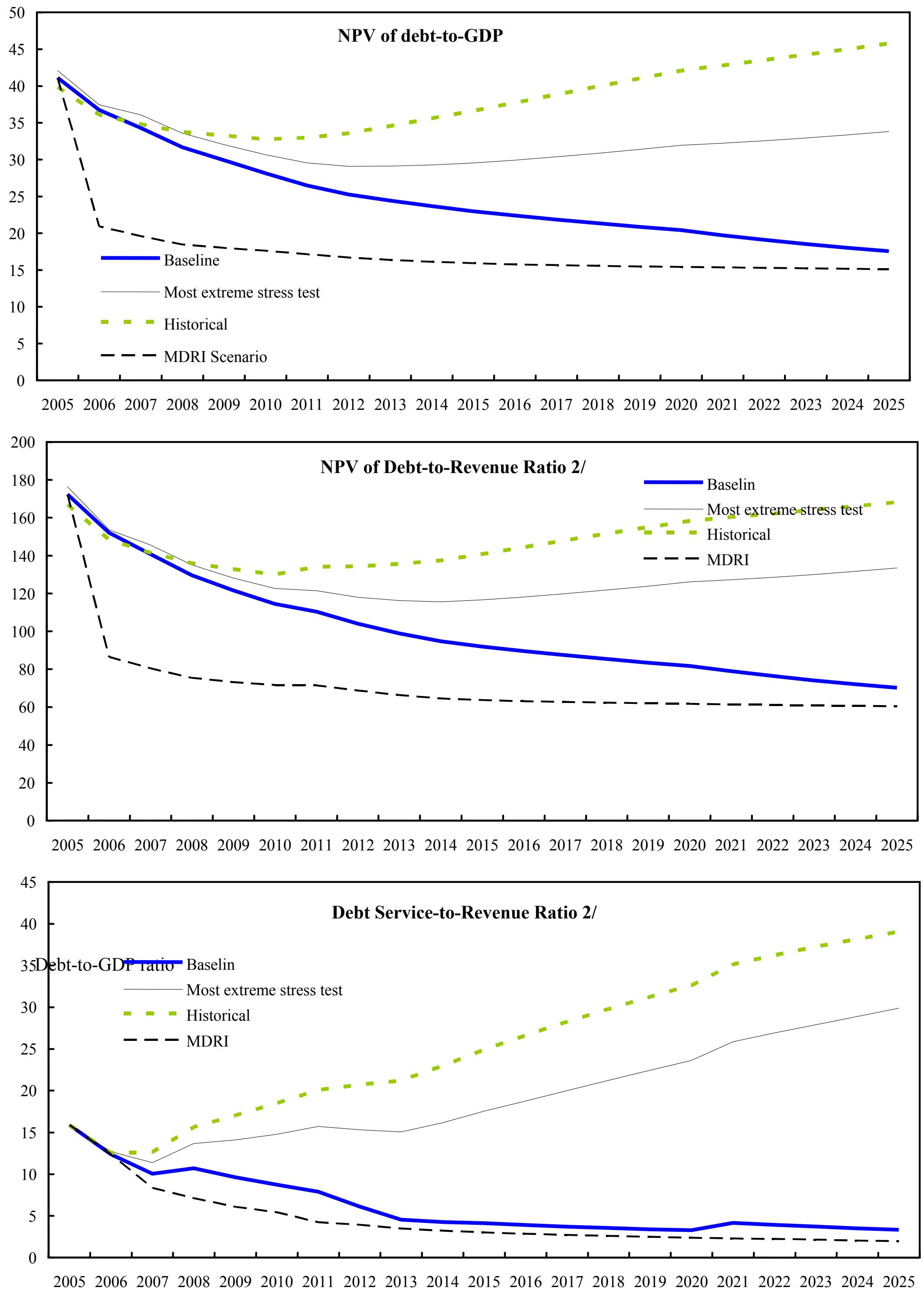
11. On the basis of the debt sustainability analysis that has been conducted, Fund and World Bank staff are of the view that Zambia is at a low risk of debt distress. Application of the LIC DSA framework to Zambia indicates that Zambia's external debt sustainability outlook is favorable under most scenarios, although it is vulnerable to a sharp setback to export earnings. Domestic debt and unfunded government liabilities represent some risks, although these stem to some extent more from the short maturity of the external debt than its volume. Implementation of the MDRI would further greatly strengthen Zambia's debt sustainability outlook and reduce Zambia's vulnerability to shocks.

Figure A1. Zambia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005-2025
(In percent)



Source: Staff projections and simulations.

Figure A2.Zambia: Indicators of Public Debt Under Alternative Scenarios, 2005-2025 1/



Source: Staff projections and simulations.
1/ Most extreme stress test is test that yields highest ratio in 2015.
2/ Revenue including grants.

Table A1. Zambia: External Debt Sustainability Framework, Baseline Scenario, 2002-2025 1/
(In percent of GDP, unless otherwise indicated)

	Actual	Historical Average 6/	Standard Deviation 6/	Estimate	Projections								
	2004			2005	2006	2007	2008	2009	2010	2005-10 Average	2015	2025	2011-25 Average
External debt (nominal) 1/	**70.3**			**51.0**	**43.1**	**41.2**	**38.6**	**36.5**	**34.0**		**25.5**	**19.2**	
o/w public and publicly guaranteed (PPG)	70.3			51.0	43.1	41.2	38.6	36.5	34.0		25.5	19.2	
Change in external debt	-24.6			-19.3	-7.8	-2.0	-2.6	-2.0	-2.5		-1.0	-0.4	
Identified net debt-creating flows	-14.6			5.9	5.3	4.2	5.6	6.0	5.8		6.4	6.2	
Non-interest current account deficit	**9.5**	**11.6**	**3.5**	**11.4**	**10.3**	**9.0**	**9.8**	**10.0**	**9.6**		**9.5**	**8.7**	9.3
Deficit in balance of goods and services	2.5			2.8	2.6	2.6	4.5	5.6	5.8		6.7	6.2	
Exports	37.6			34.6	31.4	31.2	28.6	27.0	26.2		24.1	22.4	
Imports	40.0			37.5	34.0	33.8	33.1	32.6	31.9		30.8	28.6	
Net current transfers (negative = inflow)	-4.1	-5.3	1.2	-4.1	-3.5	-3.3	-3.3	-3.3	-3.3		-3.2	-3.0	-3.1
Other current account flows (negative = net inflow)	11.1			12.6	11.2	9.7	8.6	7.7	7.1		6.0	5.4	
Net FDI (negative = inflow)	**-4.4**	**-4.2**	**1.5**	**-3.8**	**-2.9**	**-2.7**	**-2.1**	**-2.1**	**-2.0**		**-1.7**	**-1.4**	-1.6
Endogenous debt dynamics 2/	**-19.7**			**-1.7**	**-2.1**	**-2.1**	**-2.0**	**-1.9**	**-1.8**		**-1.4**	**-1.1**	
Contribution from nominal interest rate	1.2			0.7	0.4	0.3	0.3	0.3	0.2		0.1	0.0	
Contribution from real GDP growth	-4.0			-2.4	-2.5	-2.4	-2.3	-2.1	-2.0		-1.5	-1.1	
Contribution from price and exchange rate changes	-17.0			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**-9.9**			**-25.2**	**-13.2**	**-6.2**	**-8.2**	**-8.1**	**-8.3**		**-7.4**	**-6.7**	
o/w exceptional financing	-4.9			-7.0	-2.4	-2.2	-1.9	-1.7	-1.6		-1.1	0.0	
NPV of external debt 4/	28.2			22.8	19.8	18.9	17.5	16.4	15.5		13.2	10.2	
In percent of exports	75.1			65.8	63.0	60.6	61.2	60.9	59.2		54.7	45.4	
NPV of PPG external debt	**28.2**			**22.8**	**19.8**	**18.9**	**17.5**	**16.4**	**15.5**		**13.2**	**10.2**	
In percent of exports	75.1			65.8	63.0	60.6	61.2	60.9	59.2		54.7	45.4	
Debt service-to-exports ratio (in percent)	23.0			5.0	3.3	3.8	5.3	4.8	4.1		1.2	1.4	
PPG debt service-to-exports ratio (in percent)	23.0			5.0	3.3	3.8	5.3	4.8	4.1		1.2	1.4	
Total gross financing need (millions of U.S. dollars)	746.3			641.1	700.2	670.4	885.9	960.8	977.9		1389.7	3047.1	
Non-interest current account deficit that stabilizes debt ratio	34.0			30.7	18.1	10.9	12.4	12.0	12.1		10.6	9.1	
Key macroeconomic assumptions													
Real GDP growth (in percent)	5.4	3.1	3.5	4.3	6.0	6.0	6.0	6.0	6.0	5.7	6.0	6.0	6.0
GDP deflator in US dollar terms (change in percent)	21.8	2.6	12.7	21.0	14.7	1.5	2.2	1.4	2.1	7.2	2.6	2.6	2.6
Effective interest rate (percent) 5/	1.7	3.0	0.9	1.2	1.0	0.8	0.8	0.7	0.6	0.9	0.2	0.0	0.2
Growth of exports of G&S (US dollar terms, in percent)	63.7	8.0	24.4	16.3	10.2	7.0	-0.7	1.5	4.9	6.5	8.0	8.0	7.7
Growth of imports of G&S (US dollar terms, in percent)	21.1	6.2	14.9	18.0	10.2	7.1	6.0	6.0	6.0	8.9	8.0	8.0	8.0
Grant element of new public sector borrowing (in percent)	...	...	...	55.2	49.1	53.9	56.9	56.9	56.9	54.8	56.9	56.9	56.9
Memorandum item:													
Nominal GDP (millions of US dollars)	5429.3			6850.4	8331.5	8960.5	9710.9	10434.9	11295.7		17218.8	40011.6	

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments devided by previous period debt stock.
6/ Historical averages and standard deviations are derived over 1994-2004.

Table A2. Zambia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005-25
(In percent)

	Estimate	Projections						
	2005	2006	2007	2008	2009	2010	**2015**	2025
NPV of debt-to-GDP ratio								
Baseline	23	20	19	17	16	16	**13**	10
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	23	23	23	21	20	19	**17**	15
A.2 Additional borrowing for power sector investment 2/	23	20	19	21	22	24	**19**	10
A3. MDRI Scenario	23	4	5	5	5	5	**7**	8
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	23	21	21	20	19	18	**15**	12
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	23	23	28	26	25	23	**19**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	23	25	27	25	24	22	**19**	15
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	23	20	18	17	16	15	**13**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	23	27	33	30	29	27	**23**	16
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	23	27	26	24	22	21	**18**	14
NPV of debt-to-exports ratio								
Baseline	66	63	61	61	61	59	**55**	45
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	66	72	72	74	74	74	**72**	65
A.2 Additional borrowing for power sector investment 2/	66	63	61	72	83	90	**79**	46
A3. MDRI scenario	66	14	15	16	18	20	**27**	36
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	66	63	61	61	61	59	**55**	45
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	66	97	151	154	155	152	**137**	94
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	66	63	61	61	61	59	**55**	45
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	66	62	59	59	59	57	**53**	45
B5. Combination of B1-B4 using one-half standard deviation shocks	66	79	97	99	99	97	**88**	65
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	66	63	61	61	61	59	**55**	45
Debt service ratio								
Baseline	5	3	4	5	5	4	**1**	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2006-25 1/	5	4	5	7	6	5	**3**	4
A.2 Additional borrowing for power sector investment 2/	5	3	4	5	6	5	**5**	2
A3. MDRI Scenario	5	3	2	2	1	1	**1**	1
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	5	3	4	5	5	4	**2**	3
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	5	4	7	10	9	8	**5**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	5	3	4	5	5	4	**2**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	5	3	4	5	5	4	**2**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	5	4	5	7	7	6	**3**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	5	3	4	5	5	4	**2**	3
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	56	56	56	56	56	56	**56**	56

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes borrowing of $1 billion on commercial terms over 2008-11 for investment in electrecity generation.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table A3. Zambia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2002-2025
(In percent of GDP, unless otherwise indicated)

	Actual			Estimate				Projections				
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2005-10 Average	2015	2025
Public sector debt 1/	128.9	126.8	92.6	68.5	60.9	57.0	53.2	50.5	47.1		36.0	27.8
o/w foreign-currency denominated	104.3	99.7	70.3	49.4	44.5	42.0	39.5	37.4	34.8		27.0	21.8
Change in public sector debt	-19.9	-2.2	-34.1	-24.2	-7.6	-3.9	-3.8	-2.8	-3.4		-1.4	-0.5
Identified debt-creating flows	-11.0	-13.0	-20.6	-18.1	-4.9	-2.4	-2.1	-1.4	-1.6		-0.9	-0.4
Primary deficit	1.0	2.2	-0.6	-0.1	0.8	0.9	0.6	0.8	0.9	0.7	0.2	0.5
Revenue and grants	26.2	24.9	23.8	23.9	23.6	23.7	23.9	24.0	24.0		25.0	25.0
of which : grants	8.3	7.0	5.5	6.0	6.2	6.2	6.0	6.1	6.1		5.0	5.0
Primary (noninterest) expenditure	27.2	27.1	23.2	23.8	24.4	24.6	24.5	24.8	24.9		25.2	25.5
Automatic debt dynamics	-9.0	-14.7	-20.1	-17.3	-4.9	-2.5	-2.2	-1.6	-1.9		-1.7	-1.4
Contribution from interest rate/growth differential	-4.7	-6.3	-7.3	-4.5	-1.9	-1.8	-1.8	-1.5	-1.5		-1.4	-1.2
of which : contribution from average real interest rate	0.1	0.0	-0.8	-0.7	2.0	1.7	1.4	1.5	1.3		0.7	0.4
of which : contribution from real GDP growth	-4.8	-6.3	-6.5	-3.8	-3.9	-3.4	-3.2	-3.0	-2.9		-2.1	-1.6
Contribution from real exchange rate depreciation	-4.3	-8.4	-12.7	-12.8	-3.0	-0.7	-0.4	-0.1	-0.4		...	...
Other identified debt-creating flows	-3.0	-0.5	0.1	-0.8	-0.8	-0.8	-0.5	-0.5	-0.6		0.5	0.5
Recognition of implicit or contingent liabilities (Pensions)	0.0	0.0	0.0	0.5	0.5	0.5	0.5	0.5	0.5		0.5	0.5
Debt relief (HIPC and other)	-3.0	-1.5	-0.3	-1.6	-1.5	-1.5	-1.2	-1.3	-1.3		0.0	0.0
Other (financial restructuring)	0.0	1.0	0.4	0.3	0.2	0.2	0.2	0.2	0.2		0.0	0.0
Residual, including asset changes	-8.9	10.9	-13.6	-6.1	-2.7	-1.4	-1.6	-1.4	-1.8		-0.5	-0.1
NPV of public sector debt	...	71.5	50.6	41.1	36.8	34.3	31.7	29.9	28.1		23.0	17.5
o/w foreign-currency denominated	55.1	44.4	28.2	22.1	20.4	19.3	17.9	16.9	15.9		14.0	11.5
o/w external	55.1	44.4	28.2	22.1	20.4	19.3	17.9	16.9	15.9		14.0	11.5
Gross financing need 2/	6.3	6.6	15.5	9.1	8.0	7.1	6.7	6.3	6.0		3.8	3.0
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	287.0	212.4	172.3	156.0	144.5	132.7	124.5	117.2		91.9	70.2
o/w external	...	178.2	118.5	92.6	86.6	81.4	75.0	70.2	66.1		55.9	46.2
Debt service-to-revenue ratio (in percent) 3/ 4/	15.5	15.5	45.7	15.9	12.7	10.3	10.9	9.9	8.9		4.1	3.3
Primary deficit that stabilizes the debt-to-GDP ratio	20.9	4.3	33.5	24.1	8.4	4.7	4.4	3.6	4.3		1.6	1.0
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	3.3	5.1	5.4	4.3	6.0	6.0	6.0	6.0	6.0	5.7	6.0	6.0
Average real interest rate on domestic currency debt (in percent)	0.4	0.0	-3.2	-3.1	3.0	5.7	5.7	6.5	5.9	4.0	3.9	3.5
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.6	-8.4	-13.5	-19.0	-6.2	-1.5	-1.0	-0.3	-1.1	-4.8	-0.9	-0.9
Inflation rate (GDP deflator, in percent)	19.9	19.8	20.1	18.9	11.5	4.6	4.1	3.6	4.4	7.9	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.9	4.6	-9.5	6.8	8.8	7.0	5.4	7.4	6.6	7.0	6.2	6.1

Sources: Zambia authorities; and Fund staff estimates and projections.
1/ Gross debt of Central Government Overall Operations, including IMF claims to the Bank of Zambia. It includes the audited stock of statutory pension arrears, which was K 322 bn by end-March 2005, and the end-year stock of domestic arrears.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues including grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table A4. Zambia: Sensitivity Analysis for Key Indicators of Public Debt 2005-2025

	Estimate	Projections						
	2005	2006	2007	2008	2009	2010	2015	2025
NPV of Debt-to-GDP Ratio								
Baseline	41	37	34	32	30	28	23	18
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	40	35	34	32	31	30	35	45
A2. Primary balance is unchanged from 2004	42	34	29	24	21	17	9	-2
A3. Permanently lower GDP growth 1/	42	36	33	30	27	25	22	26
A4. MDRI Scenario	41	21	20	18	18	18	16	15
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-2007	42	37	36	34	32	31	31	35
B2. Primary balance is at historical average minus one standard deviations in 2006-2007	42	38	38	34	32	29	23	18
B3. Combination of B1-B2 using one half standard deviation shocks	42	38	37	34	31	28	21	14
B4. One-time 30 percent real depreciation in 2006	42	44	40	36	33	30	23	16
B5. 10 percent of GDP increase in other debt-creating flows in 2006	42	46	42	38	36	33	27	21
NPV of Debt-to-Revenue Ratio 2/								
Baseline	172	156	144	133	124	117	92	70
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	167	150	140	132	127	122	134	166
A2. Primary balance is unchanged from 2004	174	144	122	103	87	72	37	-8
A3. Permanently lower GDP growth 1/	176	152	137	123	114	106	89	103
A4. MDRI Scenario	172	87	80	75	73	72	64	60
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-2007	176	158	149	138	132	126	120	139
B2. Primary balance is at historical average minus one standard deviations in 2006-2007	176	163	158	143	131	122	93	73
B3. Combination of B1-B2 using one half standard deviation shocks	176	162	156	139	126	115	82	54
B4. One-time 30 percent real depreciation in 2006	176	188	169	150	137	126	92	62
B5. 10 percent of GDP increase in other debt-creating flows in 2006	176	193	176	160	148	138	107	82
Debt Service-to-Revenue Ratio 2/								
Baseline	16	13	10	11	10	9	4	3
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	16	13	13	16	17	19	25	39
A2. Primary balance is unchanged from 2004	16	12	8	8	6	4	-5	-16
A3. Permanently lower GDP growth 1/	16	13	11	13	13	13	11	20
A4. MDRI Scenario	16	12	8	7	6	5	3	2
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-2007	16	13	13	16	17	18	21	33
B2. Primary balance is at historical average minus one standard deviations in 2006-2007	16	13	15	20	20	20	14	12
B3. Combination of B1-B2 using one half standard deviation shocks	16	13	14	18	17	17	10	5
B4. One-time 30 percent real depreciation in 2006	16	13	11	13	12	12	8	7
B5. 10 percent of GDP increase in other debt-creating flows in 2006	16	13	26	27	26	26	19	15

Sources: Zambia authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/8
FOR IMMEDIATE RELEASE
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Zambia

On January 11, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Zambia.[1]

Background

The Zambian economy has achieved sustained robust growth in recent years, a marked turnaround after more than two decades of economic stagnation and falling per capita income. During 2000–05, real GDP growth averaged 4½ percent a year, as the mining sector recovered substantially in response to privatization and rising copper prices, while the construction sector performed particularly well, driven by strong demand for housing. Inflation has been reduced in recent years, but remains high. In addition, Zambia's external position has strengthened, owing to both a rebound in copper export receipts and relatively strong growth of nontraditional exports; nevertheless, international reserves remain low. Notwithstanding the improvements in economic performance, poverty is still widespread and the economy continues to be vulnerable to climatic and terms of trade shocks.

In 2005, real GDP growth is estimated to have moderated to 4.3 percent from 5.4 percent in the previous year, owing to a drought-related shortfall in maize production and temporary disruptions to mining activity associated with labor disputes and mining accidents. Fuel shortages in the second half of the year, arising from unanticipated shutdowns of the country's

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

oil refinery, also contributed to the economy's slowdown. Inflation remained in the high teens during most of 2005, partly reflecting drought-induced increases in food prices and rising world oil prices, before dropping to 15.9 percent at end-year, as the tightening of monetary policy and a sharp appreciation of the Zambian kwacha restrained inflation pressures.

A substantial fiscal adjustment in 2004 has helped put the public finances on a sustainable course. Spending restraint allowed the overall deficit (including grants) to be reduced to 1.7 percent of GDP from 6.6 percent in the previous year, while still allowing for increased spending on poverty-reducing programs (PRPs), including the hiring of a significant number of new teachers and health workers. As a result, government domestic borrowing was greatly reduced (to less than 1 percent of GDP), thus easing the crowding out of private sector credit, which expanded rapidly while interest rates declined. In 2005, the overall fiscal deficit is expected to be broadly in line with the target for the year of 2.5 percent of GDP, notwithstanding a temporary reduction in import and excise duties on petroleum products during the final quarter, to encourage greater imports in order to alleviate fuel shortages.

The attainment of debt relief under the HIPC Initiative coupled with the favorable trend in exports has improved markedly Zambia's debt sustainability. Including additional bilateral debt relief agreed by Paris Club creditors in May 2005, the ratio of Zambia's external public sector debt to exports is estimated to have fallen to 66 percent at end-2005. Implementation of the Multilateral Debt Relief Initiative, approved by the Fund's Board in December, would result in the cancellation of the bulk of the remaining external debt.

The government's lower domestic financing need has facilitated a firmer monetary policy stance by the Bank of Zambia, after years of excessive monetary expansion. Together with a more consistent implementation of liquidity management in recent months, growth of both reserve and broad money has been reduced and is expected to have remained well within target through the end of the year.

After having remained fairly stable in real effective terms during 2000–04, the Zambian kwacha appreciated strongly in 2005. Against the U.S. dollar, the kwacha appreciated by 26 percent during the year, driven by a marked strengthening of market sentiment stemming from record high world prices for copper, a perceived commitment to prudent fiscal and monetary policies, and the substantial improvement in Zambia's debt sustainability outlook.

In addition to the rebound in copper export earnings, a steady expansion of nontraditional exports have contributed to the strengthening of Zambia's external sector. Despite strong growth in imports, arising partly from high levels of investment in the mining sector and, more recently, high world oil prices, the current account deficit (excluding grants) narrowed sharply, from about 20 percent to about 12 percent of GDP during 2000–05. Still, international reserves have remained low, building up to only about 1½ months of imports by end-2005.

While there have been a number of delays, there has also been important progress in implementing the structural reform agenda, aimed at increasing the efficiency and effectiveness of the public sector, improving debt management, deepening the financial sector, and enabling private sector development. There has been an overall improvement in public expenditure management systems, including the introduction of a medium-term expenditure framework in the budget making process, even though the long planned for piloting of an integrated financial management and information system (IFMIS) has yet to be realized. Again, with some delays, progress has been made implementing the authorities' Financial Sector Development Plan—notably, toward the resolution of troubled state-owned nonbank financial institutions and the privatization of the Zambia National Commercial Bank. Progress to date under the Private Sector Development Initiative has been more limited.

Executive Board Assessment

Directors commended the authorities for maintaining a macroeconomic policy framework that has enabled the economy to sustain robust growth in 2005, despite a number of adverse supply shocks. They welcomed the sustained efforts to strengthen the public finances, which have contributed to improved macroeconomic stability and strong growth. Directors noted the favorable performance of nontraditional exports, and the recent strong recovery of the mining sector following privatization of mining companies. Directors were concerned, however, that poverty, though declining, is still widespread in Zambia. They were encouraged by the authorities' commitment to increase further spending on poverty-reducing programs (PRPs) and implement a structural reform agenda aimed at increasing productivity and raising incomes.

Directors agreed that prospects are favorable for achieving higher economic growth and lower inflation in the years ahead. They noted that attaining single-digit inflation by 2007 would be a historic accomplishment that would further investment, financial intermediation, and good labor relations. Noting the potential pressures on policies during an election year, Directors urged the authorities to maintain disciplined economic and financial policies to safeguard the gains achieved. Directors further observed that the authorities must maintain clear objectives for monetary policy and closely coordinate fiscal and monetary policies to help break expectations of high inflation.

Directors agreed that strengthening public expenditure management and financial accountability (PEMFA) is critical for increasing the efficiency and effectiveness of the public sector. They welcomed the progress achieved thus far under the comprehensive PEMFA reform program, and noted that it has encouraged some donors to increase their direct support for the budget. Directors, however, expressed concern over delays to the contracting for the installation of an integrated financial management and information system (IFMIS) and urged the authorities to ensure that existing public expenditure management systems are appropriately strengthened.

Directors welcomed the authorities' efforts to resolve domestic arrears and fund contingent liabilities. They agreed that clearing arrears to contractors should be a high priority. Directors urged the authorities to proceed expeditiously with a reform of the pension system.
They welcomed the initial steps taken by the authorities to provide budgetary resources over the medium term to meet projected obligations to the public sector pension fund, but emphasized that a fundamental reform is necessary to avert a major risk to the public finances.

Directors observed that expansion and deepening of financial intermediation is critical for private sector-led growth. In this regard, they welcomed the expansion in bank credit to the private sector facilitated by reduced government borrowing. Directors cautioned, however, that this credit expansion is not without risks and urged enhanced financial sector supervision and regulation as an essential step to maintain confidence in the system. Directors advised the authorities to follow through with planned measures to resolve financially troubled nonbank financial institutions and finalize privatization of the Zambia National Commercial Bank.

Directors agreed that a flexible exchange rate policy has served Zambia well. They remarked that the rapid growth of nontraditional exports in recent years suggests that Zambia has maintained its international competitiveness. However, the recent appreciation of the kwacha, supported by the improvement in Zambia’s longer-term prospects, points to the importance of increasing productivity in order to maintain competitiveness. Directors noted that appreciation pressures may provide an opportunity to accumulate international reserves more rapidly than planned, and recommended that a close watch be kept on the impact of foreign exchange market developments on the economy.

Directors urged the authorities to step up implementation of the structural reform agenda to remove impediments to business activity, expand access to credit, and improve infrastructure. They highlighted the importance of donor coordination, welcomed the Fund's good work in coordinating and consulting productively, and encouraged the Fund and the Bank to continue to strengthen their efforts in this regard.

Directors remarked that debt relief under the enhanced HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI) have greatly improved Zambia’s external debt sustainability position. They welcomed the authorities’ commitment to avoid a renewed build up of external debt by adopting a prudent borrowing policy and further strengthening their debt management capacity. In this regard, investment plans by state-owned enterprises, such as the electricity and telephone companies, should be thoroughly scrutinized to ensure that Zambia reaps the maximum benefits.

Directors noted that debt relief and the prospect of increased donor support provided a significant opportunity for directing greater resources to increasing economic growth and reducing poverty. In particular, Directors looked forward to the timely revision of the Zambian National Development Plan to map out a comprehensive agenda to achieve strong progress toward meeting the Millennium Development Goals (MDGs).

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with Zambia may be made available at a later stage if the authorities consent.

Zambia: Selected Economic and Financial Indicators, 2001-05

	2001	2002	2003	2004	2005 Est.
	(Annual percentage change)				
National income and prices					
Real GDP	4.9	3.3	5.1	5.4	4.3
GDP deflator	24.3	19.9	19.8	20.1	18.9
Consumer prices (annual average)	21.4	22.2	21.4	18.0	18.3
Consumer prices (end of period)	18.7	26.7	17.2	17.5	15.9
	(In percent of GDP)				
Investment and savings					
Gross national savings	5.1	12.8	16.0	18.9	17.5
Gross foreign savings	13.9	9.2	9.6	5.4	6.0
Gross domestic investment	19.0	22.0	25.6	24.3	23.5
Of which: Public investment	11.9	11.8	11.4	8.7	7.4
Central government budget					
Revenue and grants	24.8	26.2	24.9	23.8	23.9
Revenue	19.1	17.9	18.0	18.3	17.8
Grants	5.7	8.3	7.0	5.5	6.0
Expenditures	32.2	31.3	30.9	26.7	26.5
Current expenditures	19.7	19.4	19.5	18.0	19.2
Of which:					
Wages and salaries	6.8	8.0	8.4	7.8	7.9
Interest 1/	2.5	4.1	3.9	3.5	2.7
Capital expenditures	11.9	11.8	11.4	8.7	7.4
Change in balances and statistical discrepancy	-0.8	-1.3	-0.6	1.2	0.0
Overall balance, cash basis	-8.1	-6.3	-6.6	-1.7	-2.7
Domestic financing (net)	4.5	2.1	5.1	0.8	1.9
External financing (net)	3.6	4.3	1.5	0.9	0.7
	(Annual percentage change)				
Money and credit					
Broad money (end of period)	10.8	31.5	23.4	30.2	8.6
Claims on the private sector (end of period)	9.7	7.8	36.4	48.1	34.0
External sector					
U.S. dollar value of exports of goods and services	19.4	2.4	15.4	63.7	16.3
U.S. dollar value of imports of goods and services	23.3	-2.5	13.3	21.1	18.6
Export volume (goods)	26.2	11.2	1.8	16.6	5.5
Import volume (goods)	34.3	-3.9	6.9	4.3	9.4
Real effective exchange rate (annual average) 2/	8.5	-5.8	-1.7	8.1	12.2
Terms of trade	-1.7	-6.7	4.2	21.9	2.1
	(In percent of GDP)				
Current account balance, excluding grants	-20.8	-17.3	-16.2	-10.7	-11.9
Current account balance, including grants	-13.9	-9.2	-9.6	-5.4	-6.0
Overall balance of payments	-8.0	-11.0	-7.4	-6.1	-4.0
External official debt service 1/ 3/	13.4	11.4	15.2	18.2	7.0
	(In millions of U.S. dollars)				
Gross official reserves (end of period)	114	283	194	222	312
In months of imports of goods and services	0.8	2.1	1.3	1.2	1.4

Sources: Zambian authorities; and IMF staff estimates.
1/ After debt relief.
2/ Estimate for 2005 reflects data for January-August.
3/ In percent of exports of goods and services.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/9
FOR IMMEDIATE RELEASE
January 11, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under Zambia's PRGF Arrangement and Approves US$15.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Zambia's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement, which was approved on June 16, 2004 (see Press Release No. 04/117) in the amount of SDR 220.1 million (about US$318.8 million).

The completion of the review enables the release of a further SDR 11.0 million (about US$15.9 million), which will bring the total amount drawn under the arrangement to about SDR 187.1 million (about US$271.0 million). Zambia is on a quarterly disbursement schedule under the PRGF arrangement and received two disbursements of SDR 5.5 million each for broadly satisfactory performance through June 2005 and September 2005, respectively.

The Board also approved a waiver for the nonobservance of the end-September 2005 quantitative performance criterion on the net domestic financing of the central government.

Following the Executive Board discussion, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"The Zambian authorities are to be commended for the successful implementation of sound economic policies and the broad achievement of their program objectives in 2005. In particular, sustained efforts to strengthen the public finances, have contributed to improved macroeconomic stability and robust growth. Zambia's external position has strengthened in recent years and debt relief has greatly reduced Zambia's external debt burden. However, inflation, though declining, remains high, and there is a critical need to seize the opportunity provided by debt relief to sustain improved economic performance and accelerate the reduction of Zambia's widespread poverty.

"The strong pace of investment suggests that prospects for robust economic growth in the years ahead are favorable. The authorities' policy framework aims to extend the recent gains in macroeconomic stability, including the reduction of inflation to single-digit levels by 2007. If sustained, these policies would provide a solid foundation for continued strong economic growth and poverty reduction. Thus, it is critical that the authorities resist election year pressures that could undermine fiscal and monetary policies.

“Continued progress under the comprehensive Public Expenditure Management and Financial Accountability (PEMFA) reform would lead to substantial improvements in the effectiveness of public resources. In addition, longer-term budget planning and the allocation of resources to eliminate domestic payments arrears and provide for forthcoming contingent liabilities, including the projected cash flow deficit in the public sector pension fund (PSPF), are welcome. Proceeding expeditiously with pension system reforms will be critical to reducing risks to the public finances.

“The recent appreciation of the kwacha, spurred by the improvement in Zambia’s longer-term prospects, points to the importance of closely monitoring exchange rate developments and increasing productivity in order to maintain competitiveness. Therefore, the implementation of structural reforms to remove impediments to business activity, expand access to credit, and improve infrastructure should be stepped up. In order to maintain confidence in the financial sector, it is essential for the authorities to follow through on plans to resolve financially troubled nonbank financial institutions, privatize the Zambia National Commercial Bank and, more generally, strengthen financial sector supervision and regulation,” Mr. Kato said.

The PRGF is the IMF's concessional facility for low-income countries. It is intended that PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Statement by Peter Ngumbullu, Executive Director for Zambia
and Joseph Masawe, Senior Advisor to Executive Director
January 11, 2006

The Zambian authorities wish to express their appreciation to staff for their well balanced report on the developments in the Zambian economy. The staff report on Article IV consultation and the third review of the PRGF provides helpful policy advice, which will guide authorities going forward. The authorities want to thank the Executive Board for its continued support and reiterate their commitment to prudent macroeconomic polices. They welcome the Fund's interaction with representatives of the private sector, trade unions, NGOs and the donor community, as they constitute important stakeholders on the national development agenda.

As correctly reflected in the staff report, Zambia has made significant gains in macroeconomic stabilization. GDP growth has been strong despite lower than projected growth in 2005, caused by supply side shocks. Fiscal performance continues to stay within programmed levels and efforts to contain inflation are being strengthened. Zambia's exports are also growing and reforms in the financial sector are being deepened. The authorities recognize that despite these positive developments, downside risks remain and hence, the need for continued deepening of the reform agenda.

Recent Macroeconomic Developments

After more than two decades of economic stagnation, the Zambian economy experienced a marked rebound, with GDP growth averaging 4.5 percent over the past five years. The robust growth has been driven by a strong expansion in construction, following increased demand for housing and rapid growth in investment, especially in the copper mining sector. During 2005, GDP growth is expected to be around 4.3 percent compared with the projected growth of 5.0 percent, following the impact of drought-related decline in maize production during 2004/05 and oil shortage caused by intermittent closures of the country's INDENI Oil Refinery, which negatively affected fuel supply and caused high pump prices of petroleum products. However, despite these adverse supply side shocks, implementation of appropriate tight monetary policy by the BOZ, coupled with government's tight fiscal policy, led to a reduction in the annual overall inflation to 15.9 percent in December 2005, compared to 17.4 percent in 2004 and the program target of 15 percent for 2005. This is a marked improvement compared to the high rates experienced in the past.

Fiscal performance continued to be strong, with revenue collection surpassing the September 2005 target. It is expected that end-of-year revenue target will still be achieved, despite a projected shortfall in nontax revenue arising from reduced import and excise duties on petroleum products undertaken in October 2005 to dampen the impact of fuel shortages. Given the revenue shortfall, the government maintained tight expenditure regime over the year and ensured that all bridge finance obtained from the central bank is paid before end of the year.

Monetary policy remained tight, in line with the objective of containing inflationary pressures. Broad money supply growth declined from 30.2 percent in December 2004, to only 9.1 percent in September

2005. Exports grew strongly following high world market copper prices and a rapidly growing non-traditional export sector. However, strong growth in imports arising mainly from high world petroleum prices and a rise in capital imports following increased investment in the mining sector, is expected to lead to widening of the current account from 5.4 percent of GDP in 2004 to around 6.0 percent of GDP in 2005.

In the financial sector, good progress was also recorded. The National Savings and Credit Bank (NSCB) and the Development Bank of Zambia (DBZ) submitted their plans for incorporation under the Companies Act to the Bank of Zambia (BOZ) in April and May 2005, respectively. The government also adopted the BOZ's proposed action plan for the Zambia National Building Society (ZNBS) in August. The amendment to the Acts of the NSCB and DBZ undertaken in October 2005, has aligned these Acts with the Banking and Financial Services Act, while giving the BOZ clear supervisory mandate for these institutions. Meanwhile the privatization of the Zambia National Commercial Bank (ZNCB) is proceeding well and the process is on course. The Zambia privatization Agency (ZPA) selected Rabobank as the preferred investors for 49 percent shares in the bank.

Performance under the Program

All quantitative program targets for June 2005 were met, while only one target for September 2005 was not met. Notably, the floor on gross reserves and the ceiling on net domestic assets (NDA) of the BOZ were met with wide margins. However, despite meeting the net domestic financing of the government (NDF) ceiling with a comfortable margin in June 2005, the target for September 2005 was missed narrowly, owing to emergency outlays for food relief in drought affected areas and higher than programmed expenditures on preparations for elections and constitutional review process. The authorities are currently making every effort to ensure that domestic financing requirements remain within programmed levels. The two performance criteria under the structural program were both met. The government continued to refrain from extra budgetary expenditures, except for parliamentary approved supplementary expenditures which were necessary for emergency food relief imports. The new financial regulations and revised accounting manuals for the new Finance Act are being finalized and are expected to be issued before end-March 2006.

Macroeconomic Policies for 2006 and Medium-Term Outlook

The Zambian authorities remain committed to policies aimed at achieving a high level of growth, necessary for poverty reduction. Although recent supply side shocks to the economy, may lead to lower than projected GDP growth and higher level of inflation, the setbacks will be temporary. The authorities recognize the daunting challenges that they face in meeting the MDGs, but remain confident that with the strong continued support by the development partners, they stand a chance of meeting most of them by 2015. The government's development strategy for the medium and long-term remains focused towards transforming agriculture and substantially reducing poverty. These priorities are addressed in the National Development Plan (NDP) and the medium term expenditure framework. The key objective of sustained growth will be supported by sound macroeconomic policies including policies to create an environment for strong private sector investment and expansion in energy and pro-poor growth, mainly focusing on increased investment in small scale mining, agriculture and manufacturing. In addition, the country's export development strategy will remain focused on diversification away from metal exports, in particular copper exports.

Fiscal Policy

The government remains committed to prudent fiscal policies. Macroeconomic stabilization policies will be anchored on reduction in net domestic financing, while allocating more resources to poverty reduction programs. The government intends to conduct an overall review of its tax policy, with the objective of rationalizing the tax system and expanding the revenue base. In this context, it will ensure that a minimum revenue target of 17.5 percent of GDP is attained and expenditure will be contained within the approved limits. Expenditures related to elections scheduled for 2006 will be monitored closely with the objective of keeping such expenditures within budgeted levels.

Monetary and Financial Sector Policies

The authorities recognize that consistent with program implementation targets the reserve money will be key to curbing inflationary pressures. The authorities will therefore ensure that during the year, broad money growth is kept at around 14 percent. The monetary program will focus on increased flow of credit to the productive sector, while gross international reserves are expected to reach at least 1.5 months of import cover. The government will continue to strengthen the bond market, whose recent introduction has helped to shape the yield curve and strengthen implementation of monetary policy. The government is committed to maintaining the independence of the Bank of Zambia, which is a key aspect in pursuing its primary objective of maintaining price stability.

The flexible exchange rate regime has so far served Zambia well. The objective of the government is to ensure that this regime is maintained and further strengthened. The authorities are aware of the impact of a large and sustained exchange rate appreciation on the competitiveness of Zambian exports, but recognize that it may not be prudent for the Bank of Zambia to intervene in such appreciation immediately. Nevertheless, the authorities will continue to watch exchange rate developments closely and take appropriate measures when necessary. Other measures to improve the country's international competitiveness will also be implemented. The government intends to introduce measures to reduce the cost of doing business in Zambia, and increase competitiveness of its exports. Similarly, measure to diversify the export base will continue to be implemented and enhanced.

Structural Measures

The government will continue to pursue it structural reform agenda, with measures during 2006 focusing on public expenditure management and financial accountability (PEMFA), debt management, financial sector development and governance and transparency. As part of the PEMFA, the government intends to put in place an Integrated Financial Management and Information System (IFMIS). New rules to strengthen existing expenditure management system will be instituted, including rules to strengthen commitment control. Similarly, the government will strengthen fiscal transparency and new manuals for the new Finance Act will be issued. The government will also continue to strengthen its debt management capacity.

The authorities are thankful to the multilateral financial institutions and the international community for granting Zambia debt relief under the HIPC initiative and further under the recent multilateral debt relief initiative (MDRI). Debt relief granted to Zambia has greatly improved the country's external debt situation and overall debt sustainability. The government will ensure that the resources released from these initiatives are used to benefit the Zambian population through increased social spending and the development of rural infrastructure, both being key aspects towards achieving the MDGs and eradicating poverty .

In the financial sector, policies will be directed towards expanding financial intermediation in both urban as well as rural areas. Measures will be taken to deepen availability of microfinance services, particularly in rural areas and strengthen the overall banking system. The government is aware that despite the overall strength of the domestic banking sector, vulnerabilities still exist and hence, there is need to continue taking measure to improve the banking system. The government will continue to expand the lending resources of the DBZ as per understanding reached with the World Bank and ensure that the bank gets registered under the Companies Act and its subsequent licensing under the banking and Financial Services Act, but measures will be taken to ensure that the bank maintains prudent lending policies. Measures are also being taken to finalize reconciliation of the NSCB accounts and implement the bank's institutional development plan. The government intends to establish a credit reference bureau (CRB) to foster availability of credit to support growth, while at the same time ensuring that outstanding pension liabilities are addressed, including initiating, with the assistance of the World Bank, a reform of the pension funds.

The government recognizes the key role of the electricity sector to the economy. As the Zambia Electricity Company (ZESCO) accomplishes its first year as a commercialized government-owned company, plans to expand electricity generation and transmission will be implemented. Under the plan, government will strengthen ZESCO management and enhance profitability of the company. In this context, the government will also ensure that Zambia's capacity to collect, analyze and report various statistics of socio-economic importance is enhanced. The government will strengthen the Central Statistics Office (CSO) to ensure that the ability of this agency in compiling and reporting various statistics is improved.

Concluding Remarks

The authorities have consistently, over the past five years, implemented broad based structural reforms and moved towards market-based policies. These measures have started bearing results, as evidenced in the sustained high level of growth, which is critical for poverty reduction. However, despite this impressive performance, the authorities recognize that there remain many challenges, which must be addressed in order to meet the MDGs and eradicate poverty. The Zambian authorities remain strongly committed to policies aimed at deepening the reforms agenda as vast majority of Zambians are poor, most of whom live in rural areas. Improving their future welfare hinges upon transforming the rural sector, including improving rural infrastructure. It is for this reason that the new NDP aims at increased emphasis on rural infrastructure and attaining sustainable growth level, which are necessary for the reduction of income poverty and hence, improvement in social well-being of the majority of the Zambians.

As the country consolidates the economic gains achieved, the authorities are strongly committed to implementation of prudent macroeconomic policies and further structural reforms. They are looking forward for continued support from the Fund, other multilateral institutions and other cooperating partners in their pursuit of the reform agenda, particularly in the areas of debt management, capacity building, strengthening of the intermediation role of the financial sector, enhancement of the role of the private sector in economic development to enable meeting of the MDGs and the various challenges facing the country in the medium and longer term.

The authorities request for completion of the third review and the fifth and sixth disbursements under the PRGF arrangement. With regard to the sixth disbursement, the government requests for waiver on non-observance of the end September 2005 performance criterion on net domestic financing of the government (NDF), which was missed by a small margin owing to emergency outlays for food relief. The government also requests for modification of the performance criterion for end-December 2005 on net domestic financing to facilitate clearing of domestic arrears, as well as the end-January 2006 criterion with respect to the piloting of the IFMIS.