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June 25, 2010

Zambia: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

June 10, 2010

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The following item is a Letter of Intent of the government of Zambia, which describes the policies that Zambia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Zambia, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

LETTER OF INTENT

June 10, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431
USA

Dear Mr. Strauss-Kahn,

The attached Memorandum of Economic and Financial Policies (MEFP) reviews recent economic developments and progress in implementing the Government of the Republic of Zambia's macroeconomic and structural program under the country's three-year Extended Credit Facility (ECF), approved by the IMF Executive Board on June 4, 2008. It also sets out macroeconomic policies and structural reforms that the government will pursue for the remainder of 2010 and over the medium term.

The Government requests that the fifth disbursement be made available upon completion of the fourth review by the Executive Board of the IMF. All but one of the performance criteria for the fourth review under the ECF arrangement were met. Unfortunately, the use of an outdated concessionality calculator caused the end-December 2009 non-concessional debt ceiling to be breached, for which a waiver is requested. In December 2009 a non-electricity related loan contract was signed that was believed to be concessional. However, corrected calculations now show that the grant element (at 27 percent) was less than the program threshold of 35 percent. The December 2009 ceiling was also missed by the contracting of two loans in late-May 2009. Further, it is now understood that the contracting of these two loans means that the end-June 2009 performance criterion on non-concessional borrowing that was assessed as met at the 3rd review under the ECF arrangement was not, in fact, met. At the time, however, the Government reported to IMF staff the contracting of the May 2009 loans as well as relevant data on their terms and were under the impression that there was no issue of nonobservance. Accordingly, the associated disbursement was requested.

Structural reforms are progressing well. The structural benchmark for end-March 2010 on the supervisory regime for the government securities market was met and most of the end-June 2010 benchmarks are on track, but the planning and budgeting act cannot be submitted to parliament before the constitutional reform process has been completed. Thus, it is requested that this benchmark be rescheduled for end-December 2010.

The Government believes that by adhering to the policies and measures set forth in the attached MEFP, it is well placed to achieve the objectives of the program. The economic program for 2010 has been updated to take into account recent developments, and modifications to the end-June 2010 performance are being requested. It is also requested that three road projects are added to the list of projects that can be financed under the non-zero non-concessional borrowing ceiling set at the time of the third ECF review. The Government is firmly committed to the objectives of the program, and will promptly take any additional measures necessary for their achievement. The Government remains committed to regular consultations with the IMF—at our own initiative or whenever the Managing Director of the IMF requests such a consultation—on the adoption of these measures and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

The Government will provide the Fund with such information as the Fund may request in connection with the progress made in implementing the economic and financial policies and achieving the objectives of the program. Data reporting provisions have been strengthened in the Technical Memorandum of Understanding accordingly.

The Government authorizes the IMF to publish this letter, the attached Memorandum of Economic and Financial Policies, and the related Staff Report, including placement of these documents on the IMF website subject to the removal of market-sensitive information, following the IMF Executive Board's conclusion of the review.

Yours sincerely,

/s/

Dr. Situmbeko Musokotwane
Minister of Finance and National Planning

Attachments: - Memorandum of Economic and Financial Policies
- Technical Memorandum of Understanding for the 2010–11 Extended Credit Facility (ECF) Arrangement

ATTACHMENT I. MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum reviews recent economic developments and outlines policies and targets that the government of the Republic of Zambia will pursue for the remainder of the year 2010 and over the medium-term under the Extended Credit Facility (ECF) arrangement.
2. The ECF supports the implementation of the Fifth National Development Plan 2006–10 (FNDP). The FNDP underscores the need to create an environment conducive to private sector growth through sustained macroeconomic stability, public sector efficiency and accountability, and investments in infrastructure and the social sectors. Consistent with these principles and objectives, the program will continue to focus on: (i) maintaining macroeconomic stability and debt sustainability, while increasing fiscal space for investment in infrastructure, energy, and human resources; and (ii) diversifying the economy to lessen dependence on mining by improving the conditions for private sector-led growth.

I. RECENT ECONOMIC DEVELOPMENTS

3. **Growth in the Zambian economy was higher than projected earlier.** Initial estimates by the Zambian Central Statistical Office indicate that real GDP growth in 2009 was 6.3 percent, largely as a result of historically high growth in mining and agriculture and strong construction activity. A rebound in copper prices during the second half of the year, combined with the commencement of production at a large new copper mine, contributed to growth in the mining sector. The 2009 agricultural harvest was the highest recorded in ten years. Despite this strong performance, the tourism and tertiary sectors were negatively affected by the global economic crisis. Gross international reserves rose by US\$782 million in 2009 to reach US\$1.8 billion at end-2009 (equivalent to 5.1 months of contemporaneous imports or 3.9 months of prospective imports). This was on account of higher than expected copper revenues, an augmentation under the ECF of US\$256 million, and the one-off SDR allocations of US\$627 million. The Kwacha depreciated sharply in late 2008 and early 2009, before recovering strongly from March 2009 onwards. Inflation fell to 9.9 percent in December 2009, thus meeting the inflation target for the year.
4. **Despite a shortfall in tax collections and in inflows from cooperating partners, the fiscal program was broadly on track.** Preliminary estimates indicate that the shortfall in total revenues and grants relative to earlier projections was 0.3 percent of GDP, and 0.5 percent of GDP relative to budgeted estimates. Import-related tax collections declined compared to 2008 and fell below the program target by 0.2 percent of GDP, largely due to a decline in imports. The overall fiscal deficit of 2.5 percent of GDP remained in line with the program target.
5. **The global financial and economic crisis and the commodity price shocks of 2008 have provided an important stress test for Zambia's monetary policy framework.** These shocks increased inflation beyond single digits and created a more volatile exchange rate.

However, an appropriate monetary stance, combined with a flexible exchange rate regime provided the Bank of Zambia (BoZ) with the flexibility to intervene in the foreign exchange market. This helped address excess volatility and enabled the Zambian economy to adjust to the external shocks, particularly the decline in copper prices. This has helped in preserving a viable external sector over the medium term.

6. Monetary developments in 2009 were influenced by a sharp drop in domestic credit to the private sector. As a result, broad money growth slowed down substantially to 8.2 percent, 10.8 percent less than projected, in the 12 months to December 2009. Average reserve money in December 2009 was below target by kwacha 171 billion. Credit to the private sector contracted by 3.9 percent in 2009 driven mainly by a sharp decline in consumer loans and in domestic lending to the mining sector, compared to a programmed expansion of 14.3 percent, as financial institutions tightened lending standards amidst declining credit quality. This decline in the quality of credit was evidenced by an increase in non-performing loans in the banking system from 7.2 percent in 2008 to 12.6 percent at end-2009.

7. The balance of payments position improved during the year following the recovery in copper prices. The overall balance of payments surplus rose to 4.1 percent of GDP (equivalent to US\$540 million) in 2009 compared to 0.1 percent of GDP (US\$13 million) in 2008. This significant improvement in the overall balance was mainly on account of a large narrowing in the current account balance to -3.1 percent of GDP from -7.1 percent in 2008, together with the SDR allocation of US\$627 million. The current account deficit declined substantially partly due to the sharply compressed imports. As a result, the international reserve position improved significantly, reaching 5.1 months of contemporaneous imports in 2009 or 3.9 months of prospective imports.

8. The authorities' mid-term review of the Fifth National Development Plan found that significant strides have been made in poverty reduction efforts, but progress remains mixed. The Millennium Development Goals in reducing hunger, maternal and child mortality, preventing the spread of HIV/AIDS and malaria, and providing universal primary education are on-track. However, the water, sanitation, and environmental sustainability goals are unlikely to be met without substantial effort. With strong annual average real GDP growth over the FNDP period, per capita income grew to US\$980 in 2009, placing Zambia in lower middle-income status. While there has been significant progress in urban poverty reduction, the challenge for the government remains to tackle rural poverty and service delivery. Consultations with stakeholders on the draft of the Sixth National Development Plan (2011–15) are underway.

9. The program was essentially on track at end-2009, and all but one of the quantitative performance criteria were met; one indicative target on domestic arrears clearance was missed. The target relating to the ceiling on contracting of non-concessional debt was not met: the government signed two loans with China EXIM Bank for storage sheds

and the completion of a government complex building in late-May 2009 (equivalent to US\$37 million) and a US\$46 million loan agreement with China EXIM Bank for procurement of container scanning equipment in late December 2009. At the time these loans were signed, information available to the authorities indicated a computed grant element of 35 percent, thereby meeting the program threshold. Re-calculations using corrected information on the commercial interest reference rates provided to the authorities by the IMF staff at the time of discussions for the fourth review, however, indicate that the computed grant element is lower, at 28 and 27 percent respectively. In addition, payment of domestic arrears was less than the indicative program floor. This was as a result of the audit and verification process taking longer than expected. On the structural front, in order to enhance the efficiency of monetary policy, an overnight lending facility was introduced on December 1, 2009. This facility is expected to lower volatility of short-term interest rates as well as ease structural rigidities relating to market segmentation in the financial sector. The establishment of a supervisory regime for the secondary market in government securities was launched on March 26, 2010.

II. MEDIUM-TERM MACROECONOMIC FRAMEWORK

10. **Economic growth is expected to remain strong over the medium term, in line with previous projections.** As agricultural output reverts to trend levels, real GDP growth is expected to fall marginally to 5.8 percent in 2010 before rising to 6 percent thereafter. Growth in 2010 will be driven by a recovery in the tertiary sector and by continued investment in the mining and construction sectors. Mines that had been closed down as a result of the crisis have reopened, and a rebound in tourism activity is expected in connection with the 2010 Football World Cup in South Africa. Downside risks, however, still remain amidst uncertainties about a full-fledged global recovery in 2010 and rising oil prices. Growth over the medium term is premised on the realization of policy initiatives and structural reforms aimed at economic diversification and enhanced competitiveness. Additionally, growth will be boosted by anticipated new investments in mining and electricity generation.

11. **A key government goal in the medium-term is to increase capital expenditure, particularly on infrastructure and social spending.** Stagnating revenues as a percentage of GDP, however, pose a significant challenge towards the attainment of this goal. The government is committed to addressing potential weaknesses in tax administration and policy, and is taking remedial measures to reduce current spending to provide room for capital expenditures. The measures will include rationalization on the purchase of goods and services and reduction in the number of foreign trips and holding of workshops.

12. **Earlier projections on increasing foreign direct investment (FDI) flows have been maintained.** A number of large investments in the mining and energy sector are expected over the medium-term, as indicated by pledges recorded at the Zambia Development Agency. Import-intensive infrastructure projects, particularly in the energy

sector, will require government equity participation, although the private sector is expected to play the lead role in the development of these projects.

III. POLICIES FOR 2010

A. Fiscal Policy

13. **Fiscal policy in 2010 remains geared towards the containment of current expenditures in favor of higher capital expenditures.** Domestic revenues are expected to rise to 16.3 percent of GDP, premised on tax administration gains and the introduction of some tax measures, such as the increase in the excise tax on diesel from 7 to 10 percent. Current expenditures will be reduced by 0.9 percentage points of GDP relative to 2009, in order to create fiscal space for capital spending which is expected to increase to 4.6 percent of GDP. The overall fiscal deficit is expected to rise remain at 2.5 percent of GDP and domestic financing is expected to remain as programmed at 1.9 percent of GDP. This fiscal framework is consistent with the inflation target and provides adequate room for the expansion of private sector credit.

14. **Improving the performance of revenues will be a key area of focus in the medium-term.** While the contribution to GDP by sectors such as mining has increased dramatically over the last decade, this has not been matched by commensurate contributions to domestic revenues. In addition, the revenue burden continues to be borne by personal income taxpayers, while corporate and import taxes and VAT continue to underperform. The government remains on track to undertake a comprehensive review of tax policy and administration this year (structural benchmark for end-September 2010), and will draw on past technical assistance and the ongoing technical assistance on VAT. In the mining area, the government has commenced discussions with the mining sector aimed at resolving legacy issues related to the development agreements as well as the adherence to the current tax regime. In this context, the government intends to draw on lessons stemming from the ongoing audit of selected mining companies. The Government will continue to draw on the expertise of the IMF and other relevant development partners on the ramifications stemming from these discussions for the fiscal regime of the mining sector.

15. **Progress is being made towards reducing the high proportion of the public service wage bill relative to domestic revenues.** During the first half of 2009, the government undertook a review of pay policy and the recommendations of this review have now been approved by Cabinet (structural benchmark for end-June 2010). Implementation is expected to begin in 2010 through the establishment of a secretariat that will supervise the process of pay reform. The Cabinet Office has begun the process of undertaking a job evaluation exercise, which will determine the right-sizing requirements over the medium-term. In addition, progress continues to be made in rolling out the payroll management and establishment control (PMEC), to all remaining ministries and spending agencies during 2010.

B. Monetary and Exchange Rate Policies

16. **The government and Bank of Zambia will aim to bring down inflation further to 8 percent by the end of 2010.** Broad money is projected to expand in line with nominal GDP and the money multiplier to increase gradually towards past levels, as increased private sector credit drains excess liquidity. This should result in short term interest rates returning to positive real levels and in a flattening of the yield curve. Consistent with this, reserve money is targeted to grow by 9.7 percent from end-December 2009 to end-December 2010.

17. **The current reserve money-based program will remain in place, while at the same time progress is being made towards the use of interest rates as the main instrument to anchor inflationary expectations.** The Bank of Zambia is actively working on tackling the necessary preconditions and is in the process of developing draft operational guidelines to ensure a smooth eventual migration. The Bank will draw on technical assistance by the IMF to ensure the adoption of international best practices.

18. **The government will continue to maintain a flexible exchange rate regime.** Interventions in the foreign exchange market by the Bank of Zambia will be limited to the smoothing of excessive fluctuations, while allowing for a gradual buildup of international reserves.

19. **The government will continue examining the possibility of redeeming domestic debt securities financed through a drawdown on reserves.** This drawdown is initially expected to be in the amount of up to US\$100 million. It is expected that this portfolio swap, focusing on longer-term more expensive instruments, will lead to a lower debt service burden and create room for more private sector borrowing in domestic markets.

C. Structural Policies

Public financial management

20. **Improving public financial management continues to remain a priority in 2010.** As a result of a constitutional amendment, the 2010 budget was presented and approved in advance of the fiscal year, allowing for implementation over the full financial year. The introduction of a planning and budgeting act in 2010 (that was structural benchmark for end-June 2010), however, is likely to be delayed as a result of the national constitutional reform process. While a draft of the act has been prepared, certain provisions pertaining to the budgeting process during and after a national election can only be finalized after the constitutional reform process is complete. As a result, the submission to parliament is likely to be delayed, and is expected to be completed by end-December 2010.

21. **The government's Integrated Financial Management and Information System (IFMIS) commenced pilot operations in January 2010.** The first pilot site, the Ministry of Finance and National Planning, has commenced use of all of the technology modules under

IFMIS. Additional ministries, provinces and spending agencies (MPSAs) are expected to launch operations over the course of 2010. A full rollout of IFMIS remains on track for end-2011.

22. Trial runs of the Treasury Single Account (TSA) have commenced in 2010 at the Ministry of Finance and National Planning. The payment of salaries from the TSA has already commenced, with 54 MPSAs participating. Implementation of the TSA will go hand-in-hand with the rollout of IFMIS over the course of the year. The government remains on track towards the rollout of the TSA at six MPSAs in 2010 (structural benchmark for end-December 2010).

Financial sector development

23. The government remains on-track to implement the second phase of the Financial Sector Development Plan (FSDP II). The FSDP II will focus on improving access to credit, thereby deepening financial markets, and reducing the high cost of borrowing.

24. The Bank of Zambia is on course to revise its lender of last resort policy by end-June 2010 to align it with accepted international standards and ensure its effectiveness and relevance. In the mean time, BoZ is enhancing its own stress testing capacity with a view of having an operational stress testing capability up and running by end-September 2010. Progress is also being made towards the development of a financial sector contingency plan to address the impact of a system-wide crisis in the financial sector and the broader economy (structural benchmark for end-June 2010).

Energy

25. The government remains strongly committed to addressing constraints in electricity generation. A multi-year tariff framework was announced to raise electricity tariffs to cost-recovery levels by 2011. A first adjustment of 35 percent was implemented in April 2009 and an indicative increase of 26 percent was announced for 2010. ZESCO, the public utility, has formally applied to the Energy Regulation Board (ERB) for a 36 percent tariff increase. After statutory public consultations, the ERB will announce the exact percentage of the next increase. The government is committed to meeting the related structural benchmark for end-June 2010. We also intend to modify the regulatory process to allow for implementation of phased multi stage tariff adjustments, as a way to streamline the process.

26. Progress continues to be made in the development of electricity generation projects across the country. Work will continue on the Kariba North Bank extension project in 2010, which will add 360 MW of additional capacity by 2013. Part of this work was financed by contracting US\$315.6 million in nonconcessional financing in 2009. In addition, the government will continue, in 2010, with preparatory work for eventual

development of the 600 MW Kafue Gorge Lower (KGL) and the 120 MW Itezhi-tezhi projects, which are likely to be completed by 2017. Both of these projects will also require contraction of non-concessional financing, while remaining consistent with the nonconcessional debt ceiling under the program. Financial negotiations for the KGL project are expected to commence in 2010.

27. **The government has reinstated full cost recovery pricing of petroleum products.** Fuel prices were kept constant between December 2008 and January 2010, at which point a partial adjustment towards cost recovery was made. An average fuel price increase of 11.2 percent on May 11, 2010 has brought domestic petroleum prices fully in line with supply costs, and going forward the ERB will ensure that prices adjust automatically at the time of arrival of each shipment to ensure that domestic prices fully cover the supply costs. The fact that prices were below cost in 2009 and the first part of 2010 resulted in an unbudgeted subsidy of US\$90 million that will be covered by additional revenues and by savings elsewhere in current spending in the 2010 fiscal year.

Debt and aid management

28. **Improved public debt management remains a priority for the Government.** A medium-term debt strategy has been developed for Zambia with assistance from the IMF and World Bank. Progress is also being made to restructure debt management operations of government, with a view to improve risk management, ensure that financial obligations are honored, and minimize the cost of financing the budget.

29. **There is a growing demand for resources to finance large infrastructure projects of high economic return in Zambia.** Given the constraints of limited concessional financing, and in order to attract private sector investment, there is likely to be need for government equity participation in infrastructure projects. In addition to energy projects already outlined, the government will also undertake the development of a number of roads in 2010. These projects have been identified through the Road Sector Investment Program (ROADSIP I and draft ROADSIP II), which was developed after wide consultation with stakeholders, and will play a strategic role in the development of the Zambian economy. The government is likely to contract some non-concessional financing, consistent with the nonconcessional debt ceiling under the program, to facilitate the development of the most important of these projects in 2010.

30. **Aid management will remain a medium-term priority for the government.** The government and cooperating partners successfully concluded discussions on the underlying values of the Poverty Reduction Budget Support (PRBS) process, which was initiated in 2009 after concerns were raised over governance issues. Work has now commenced towards the development of a new Joint Assistance Strategy for Zambia, and a new memorandum of understanding for PRBS. Progress also continues towards improved aid data management between the government and cooperating partners. These measures will improve dialogue

and effectiveness of aid delivery in Zambia. The government remains committed to improving governance, and stands ready to deal swiftly with any mismanagement of public financial resources.

31. **Recent use of incorrect reference interest rates in assessing the concessionality of external debt highlights the need to strengthen debt management capacity.** As a result, the government intends to strengthen the process of assessing, recording, and providing timely external debt data, and related operational procedures and the document tracking system. The government will share information with IMF staff prior to contracting any potentially nonconcessional loans.

IV. PROGRAM MONITORING

32. **The government is committed to enhancing further the consultation process and information sharing with the IMF.** As an important step, a high level monitoring committee has been established comprising among others, the Secretary to the Treasury and the BoZ Deputy Governor for operations, and the IMF resident representative. This committee will meet often and with regularity.

33. **Semi-annual disbursements under the ECF arrangement will be based on the observance of quantitative performance criteria.** Completion of the sixth review under the arrangement will be based on the observance of quantitative performance criteria through end-December 2010 (Tables 1 and 2). The sixth review is expected to be completed by end-May 2011.

MEFP Table 1. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets, 2009¹
(Billions of kwacha, unless otherwise indicated)

| | 2008 | | 2009 | | | | | | | | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|---------|---------|---------|---------|------------|---------|---------|----------|-------|---------|
| | Dec | Dec | June | | | September | | | December | | |
| | Prog. | Level | Prog. | Act. | Status | Indicative | Prel. | Status | Prog. | Prel. | Status |
| Performance criteria: | | | | | | | | | | | |
| Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia ^{2,3} | -776 | -1,449 | 397 | 1134 | Met | 642 | 1176 | Met | 1670 | 1226 | Met |
| Adjusted ceiling | 83 | | 578 | | | | | | 1585 | | |
| Ceiling on the cumulative increase in net domestic financing (NDF) ² | -64 | 5,291 | 447 | 35 | Met | 844 | 750 | Met | 1,443 | 1387 | Met |
| Adjusted ceiling | 795 | | 628 | | | | | | 1,560 | | |
| Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars) ^{2,4} | 382 | 976 | 44 | 16 | Met | 29 | 684 | Met | 714 | 782 | Met |
| Adjusted floor | 158 | | 14 | | | | | | 737 | | |
| Ceiling on new external payment arrears ⁵ | 0 | 0 | 0 | 0 | Met | 0 | 0 | Met | 0 | 0 | Met |
| Ceiling on short-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars) ^{5,6} | | 0 | 0 | 0 | Met | 0 | 0 | Met | 0 | 0 | Met |
| Ceiling on medium- and long-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars) ⁶ | | | | | | | | | | | |
| Electricity projects | 450 | 0 | 400 | 0 | Met | 400 | 0 | Met | 400 | 316 | Met |
| Other sectors | 0 | 0 | 0 | 37 | Not Met | 0 | 37 | Not Met | 0 | 82 | Not Met |
| Indicative targets: | | | | | | | | | | | |
| Floor on the cumulative payment of domestic arrears | 669 | | 161 | 199 | Met | 264 | 205 | Not Met | 352 | 278 | Not Met |
| Ceiling on cumulative increase in reserve money | 289 | 3,211 | -60 | 26 | Not Met | 112 | 55 | Met | 610 | 438 | Met |
| Memorandum items: | | | | | | | | | | | |
| Cumulative net budget support (millions of U.S. dollars) | 141.2 | 142 | 110 | 72 | | 126 | 73 | | 160 | 178 | |
| General budget support | 200.0 | 203 | 110 | 91 | | 201 | 113 | | 212 | 231 | |
| Central Government debt service obligations (excl. IMF) | -58.8 | -61 | 0 | -19 | | -75 | -39 | | -52 | -54 | |
| Domestically financed capital expenditure | | 1271 | -- | -- | | -- | -- | | 1810 | 1842 | |
| Program exchange rate (Kwacha per U.S. dollar) | | 4,832.3 | 4,832.3 | 5,074.9 | | 4,832.3 | 4,654.0 | | 4,832.3 | 4641 | |

Sources:

¹ The definitions of the items in the quantitative program are contained in the Technical Memorandum of Understanding (TMU)

² Adjustors, including for general budget support, are defined in the TMU.

³ The ceiling will be adjusted for changes in the legal reserve requirements as specified in the TMU.

⁴ Reserves are calculated at program exchange rates.

⁵ Continuous performance criteria.

⁶ Nonconcessional loans are those having a grant element of less than 35 percent.

MEFP Table 1. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets, 2010¹

(Billions of kwacha, unless otherwise indicated)

| | 2009 | | 2010 | | | | | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------|----------------------------|----------|---------|------------|------------|--------|--------|
| | Prel. | Indicative CR No. 10/17 | March 31 | | | Jun 30 | Sep 30 | Dec 31 |
| | | | Act. | Status | Rev. Prog. | Indicative | Prog. | |
| (Cumulative from January 1st, 2010) | | | | | | | | |
| Performance criteria: | | | | | | | | |
| Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia ^{2,3} | 58 | 405 | 80 | Met | 390 | 33 | 183 | |
| Adjusted ceiling | | 410 | | | | | | |
| Ceiling on the cumulative increase in net domestic financing (NDF) ⁴ | 6,677 | 321 | 447 | Not Met | 825 | 1,386 | 1,487 | |
| Adjusted ceiling | | 151 | | | | | | |
| Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars) ^{2,4} | 1,758 | -2 | -22 | Not Met | 40 | 126 | 150 | |
| Adjusted floor | | -7 | | | | | | |
| Ceiling on new external payment arrears ⁵ | 0 | 0 | ... | | 0 | 0 | 0 | |
| Ceiling on short-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars) ^{5,6} | ... | 0 | ... | | 0 | 0 | 0 | |
| Ceiling on medium- and long-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars) ^{5,6} | | | | | | | | |
| Electricity ⁷ and road projects ⁸ | | 600 | 50 | | 600 | 600 | 600 | |
| Other sectors | | 0 | ... | | 0 | 0 | 0 | |
| Indicative targets (cumulative): | | | | | | | | |
| Floor on payment of domestic arrears of the government | 278 | 59 | ... | | 153 | 157 | 269 | |
| Increase in reserve money (end of period) | 4,054 | 239 | -61 | Met | 223 | 264 | 394 | |
| Floor on social spending by the government of Zambia | ... | 930 | ... | | 1,875 | 2,838 | 3,938 | |
| <i>Memorandum items:</i> | | | | | | | | |
| Cumulative budget support net of Central Government debt service (U.S. dollars) | | 61 | 98 | | 204 | 235 | 223 | |
| General budget support (Fiscal accounts) ⁹ | | 78 | 108 | | 235 | 288 | 288 | |
| Cumulative BoP support net of Central Government debt service (U.S. dollars) | | 61 | 56 | | 162 | 193 | 182 | |
| General BoP support | | 78 | 66 | | 193 | 246 | 246 | |
| Central Government debt service obligations (excl. IMF) | ... | -17 | -11 | | -31 | -52 | -64 | |
| Program exchange rate (Kwacha per U.S. dollar) | 4,832 | 4,622 | 4,690 | | 4,641 | 4,641 | 4,641 | |

Sources:

¹ The definitions of the items in the quantitative program are contained in the Technical Memorandum of Understanding (TMU)

² Adjustors, including for general budget support, are defined in the TMU.

³ The ceiling will be adjusted for changes in the legal reserve requirements as specified in the TMU.

⁴ Reserves are calculated at program exchange rates.

⁵ Continuous performance criteria.

⁶ Nonconcessional loans are those having a grant element of less than 35 percent.

⁷ The electricity projects are: Kariba North bank extension, Itezhi-Tehzi power station, Kafue Gorge Lower;

⁸ The road projects are: Mutanda-Chawuma Road, Choma-Chitongo-Namwala Road, Kasama-Luwingu Road.

⁹ Includes US\$ 41.8 mn of budget support from the EU (V-flex) received from the Bank of Zambia on December 31, 2009 (BOP recording) and disbursed to GRZ government in January 2010.

Table 3 MEFP. Zambia: Structural Benchmarks for 2009

| Measure | Timing | Macro Rationale | Status |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------|
| Prepare a comprehensive strategy for phased implementation of the establishment of the treasury single account system. | End-June 2009 | Strengthen public expenditure management and budget execution, including improving cash flow management and forecasts. | Met |
| Set up a supervisory regime for the secondary market in government securities. | End-June 2009 | Financial sector deepening which is vital to achieving the growth objectives of the program. | Reset to end-March 2010; Met on March 26, 2010. |
| Raise the average electricity tariff in 2009 and publicly announce indicative tariffs for 2010-11 consistent with the policy to reach cost-reflective levels by 2011. | End-June 2009 | To ensure an efficient and sustainable power supply. Solving the current problems in the energy sector is essential to achieving the growth objectives of the program. | Met |
| Approval by Cabinet of all necessary amendments to the Public Finance Management Act specifying the general principles of the treasury single account system. | End-September 2009 | Strengthen public expenditure management and budget execution, including improving cash flow management and forecasts. | Met |
| Bank of Zambia will introduce a new standing overnight lending facility. | End-September 2009 | Strengthen liquidity management, reduce volatility in the money market, and enhance the effectiveness of monetary policy. | Met with delay (December 1, 2009) |

Source: Zambian authorities and IMF staff estimates.

Table 4 MEFP Zambia: Structural Benchmarks for 2010

| Measure | Timing | Macro Rationale | Status |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|--------------------------------------------------------------------------------------------------------------------------------------|----------------------------|
| Approval by Cabinet of the pay policy reform | End-June 2010 | Strengthen payroll management, and increase productivity of the public sector. | Met |
| Establish a Lender-of-Last Resort Framework and draft legislation and procedures for a financial sector contingency plan in the event of a crisis. | End-June 2010 | Strengthen the Central Bank's crisis preparedness. | |
| Submit to parliament the Planning and Budgeting Act. | End-June 2010 | Strengthen public expenditure management and budget execution, including improving cash flow management and forecasts. | Reset to end-December 2010 |
| Raise the average electricity tariff in 2010 and publicly announce indicative tariffs for 2011 consistent with the policy to reach cost-reflective levels by 2011. | End-June 2010 | To ensure an efficient and sustainable power supply. Solving the current problems in the energy sector is essential to achieving the | |
| Prepare a review of tax administration and policy | End-September 2010 | Strengthen revenue performance | |
| Adoption of Treasury Single Account by six ministries, provinces, and spending agencies. | End-December 2010 | Strengthen public expenditure management and budget execution, including improving cash flow management and forecasts. | |

Source: Zambian authorities and IMF staff estimates.

**ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING FOR THE 2010–11
EXTENDED CREDIT FACILITY (ECF) 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 performance criteria and indicative targets for the program supported by the ECF arrangement, as well as the program adjusters and the related reporting requirements.

**II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS: DEFINITIONS
AND DATA SOURCES**

A. Net Domestic Assets (NDA) of the Bank of Zambia (BoZ)

2. Net domestic assets (NDA) of the BoZ are defined as the monthly average (based on daily data) of reserve money (as defined below) less the monthly average of net foreign assets of the BoZ calculated at kwacha 4,640.6 per U.S. dollar for 2010.¹ Net foreign assets of the BoZ are defined as gross international reserves (defined in paragraph 9) plus any other foreign assets, minus foreign liabilities (defined in paragraph 3).² The kwacha values of net foreign assets are derived from the U.S. dollar values using the program exchange rate.

3. Foreign liabilities are defined as short term (one year or less in original maturity) liabilities of the BoZ to nonresidents, plus any outstanding use of IMF credit, plus the stock of SDRs allocations to Zambia, and plus any other medium and long term foreign liabilities of BoZ.

4. Daily data on NDA, including all its components and calculation, will be reported by the BoZ weekly in electronic format and shall be consistent with the Standard Reporting Format (SRF) for monetary accounts.

B. Reserve Money

5. Reserve money (monthly average based on daily data) is defined as currency in circulation, plus required reserves on kwacha deposits, plus required reserves on foreign currency deposits (at the program exchange rate), plus any positive current account balance

¹ Unless otherwise defined, program exchange rates for 2010 between the U.S. dollar and other (non-kwacha) currencies will be equal to their end-December 2009 values. For the 2010 program, the U.S. dollar/SDR rate is 1.567; the U.S. dollar/GBP rate is 1.624, the U.S. dollar/euro rate is 1.459, and the U.S. dollar/South Africa Rand is 0.133. All other assets (e.g. gold) would be revalued at their end-December 2009 market prices for 2010.

² Other foreign assets include encumbered reserves and any other foreign assets of BoZ.

of Other depository corporations (ODC) with the BoZ, and plus deposits in the BoZ of sectors other than central government.

6. Daily data on reserve money, including its components, will be reported by the BoZ weekly in electronic format and shall be consistent with the SRF for monetary accounts.

C. Net Domestic Financing (NDF)

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

(a) the net position of the central Government with commercial banks, including:

(i) Treasury bills; (ii) government bonds; (iii) loans and advances; less (iv) support to Meridien Bank of Zambia (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) kwacha bridge loan (overdraft facility); less (iv) the government's deposits at the BoZ; and (v) the donor suspense account; plus (vi) the outstanding amount of the long-term non-transferable security (10-Year Mega Bond) issued against the government's indebtedness to BoZ as at end-2002; plus

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

8. The data source for NDF will be the "Net Domestic Financing" Table produced by the Economics Department of the BoZ. The Table will be submitted on a weekly basis in electronic format, and end-month outturns will be fully reconciled with the monthly monetary survey.

D. Gross International Reserves of the BOZ

9. 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.

³ The Budgetary Central Government includes all the units identified by the budget heads listed in the Yellow Book for 2010 and listed in Table 1.

10. Gross international reserves consist of: (i) monetary gold; (ii) foreign currency; (iii) unencumbered foreign-currency deposits at non-resident banks; (iv) foreign securities and deposits; and (v) SDR holdings and Zambia's reserve position with the IMF. Gross reserves exclude non-convertible currencies, any encumbered reserve assets including but not limited to reserve assets pledged, swapped or used as collateral or guarantee for third-party external liabilities, other depository corporation reserve requirements on foreign currency deposits, and the US\$25 million deposit in MBZ (in liquidation).

11. For the purpose of this target valuation will be in U.S. dollars at program exchange rates.

12. Daily data on gross international reserves, including its components, will be reported by the BoZ weekly.

E. External Payment Arrears

13. The performance criterion on the non-accumulation of new external payment arrears is continuous. Official external payment arrears are defined as unpaid debt service by the central Government and BoZ 30 days beyond the due date and/or the grace period. This definition excludes arrears on debt subject to rescheduling.

14. Data on arrears, at program exchange rates, 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.

F. Official External Debt

15. 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, BoZ, ZESCO, ZAMTEL, and Zambia Railways Limited with nonresidents having a grant element of no less than 35 percent, since the beginning of the calendar year. The grant element is the difference between the present value (PV) of debt and its nominal value, and is expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt.⁴ The discount rates used for this purpose are the currency-specific commercial interest reference rates (CIRRs) published by the Organization for Economic Cooperation and Development (OECD).⁵ For debt with a maturity of at least

⁴ The calculation of concessionality will take into account all aspects of the loan agreement, including maturity, grace period, payment schedule, upfront commissions, and management fees.

⁵ Available at <http://www.oecd.org/dataoecd/21/52/39085945.xls>. Where the CIRR is not available, the SDR rate shall be used.

15 years, the ten-year-average CIRR will be used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more). Lending from the IMF will be excluded.

16. This minimum grant element applies not only to debt as defined in Point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements (Decision No. 6230-(79/140), as subsequently amended, including by Executive Board Decision No. 14416-(09/91), effective December 1, 2009, but also to commitments contracted or guaranteed for which value has not been received.

17. Official external non-concessional debt is defined as the contracting or guaranteeing of debt with nonresidents other than concessional debt as defined in paragraph 15, owed or guaranteed by the central Government, BoZ, ZESCO, ZAMTEL, and Zambia Railways Limited.

18. The ceiling on contracting or guaranteeing of medium and long-term non-concessional external debt by the central government, BoZ, ZESCO, ZAMTEL, and Zambia Railways Limited excludes: (i) non-concessional loans stemming from the rescheduling of external debt; and (ii) central government securities issued in domestic currency, placed in the domestic primary or secondary markets, and held by non-residents.

19. Official external short-term debt is defined as the contracting or guaranteeing of debt with nonresidents with original maturity of one year or less, and includes forward commodity sales but will exclude normal trade credit for imports, incurred since the beginning of the calendar year. The term “debt” has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt (Decision No. 6230-(79/140), as subsequently amended, including by Executive Board Decision No. 14416-(09/91), effective December 1, 2009.

20. Detailed data on all new external debt (concessional and non-concessional) contracted or guaranteed by the central government, BoZ, ZESCO, ZAMTEL, and Zambia Railways Limited will be provided by the MoFNP on a monthly basis. Information will include (i) amounts contracted or guaranteed; (ii) currencies; and (iii) terms and conditions, including interest rate, maturity, grace period, payments per year, commissions and fees, and collaterals.

G. Domestic Arrears of Central Government

21. 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 other payment to government employees, including pension contributions and 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.

22. Information regarding domestic arrears will 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. Floor on Social Spending

23. Social spending is defined as central government domestically financed expenditure on health and education as listed in the 2010 Yellow Book under the functional classification. The corresponding indicative target sets the minimum spending on these sectors combined.

III. ADJUSTERS

24. The quantitative performance criteria specified under the program are subject to the following adjusters:

General budget support (GBS) net of debt service⁶

(i) The ceilings on NDA and NDF will be adjusted downward (upward) by the full amount of the excess (shortfall) in GBS net of debt service relative to the programmed levels specified in Table 1 of the MEFP.^{7,8}

(a) The total adjustment for shortfalls will be limited to US\$40 million for January-June 2010 and US\$60 million for January-December 2010.

(ii) The floors on GIR will be adjusted upward (downward) by the full amount of the excess (shortfall) in GBS net of debt service relative to the programmed levels (Table 1 of the MEFP).

Change in reserve requirements

⁶ General budget support consists of grants and loans received by the central government for financing its overall policy and budget priorities following Zambian budget procedures.

⁷ For the purpose of adjusting the NDA ceiling, external disbursements will be treated as if they were received the first day of the month. The targeted NDA will be increased by the amount of the disbursement divided by the number of business days in the month multiplied by the number of business days from the beginning of the month to the day prior to the disbursement.

⁸ For purpose of adjusting the NDF ceiling, the cumulative excess/shortfall will be converted to kwacha value using the program exchange rate.

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

IMF disbursement

(v) The floors on GIR will be adjusted upward (downward) for any excess (shortfall) in the disbursements from the IMF (US dollar value at the program exchange rate) relative to the programmed levels.

BoZ short-term debt

(vi) The floor on GIR will be adjusted upward for any increase in the US dollar value at the program exchange rate of BoZ short-term debt, (see definition of short-term debt above).

IV REPORTING REQUIREMENT

25. To facilitate monitoring of the program, the information listed in Table 2 below will be reported to the IMF within the timeframe indicated. These data, and any other information needed for monitoring of adherence to program targets, will be provided electronically by email to AFRZMB@IMF.ORG.

Table 1. Administrative units comprising the Budgetary Central Government

| | |
|---------------------------------------------------------|-----------------------------------------------------------------|
| Office of the President | Ministry of Finance and National Planning |
| Office of the Vice President | Ministry of Labour and Social Security |
| National Assembly | Ministry of Community Development and Social Services |
| Gender in Development Division | Ministry of Health |
| Electoral Commission | Ministry of Communications and Transport |
| Public Service Commission - Office of the President | Ministry of Works and Supply |
| Office of the Auditor General | Ministry of Science, Technology and Vocational Training |
| Cabinet Office - Office of the President | Ministry of Tourism, Environment and Natural Resources |
| Teaching Service Commission - Office of the President | Ministry of Sport, Youth and Child Development |
| Police and Prisons Service Commission | Ministry of Defence |
| Zambia Police - Ministry of Home Affairs | Zambia Security Intelligence Services - Office of the President |
| Commission for Investigations - Office of the President | Ministry of Education |
| Ministry of Energy and Water Development | Ministry of Lands |
| Ministry of Mines and Mineral Development | Anti-Corruption Commission |
| Ministry of Home Affairs | Ministry of Livestock, and Fisheries Development |
| Ministry of Foreign Affairs | Ministry of Agriculture and Cooperatives |
| Judiciary | Office of the President - Lusaka Province |
| Loans and Investments - Local Government and Housing | Office of the President - Copperbelt Province |
| Loans and Investments | Office of the President - Central Province |
| Ministry of Information and Broadcasting Services | Office of the President - Northern Province |
| Public Service Management Division | Office of the President - Western Province |
| Ministry of Local Government and Housing | Office of the President - Eastern Province |
| Ministry of Justice | Office of the President - Luapula Province |
| Ministry of Commerce, Trade and Industry | Office of the President - North-Western Province |
| Human Rights Commission | Office of the President - Southern Province |

Table 2: Reporting Requirements

| Data description | Data Freq. | Reporting | | Date | Mode |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|-----------|-------|---------------------|------|
| | | Agency | Freq. | | |
| Monetary and financial sector | | | | | |
| Reserve money and its components (NDA and NFA) at current and program exchange rate | D | BoZ | W | T5 | E |
| Excess reserves | D | BoZ | M | T5 | E |
| Overnight interbank rates | D | BoZ | W | T5 | E |
| Treasury bill and BoZ bill auction results | W | BoZ | W | T5 | E |
| Interest rates | M | BoZ | M | T15 | E |
| Holdings of government and BoZ securities by maturity and type of investors (local commercial banks, nonbanks, and foreigners) | M | BoZ | M | T15 | E |
| Monetary survey (and the BoZ, and Other Depository Corporations surveys) | M | BoZ | M | T15 | E |
| Commercial bank lending. Credit to the economy by sector and type of institution | M | BoZ | M | T15 | E |
| Financial soundness indicators by banks | M | BoZ | M | T15 | E |
| External sector | | | | | |
| Exchange rates | D | BoZ | W | T5 | E |
| Gross international reserves, and foreign exchange purchases and sales | D | BoZ | W | T5 | E |
| Copper prices | D | BoZ/CSO | W | T5 | E |
| BoZ foreign exchange cash flow | M | BoZ | M | T10 | E |
| Import and export data | M | CSO | M | T15 | E |
| Balance of payments | Q | BoZ | Q | T30 | E |
| Copper production and exports (quantities, prices and US dollar value) | M | MoF | M | T15 | E |
| Foreign direct investment (actuals and pledges) | M | MoF/ZDA | M | T15 | E |
| Fiscal | | | | | |
| Net Domestic Financing | D | BoZ | W | T5 | E |
| Fiscal table including revenue, expenditure, and financing. | M | MOF | M | T30 | E |
| Real sector | | | | | |
| Consumer price index and monthly statistical bulletin | M | CSO | M | T15 | E |
| National accounts | A | CSO | BA | Mar. 15; Sep. 15 | E |
| Program monitoring | | | | | |
| Report on IMF program performance | Q | MOF | Q | T15 | E |
| Stock of domestic and external payment arrears | Q | AuG | Q | T15 | E |
| Central government domestic borrowing | Q | BoZ | M | T15 | E |
| New external loans contracted or guaranteed by the central government BoZ, ZESCO, ZAMTEL, and Zambia Railways Limited or any other agency on their behalf ¹ | Q | MOF | Q | T30 | E |

D-Daily, W-Weekly, M-Monthly, Q-Quarterly, BA-Bi-annual A-Annual; Tx: x days after the date of the last observation; E-email, H-Hard copy

¹ Detailed information on the amounts, currencies, terms, conditions, and purpose (to finance electricity and road projects listed on the quantitative performance criteria table, or other purposes).