International Monetary Fund

Zambia and the IMF

Press Release:
IMF Executive Board Completes Fifth and Sixth Reviews Under Zambia's PRGF Arrangement and Approves US$33.4 Million Disbursement
June 8, 2007

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

May 22, 2007

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.

May 22, 2007

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

Dear Mr. de Rato,

The Government of the Republic of Zambia has been implementing a financial and economic program with support from the International Monetary Fund under the Poverty Reduction and Growth Facility (PRGF) since June 2004. The fourth review of the program was completed on July 12, 2006. The attached Memorandum of Economic and Financial Policies (MEFP) and Technical Memorandum of Understanding (TMU) reviews progress in implementing the program since the fourth review and sets out the policies that the Government will pursue in 2007 and beyond.

The Government's development strategy and policies will continue to focus on achieving high rates of sustainable economic growth, founded on a stable macroeconomic environment, and reducing poverty through wealth and job creation. In this regard, the Government will continue to implement prudent fiscal and monetary policies and structural reforms to support private sector development, strengthen further expenditure management, financial accountability, debt management, and improve governance and transparency. The resources made available by the Multilateral Debt Relief Initiative (MDRI) will be used to increase spending on priority areas in agriculture, infrastructure, water and sanitation, health, and education, in line with Zambia's Fifth National Development Plan 2006–10.

The Government requests the completion of the fifth and sixth reviews and the eight and ninth disbursements of the PRGF arrangement (each in the amount of SDR 11.0045 million). On the basis of the corrective actions it has taken, the Government requests waivers for the non-observance of the June and December 2006 performance criteria on net domestic financing (NDF) and the June 2006 performance criterion on gross international reserves. The higher NDF is explained by a larger-than-programmed reduction in the carryover of unspent budget resources.

Cognizant of the undermining effects of the large carry-over of unspent balances from one fiscal year to the next on budget execution and monitoring, Government took firm steps to address the problem. In November 2006, the Government introduced a number of measures to enhance Treasury and cash management. While these measures effectively eliminated the carryover of unspent balances at the end of 2006, the reduction in spending budgeted in 2006 that would have been required to meet the NDF ceiling was not possible within the last couple of months of the year.

Looking ahead, the strengthened Treasury and cash management measures will ensure a small carryover of unspent budget resources to the next fiscal year, which, in turn, will markedly improve our control of NDF. Furthermore, the liquidity effects of the NDF overrun in 2006 were mopped up by the Bank of Zambia in the first few months of the year. The small shortfall in the accumulation of official international reserves as of end-June was more than made up in subsequent months and gross international reserves substantially exceeded the program floor at end-December 2006.

The Government also requests waivers for the non-observance of the end-September 2006 and end-March 2007 structural performance criteria on implementation and reporting of the IFMIS pilots. Progress, albeit somewhat delayed, has been made on the IFMIS project. The contract for the installation of the IFMIS was signed in November 2006 and implementation of the pilot program began in January. To ensure a successful piloting and realize sooner the benefits of the project, the number of pilot sites has been increased from three to eight and the required functional training will be advanced. The preliminary review of the piloting of the IFMIS will be undertaken at the end of the pilot implementation phase, which will last about 18 months.

The Government of Zambia believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, and will take any further measures that may become appropriate for this purpose. The Government 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 the Fund's policies on such consultation.

The Government of Zambia authorizes the IMF to make the staff report for the fifth and sixth review under the PRGF arrangement and this letter and attached memoranda available to the public, 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/

Ng'andu P. Magande, MP
MINISTER OF FINANCE AND NATIONAL PLANNING

Memorandum of Economic and Financial Policies

1. The current economic and financial program of the Government of the Republic of Zambia has been supported by the IMF through a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. This memorandum reviews the performance of the program in 2006 and outlines the policies and targets that the Government will pursue in 2007 and the medium term.

I. Performance in 2006

2. **The Zambian economy continued to grow at a robust pace.** Sound macroeconomic policies and a favorable external environment have been major factors behind the improved performance in recent years. Annual real GDP growth is estimated to have increased to nearly 6 percent in 2006, led by solid expansions in mining and construction and a recovery in agricultural production. The annual average rate of inflation declined from 18.3 percent in 2005 to 9.1 percent in 2006—its lowest point in more than three decades—aided by stable food prices. The current account of the balance of payments recorded a marked improvement to an estimated overall surplus of 2.8 percent of GDP in 2006 from a deficit of about 6 percent of GDP in 2005. This was largely due to a steep rise in the value of copper exports as prices rose to record highs. Gross international reserves increased to 2.2 months of imports at end-2006 from 1.5 months a year earlier.

3. **Progress was made in implementing the PRGF-supported program in 2006.** As regards the quantitative elements of the program, all but two of the June and all but one of the December performance criteria and benchmarks were observed (Table 1). Specifically, the ceiling on net domestic financing (NDF) was exceeded by a large margin in June and December. The accumulation of gross international reserves fell short of the program floor by a small margin in June, but reserves significantly exceeded the program floor in December.

4. **Despite a strong effort to restrain spending, NDF persistently exceeded programmed ceilings by wide margins in 2006.** This was mainly due to the running down of large X-account deposits (which stood at K596 billion on January 1, 2006) for expenditures under the 2005 budget that were carried over to 2006. Cognizant that excessively large carryovers undermine budget execution and monitoring, the Government introduced a number of measures to enhance Treasury and cash management. These were described in circulars issued to all Controlling Officers. These circulars stipulated that releases for new capital projects would stop at end-October, except for capital projects where tender procedures had been completed. For ongoing capital projects, releases would only be made against certificates indicating that payments are due. In addition, efforts were made to front-load current expenditures in December. These and other administrative measures effectively reduced the carryover at the end of the 2006 budget year, but the reduction in spending required to meet the NDF target was not possible within the last few months of the

year. To further support the Government's efforts to strengthen budget execution and treasury management going forward, donors have agreed to disburse their budget support by the end of September. The carryover of unspent releases to the 2006 budget year amounted to 1.5 percent of GDP while the carryover to the 2007 budget year only amounted to 0.4 percent of GDP.[1] Notwithstanding the greater-than-programmed net domestic financing of Government, the fiscal deficit excluding grants declined by 1.1 percentage points to 7.1 percent of GDP in 2006**.** The lower deficit was largely related to a decline in donor-financed spending and interest payments.

5. **The programmed target for net domestic assets (NDA) of the Bank of Zambia (BoZ) was met in June and December 2006, but reserve money expanded at a much faster pace than projected, particularly late in the year.** The BoZ stepped up purchases of foreign exchange in the second half of 2006. As a result, the international reserve target at end-December 2006 was exceeded by about US$70 million, reversing the shortfall experienced at end-June. However, the liquidity generated by the build-up of international reserves and the spending of larger-than-projected resources from external budget support was only partially sterilized, resulting in a surge in reserve money to well above program projections. In part, this reflected the BoZ's limited scope to undertake sterilization operations. This deficiency began to be addressed in November with the agreement to convert a significant portion of BoZ's claims on the Government into marketable securities and to increase the tender sizes of government securities. In the first few months of 2007 the BoZ successfully mopped up the liquidity-overhang.

6. **On the structural program, all but two of the performance criteria through March 2007 were met (Table 2).** Difficulties with contract negotiations and in complying with procurement procedures resulted in slippages in the signing of the contract for the Integrated Financial Management and Information System (IFMIS). Consequently, the September 2006 and March 2007 performance criteria relating to the IFMIS were not observed. Implementation of the pilot program began in January 2007 and is expected to be completed over an 18-month period, at which time an evaluation of the system will be made. However, to maximize earlier realization of the benefits of the project, the number of pilot sites has been expanded from three to eight and functional training was advanced from Phase II to Phase I of the project. Most of the structural benchmarks were either met or met with some delay; however, little progress has been made on the resolution of the nonbank financial institutions because of a lack of budgetary resources. Agreement on the sale of 49 percent of the shares of Zambia National Commercial Bank was reached in December.

[1] The reported carryover of unspent budget releases includes checks that were issued through end-December but were not cleared by the Bank of Zambia until early January.

II. POLICY FOR 2007 AND THE MEDIUM TERM

7. **The Government's key economic objectives are to further raise growth and enhance the employment and income opportunities for the poor.** The recently launched Fifth National Development Plan 2006–2010 (FNDP)—which serves as Zambia's Poverty Reduction Strategy Paper—sets out the policy framework for meeting these objectives. The FNDP emphasizes the need to create an environment that encourages private sector growth through macroeconomic stability, public sector accountability, and investments in infrastructure and human resources.

8. **The medium-term outlook for the Zambian economy is favorable.** Real GDP is projected to grow by 6-7 percent a year through 2010. Major investments in the mining, manufacturing, and electricity sectors are ongoing, while small and medium-sized enterprises are expected to gradually increase their contribution to growth and employment. Strong demand for housing is expected to bolster the construction sector. Furthermore, government policies to support agriculture and tourism, including infrastructure investments, should increase growth in these sectors. With sustained prudent fiscal and monetary policies, inflation is expected to be in the low single digits. The economy nevertheless remains vulnerable to shocks in the terms of trade and variations in rainfall patterns.

9. **Fiscal space needs to be created in the medium term to increase poverty reducing spending, develop infrastructure, and support other FNDP programs.** The Government intends to improve revenue collection and restrain non-priority spending. Revenues are expected to rebound to around 18 percent of GDP, reflecting higher collections from the mining sector and improved tax administration. Planned reforms to broaden the tax base will further increase revenues. Capital spending is projected to recover to about 7 percent of GDP in 2009. Net domestic financing of Government is projected to decline gradually over the medium term to 1 percent of GDP in 2009. This will help to lower interest rates and crowd-in private sector investment. The fiscal deficit excluding grants is projected to decline moderately to 6.3 percent of GDP in 2009. However, greater in-flows of external assistance than are currently projected are required to fully finance the FNDP.

A. Fiscal policies

10. **In 2007, net domestic financing of Government will be reduced to 1.6 percent of GDP from 2.4 percent of GDP in 2006, in part reflecting a pick-up in external financing.** Revenues are projected to increase by about 1 percentage point to 17.7 percent of GDP, owing to higher company income tax (mainly from the mining sector) and higher trade taxes supported by a lower and more stable exchange rate. Revenue is expected to be boosted also by the additional resources being provided to the Zambia Revenue Authority (ZRA) to recruit additional staff and enhance enforcement activities. Expenditures are assumed to rise to 25.2 percent of GDP, almost entirely on account of a rebound in capital spending to 6 percent of GDP. This increase, which is partly financed by additional donor inflows, covers

implementation of FNDP projects, particularly in agriculture, education, infrastructure and health. The Government will ensure that proper monitoring and reporting procedures are in place and will submit periodic progress reports to Cabinet on the implementation of the FNDP projects. Further, spending on Poverty Reduction Programs (PRPs) will increase to about 12 percent of GDP in 2007.

11. **The ZRA has embarked on a modernization program to strengthen the effectiveness of tax administration.** The process of adopting an integrated and taxpayer-segmented organizational structure has already begun. A roadmap of reforms has been prepared and key appointments have been made, including a Commissioner for the new Domestic Tax Division (DTD) and a modernization project manager. Measures that will be implemented in the remainder of 2007 include establishing a Large Taxpayer Office, transferring domestic excise administration from customs to DTD, and expediting the roll-out and enhancement of the Integrated Tax Administration System (ITAS) software.

12. **The Government intends to provide incentives, including tax holidays, to priority sectors and for Multi-Facility Economic Zones (MFEZs).** These incentives, which are applied through the recently adopted Zambia Development Agency (ZDA) Act, are expected to have limited effects on revenue collection in 2007, as they apply only to new investments. To avoid significant long-term revenue losses, the Government will strictly circumscribe granting tax holidays and address the administrative challenge of ensuring correct reporting of profits by companies that have operations both inside and outside of the MFEZs. The Ministry of Finance and National Planning will develop a methodology to calculate tax expenditures, with a view to publishing in the future the revenue foregone from granting tax holidays and other exemptions.

13. **The Government will soon start discussions with the mining companies on re-negotiating existing development agreements with the aim of increasing revenues.** These discussions will be based on announced changes in the tax regime for the mining sector, including an increase in the income tax rate from 25 percent to 30 percent and the royalty rate from 0.6 percent to 3 percent of gross value, and withholding tax from 0 percent to 15 percent. Future development agreements will be based on the revised fiscal terms for the sector. The Government will also amend Section 9 of the Mines and Minerals Act to ensure that there shall be no fiscal terms in future development agreements.

14. **Enhancing transparency in the mining sector is important to ensure that available public resources from the sector are realized and used effectively.** To this end, the Government intends to adhere to the standards of the Extractive Industries Transparency Initiative. A working group will be established no later than end-June 2007 to move the process forward.

B. Public Expenditure Management

15. Stepped up implementation of the public expenditure management and financial accountability (PEMFA) program is critical for increasing the effectiveness and productivity of the public sector. To this end, the existing Financial Management System (FMS) will be enhanced given that the IFMIS is not expected to be fully operational in all Ministries, Provinces, and Spending Agencies (MPSAs) for another three years (the first eight pilot sites are expected to be fully functional by April 2008). As an immediate priority, the FMS will be made compatible with the 2007 budget, which is based on the 2001 Government Finance Statistics (GFS) classification. Subsequent enhancements, which will be completed by end-June 2007, include upgrading the software to a network based FMS and integrating the activity-based budgeting, funding, and cash flow forecasts and expenditure modules. The Government will proceed on moving towards establishing a Treasury Single Account (TSA) system, that could be in place by end-2008, to strengthen budget execution and cash management. In preparing for the TSA, the Ministry of Finance and National Planning will gradually consolidate government accounts in commercial banks into a limited number of accounts at the BoZ and create a Treasury Department by end-June 2007.

16. **Budget execution reports will continue to be published quarterly.** Beginning with the first quarter of 2007, the set of reports will include an analysis of budget provision, releases, and expenditures by functional classification, using the streamlined format agreed with the PEMFA JTWG. The usefulness of current reports has been hampered by the failure of various MPSAs to submit accurate monthly expenditure returns in a timely manner. Measures to enforce compliance will be stepped up, including withholding funding to those MPSAs that fail to submit the relevant returns in line with Section 17 of the Public Finance Act. Another issue that will be addressed, in conjunction with cooperating partners, is the need for donor project funding to be channeled through the financial management system. At present, donor project funding is included in the budget provision to MPSAs but excluded from releases and reported expenditure by the MPSAs, which makes it difficult to reconcile data on releases and expenditures with that on provisions.

17. **The Commitment Control System (CCS) and cash flow management will be strengthened in order to prevent the continued buildup of domestic arrears.** Notwithstanding significant payments of arrears in 2006, the stock of arrears was only slightly lower at end-2006 compared to the year before. The new arrears incurred reflected difficulties in cash flow management and shortfalls in releases relative to the agreed quarterly profile. To improve the monitoring of the CCS, the Accountant General will prepare, within 60 days of the end of each quarter, reports for the Secretary to the Treasury on compliance with the CCS by MPSAs. Particular attention will be given to preventing the accumulation of arrears on capital projects, especially roads, which currently accounts for two-thirds of the total stock of arrears. Efforts to ensure that MPSAs stay current on utilities will also be boosted, so as to put an end to the practice of MPSAs incurring arrears with ZESCO and

ZAMTEL and these parastatals in turn incurring tax arrears. In this regard, Government has allocated K36.3 billion to MPSAs for the payment of outstanding bills on utilities.

C. Monetary and Exchange Rate Policies

18. **The BoZ will continue with a firm monetary policy stance aimed at reducing the annual rate of inflation to 5 percent in the medium term.** While food prices and uncertainties about the pass-through effects of higher oil prices and the past depreciation of the Kwacha pose risks to the inflation outlook, tight monetary policy will contribute to keeping inflation on a downward trend. With the stepped up efforts in the first quarter of 2007 to mop up excess liquidity, end-period reserve money is targeted to grow by about 5 percent in 2007. This implies a pickup in reserve money growth for the last three quarters of the year to meet an expected increase in the demand for liquidity associated with the maize harvest and the accelerated implementation of capital projects. It will also accommodate a robust expansion in credit to the private sector of about 18 percent and a buildup of international reserves to 2.4 months of imports by end-2007.

19. **The Government remains committed to a flexible exchange rate regime.** The BoZ will confine interventions in the foreign exchange market to smoothening fluctuations in the exchange rate while allowing a gradual build-up of international reserves. In this regard, the BoZ will seek to continue to improve the operation of the foreign exchange market and encourage the development of hedging instruments. Steps being considered by the BoZ to further enhance stability in the market and primary dealerships and introducing the technological platform for real-time operation of the market.

D. Financial Sector Development

20. **While the banking sector remains generally healthy, banking supervision will continue to be vigilant.** Overall performance indicates that the system remains fundamentally sound. However, performance ratios relating to capital and earnings suffered in 2006 from increased non-performing assets, especially in agriculture as a result of the drought in 2004/2005 and the appreciation of the kwacha in late 2005 and early 2006. Performance so far in 2007 indicates a general improvement compared to end-December 2006. The BoZ is working to finalize risk management guidelines for banks and NBFIs, which would move supervision to a more pro-active framework. These guidelines are expected to come into effect in 2007.

21. **Progress has been made in the implementation of the Financial Sector Development Plan, which enters the second phase in 2007.** The agenda for 2007 includes completing a number of ongoing legislative and other reforms and embarking on some of the core reforms under the second phase of the program. Among these are the enactment of the Payments Systems Bill; the preparation of a law for credit reference bureau services—a follow up to the guidelines under which a credit reference service provider was licensed in

2006; and the finalization of a draft deposit protection law. The second FinScope survey on the supply-side of financial services will also be undertaken. The first, completed in 2006, was on the demand for financial services. These studies are expected to provide valuable input for the expansion of financial services to areas that currently are not being adequately met. As regards the resolution of Government-owned non-bank financial institutions, incorporation of the National Savings and Credit Bank and the Development Bank of Zambia under the Companies Act has been postponed until these institutions are on sounder footing. On the Zambia National Building Society, the BoZ is reviewing a revised strategic plan and will present a report to the Government before end-April 2007.

E. External Sector Outlook and Debt Management

22. **Medium-term prospects in the external sector will be affected by the projected decline in the price of copper.** Although a strong increase in copper export volumes arising from major investments in the sector will dampen the impact of falling copper prices, the deterioration in the terms of trade will result in higher current account deficits. By the end of 2009, official international reserves are envisaged to reach about 3 months of imports. This will help buffer against external shocks.

23. **Central Government foreign financing is expected to increase over the medium term.** Budget support is expected to increase by about US$50 million to US$178 million in 2007, while sector wide approach (SWAP) grants and project support (grants and loans) are projected to increase by about US$70 million to about US$492 million. Baseline projections are based on the assumption that total donor support to Zambia will reach US$652 million and US$702 million in 2008 and 2009, respectively.

24. **The Ministry of Finance and National Planning has prepared an Aid Policy and Strategy aimed at strengthening the efficiency of aid.** The paper has been circulated to the line ministries and will be submitted to Cabinet by end-June, so that implementation can begin later in the year. In line with this strategy, a foreign aid reporting and monitoring system will also be developed. As a first step, MoFNP will create an integrated database on external aid to ensure the reliability and comprehensiveness of the aid financing included in the budget.

25. **The Government will continue to pursue an open trade regime.** In line with the implementation of the SADC Trade Protocol, tariffs were further reduced in January 2007. The tariff phase down is scheduled to be completed by January 2008, when Zambia's imports from the region will be subject to zero tariff.

26. **The Government is committed to improving public debt management.** Following the sizeable improvement in Zambia's public debt indicators from the debt relief received under the Enhanced HIPC Initiative and the MDRI, public debt management will be further strengthened to ensure that a relapse into unsustainable public debt does not occur.

Reforms will continue to focus on implementing the recommendations provided by the World Bank in the 2004 Assessment Report. The following measures will be adopted:

- a comprehensive debt management strategy will be submitted to the Minister of Finance and National Planning by end-June 2007 (performance criterion);
- the public debt database will be improved further—the reconciliation of public external debt at end-2005 and end-2006 with Zambia's creditors on a loan-by-loan basis will be completed by end-June 2007;
- the contracting of non-concessional debt will be avoided until the capacity to assess the implications for debt sustainability is developed; and
- an action plan to deal with the on-lending transactions will be developed.

27. **Efforts to obtain debt relief under the enhanced HIPC Initiative from remaining creditors have been stepped up.** Of the three official bilateral creditors that have not provided HIPC debt relief, two creditors (Brazil and Bulgaria) have recently been contacted and relief from Iraq will be sought shortly. The Government will also seek full relief from India and continue discussions with Russia to obtain full debt cancellation. In February 2007, China signed a Protocol partially cancelling Zambia's Government debt due by end-2005.

F. Other Structural Reforms

28. **The Government is determined to create a more conducive environment for doing business in Zambia for both domestic and foreign investors.** In this regard, the newly established ZDA, which merged five agencies, will focus on streamlining licensing and other administrative procedures to create a one-stop shop for supporting investors in Zambia. At the same time, quality improvements in telecommunications, energy, and transportation infrastructure will be critical for increasing productivity and enhancing competitiveness. Given the role of public enterprises in the provision of infrastructure and other services, the highest standards for corporate governance and transparency will be instituted, including the timely payment of tax obligations and debt service owed to the Government, especially in companies undergoing a commercialization process, notably ZESCO and ZAMTEL.

G. Economic Statistics

29. **The Government will take steps to expand Zambia's capacity to collect and disseminate economic data.** At present, there are shortcomings in the quality of some of the economic statistics. The Central Statistics Office will update and rebase the national accounts and associated price indices in 2007. In support of this work, the pilots for the economic census will be completed in June and the rebasing will be finalized by end-2007. Similarly,

the BoZ and MoFNP will allocate sufficient resources to produce and maintain quality balance of payments and government finance statistics.

III. Program Monitoring

30. The tenth disbursement (in the amount of SDR 5.5024 million) under the PRGF arrangement will be based on the observance of quantitative and structural performance criteria through end-June 2007 (Tables 1 and 2).

Table 1. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets Under the PRGF Program[1]
(Billions of kwacha, unless otherwise indicated)

	2006	2006						2007		
	Base	Jun			Dec			Base	Jun	Dec
		Prog	Act	Status	Prog.	Act	Status		Prog.	Indicative
Performance Criteria										
Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia[2, 4, 5]	2,911	-138	-274	Met	-241	-453	Met	-84	-357	-281
Adjusted ceiling		-161			-302					
Ceiling on the cumulative increase in net domestic financing (NDF)[2]	3,917	439	643	Not met	706	945	Not met	4,674	339	743
Adjusted ceiling		416			645					
Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars)[2, 3]	342	58	51	Not met	153 155	224	Met	595	83	134
Adjusted floor		56								
Ceiling on new external payment arrears		0	0	Met	0	0	Met		0	0
Ceiling of short-term debt and on contracting or guaranteeing of nonconcessional debt (millions of U.S. dollars)[6]		0	0	Met	0	0	Met		0	0
Floor on the cumulative payment of domestic arrears of the central government[7]		89	116	Met	238	247	Met		118	339
Indicative Targets										
Central government wage bill		1,385	1,304	Met	2,967	2,833	Met		1676	3535
Ceiling on the cumulative arrears on the Central Government wage bill		0	0	Met	0	0	Met		0	0
Memorandum items:										
Cumulative net balance of payments support (millions of U.S. dollars)		3.6	10.1		42.9	60.2			109.7	134.9
Balance of payments assistance		49.3	43.4		125.6	125.1			128.6	178.3
Central Government debt service obligations (excl. IMF)		-45.8	-33.3		-82.7	-65.0			-19.0	-43.4
Shortfall (–)/Excess (+) net BOP support			6.5			17.3				
Less shortfall in IMF disbursements						15.8				
Program exchange rates										
Kwacha/US$	3,509							4,406.7		
US$/SDR	1.429							1.485		

[1] The definitions of the items in the quantitative program are contained in the Technical Memorandum of Understanding (TMU).
[2]Adjusted for balance of payments support less debt service payments.
[3]The base for 2006 GIR corresponds to end-January 2006 stock; that for 2007 corresponds to end-December 2006 stock.
[4]Excludes HIPC debt relief from the IMF.
[5]The ceiling will be adjusted for changes in the legal reserve requirements.
[6]Nonconcessional loans are those having a grant element of less than 40 percent.
[7]This includes K100 billion for the payment of arrears to the Public Service Pension Fundin 2006 and K112 billion in 2007.

Table 2. Zambia: Structural Program for 2006 and 2007

Measure	Timing	Status
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	Observed in 2006
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	Observed in 2006
The Investment and Debt Management Department (IDM) of the Ministry of Finance and National Planning (MoFNP) will verify the stock of onlending agreements with a view to effectively enforcing them. The IDM will report to the Secretary to the Treasury on validation of these agreements.	End-June 2006	Observed
Pilot an integrated financial management and information system (IFMIS) in at least three line ministries.	End-September 2006	Not observed Contract was signed in November 2006 and the piloting began in January 2007. The number of pilot sites has been expanded to eight.
Complete a diagnostic review of tax policy and administration.	End- December 2006	Observed
The IDM will verify the stock of government contingent liabilities, including loan guarantees, and pension obligations. The IDM will report to the Secretary to the Treasury on their validation.	End- December 2006	Observed
Report on the findings of a preliminary review of the piloting of the IFMIS in at least three line ministries.	End-March 2007	Not observed The review has been postponed since the new pilot will cover eight sites and take 18 months to complete.
Submit to the Minister of Finance a comprehensive debt management strategy	**End-June 2007**	
Benchmarks		
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 in 2006
Quarterly budget execution reports using the activity-based budgeting (ABB) classification will be published within 45 days of the end of each quarter, including summary tables developed in consultation with the PEMFA JTWG.	Continuous	Not observed ABB classification was used for the 2006:Q4 report. However, summary tables have yet to be published.
The Accountant General will, within 60 days of the end of each quarter, submit to the Secretary to the Treasury quarterly reports on compliance with the commitment control system by ministry, province, and spending agency.	Continuous Beginning September 2006	Not observed Format has been finalized and a draft report for 2006:Q4 produced but a final report has yet to be submitted to the Secretary to the Treasurer.

Table 2. Zambia: Structural Program for 2006 and 2007 (concluded)

Measure	**Timing**	**Status**
Issue new regulations and revised accounting manuals for the new Finance Act.	End-March 2006	Not observed The regulations were finalized and distributed by end-December 2006. The accounting manuals will be published by the end of June 2007.
Issue summary tables, developed in consultation with the PEMFA Joint Technical Working Group (JTWG), using activities based on budgeting classification and identifying poverty reducing programs.	End-March 2006	Observed with delay
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 MoFNP.	End-March 2006	Observed with delay
The MoFNP will issue an annual report on external debt management during 2005.	End-June 2006	Observed
Execute the action plan adopted by the Government on the resolution of the Zambia National Building Society (ZNBS).	End-June 2006	Not observed Budgeted resources were not sufficient. Resources are being provided in the 2007 budget.
Submit to Cabinet a proposal for laws establishing a credit reference bureau, including necessary amendments to privacy laws.	End-June 2006	Observed
ZESCO's management will provide all the financial, technical, and managerial information the World Bank and the IMF need to assess ZESCO's performance in line with the conditions for reaching the evaluation point under the commercialization process.	End-July 2006	Observed with delay
Submit to cabinet the first draft ("Green Paper") of the Medium-Term Expenditure Framework (MTEF) for 2007-2009.	End-August 2006	Observed
Incorporate the NSCB and DBZ under the Companies Act.	End- December 2006	Not observed Postponed until the finances of the institutions are sounder.

Technical Memorandum of Understanding for the Poverty Reduction and Growth Facility (PRGF) Arrangement

I. Introduction

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 remainder of the program supported by the PRGF arrangement, as well as the related reporting requirements.

II. Quantitative Performance Criteria and Benchmarks: Definitions and Data Sources

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

1. Net domestic assets (NDA) of the BoZ are defined as the monthly average (based on daily data) of reserve money less net foreign assets of the BoZ calculated at kwacha 3,509.0 per U.S. dollar for 2006 and 4,406.7 per U.S. dollar for 2007.[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 reserve liabilities (defined below). The kwacha values are derived from the U.S. dollar values using the program exchange rate.

2. 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.

3. 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 1 of the Memorandum of Economic and Financial Policies (MEFP), up to a maximum of US$35 million for the period end-December 2006 to end-June 2007. External disbursements that occur anytime during the month of the test date will be treated as if they were disbursed on the first day of

[1] Unless otherwise defined, program exchange rates for 2006 and 2007 between the U.S. dollar and other (non-kwacha) currencies will be equal to the end-December 2005 and end-December 2006 rates, respectively. The U.S. dollar/SDR rate for program purposes is 1.4293 for 2006 and 1.485 for 2007. Any other assets (e.g., gold) would be revalued at their end-December 2005 market prices for 2006 and end-December 2006 for 2007.

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. The kwacha value of the cumulative shortfall/excess will be calculated at the program exchange rate.

4. 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 required reserves (kwacha and foreign-currency denominated) at the end of the previous calendar month.

B. Net Domestic Financing (NDF)

5. **Net domestic financing (NDF) 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 outstanding amount of the long-term non-transferable security issued against the government's indebtedness to BoZ as at end-2002; plus

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

6. 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 1 of the MEFP, up to a maximum of US$35 million for the period end-December 2006 to end-June 2007. 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 kwacha value of the cumulative shortfall/excess will be converted at the program exchange rate.

[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 Yellow Book for 2006 and 2007, respectively.

7. 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

8. 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 (5^{th} 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.

9. 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).

10. 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 1 of the MEFP, up to a maximum of US$35 million for the period end-December 2006 to end-June 2007; (ii) upward by 100 percent of the cumulative excess balance of payments support net of debt service; (iii) downward/upward for any shortfall/excess in the U.S. dollar value of programmed 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.

11. 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 rates.

12. 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

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, beyond the due date and/or the grace period, if any. This definition excludes arrears subject to rescheduling.

14. 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

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 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 DAC of 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. The use of IMF resources will be excluded from this performance criterion.

16. This minimum grant element 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 performance criterion excludes non-concessional loans stemming from the rescheduling of external arrears.

17. 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

18. 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. No new nonconcessional official external short-term debt will be contracted or disbursed 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).

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

G. Domestic Payment Arrears of Central Government

20. Domestic payment 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. Included in the quarterly program floors for payment of domestic payment arrears in 2006 is payment of K 25 billion each quarter and K 26 billion in the first two quarters of 2007 toward Government's arrears on contributions to the Public Sector Pension Fund.

21. 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

22. For the purposes of the wage bill, the definition of Central Government includes all expenditure heads covered in the Yellow Book for 2006 and 2007 respectively. 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.

23. 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

24. The Debt Strategy Working Group, which include high level officials from MoFNP and BoZ, will submit a draft debt management strategy to the Minister of Finance by June 2007, including the following:

- ***Assessment of existing debt***: assessment of stock of public and publicly guaranteed debt as of end-2005 (composition by creditor, by maturity, and by currency) and description of main risks (interest, currency, and refinancing).

- ***Description of debt management practices during 2006*:** objectives pursued, description of decision process, procedures and regulations for borrowing externally as well as domestically and granting of guarantees; and identification of debt management constraints, particularly on portfolio choice (including market development, lack of access to preferred source of funds, and implementation of monetary policy), and weaknesses.

- ***Identification of options for 2007 and changes envisaged with respect to previous year***: specify procedures and regulations that need to be changed; ways to address weaknesses; explicitly assign responsibilities for directly contracting public debt, guaranteeing public debt, and reporting. Describe the environment for debt management in 2007, including main macroeconomic assumptions used in 2007 budget (i.e.; GDP, interest rates, exchange rates) and 2007 fiscal projections. Determine the composition (external vs. domestic debt), maturity (short- vs. medium-term debt), concessionality, and currency (foreign vs. local) of envisaged 2007 financing operations.

- ***Formulate interim debt management strategy to be applied through 2008*:** Set out objectives, scope of the interim strategy, role of the institutions involved, ability to borrow and accountability, procedures, and principles that should be taken into account when developing Zambia's medium-term debt management strategy. The strategy should also identify how to ensure high quality debt data and ways to strengthen risk management capacity. In addition, the Working Group should establish a timetable for developing and implementing Zambia's comprehensive medium-term debt management strategy.

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

(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.

TMU Table 1. Zambia: Net Domestic Financing

	2006		2007
	End-Dec.	End-Dec.	
		Program Base	
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 [1]			
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).

TMU Table 2. Zambia: Gross International Reserves [1]

(In millions of U.S. dollars)

	2006 December			2007 March, June, September, December				
	12/31/2006 = Base				Current		31/12/07	
	Amount	Exch rate or price	U.S. dollars	Amount	Exch rate or price	U.S. dollars	Exch rate or price	U.S. dollars
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 net 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 lent and 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: Operational 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 BoZ and are available for balance of payment 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.