International Monetary Fund

Zambia and the IMF

Press Release:
IMF Executive Board Completes First and Second Reviews under the PRGF Arrangement with Zambia and Approves US$ 256.4 Million Increase in Financial Support and US$ 160.1 Million Disbursement
May 1, 2009

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

April 8, 2009

April 8, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C.
UNITED STATES OF AMERICA

Dear Mr. Strauss-Kahn,

The attached Memorandum of Economic and Financial Policies (MEFP) reviews recent economic developments and progress in implementing the PRGF-supported program during 2008 and sets out the macroeconomic policies and structural reforms that the Government will pursue in 2009 and the medium term.

Since the PRGF arrangement was approved by the IMF Executive Board in June 2008, Zambia has experienced a number of adverse developments that have affected economic conditions and prospects, as well as program performance. As a result, while all quantitative and structural performance criteria for end-June 2008 were met, slippages occurred towards the end of the year. Two developments in particular have had far-reaching effects:

First, the surge in global food and fuel prices through the fall of 2008, which came on top of a poor domestic agricultural harvest, put the achievement of the end-2008 target for inflation well beyond reach. The need to accommodate the first-round impact of the food and fuel price shocks made it impossible to observe the December 2008 target for net domestic assets (NDA) of the Bank of Zambia. Regrettably, a bunching of government spending late in the year also contributed to a greater-than-programmed expansion in reserve money. However, in the first quarter of 2009, reserve money has been brought back onto a path consistent with the objective of reducing inflation to close to single digits by the end of 2009.

Second, the global financial crisis and economic downturn is having a severe impact on mining and mining-related sectors, which are the mainstay of the Zambian economy. Government revenue has been compressed, narrowing the fiscal space necessary for increased investment in infrastructure. Furthermore, the sharp fall in copper prices has resulted in a large deterioration of the trade balance, reduced foreign direct investment, and led to an outflow of portfolio capital. The Kwacha has depreciated by about 40 percent against the US dollar since early October 2008. At times, pressure on the Kwacha has been intense, requiring the Bank of Zambia to intervene to maintain orderly conditions in the foreign exchange market and sustain confidence in the currency. Under these circumstances, it was not possible to accumulate the gross international reserves (GIR) expected under the program in 2008.

In light of the above, the Government requests waivers for the non-observance of the performance criteria for NDA and GIR, and that the second and third disbursements be made available upon completion of the first and second reviews by the Executive Board of the IMF. The Government also requests an augmentation of access under the PRGF arrangement of 35 percent of quota, bringing total access to 45 percent of quota. This would be critical in helping

Zambia to adjust to the severe external shock it has experienced and in maintaining a level of foreign exchange reserves that would foster market confidence and support the Bank of Zambia's ability to maintain orderly conditions in the foreign exchange market.

The Government believes that the policies set forth in the attached MEFP are adequate to achieve the program objectives, but it 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 authorizes the IMF to make the staff report for the new PRGF arrangement and this letter and the 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 reviews.

Yours sincerely,

/s/
Dr. Situmbeko Musokotwane, MP
Minister of Finance and National Planning

Attachments (2)

Attachment 1—
Zambia: Memorandum of Economic and Financial Policies

1. This memorandum reviews recent economic developments and outlines the policies and targets the Government of the Republic of Zambia will pursue in 2009 and the medium-term under the Poverty Reduction and Growth Facility (PRGF) arrangement.

I. Recent Economic Developments

2. **The global financial crisis has profoundly affected economic conditions and prospects for Zambia.** It is doing so most directly through the sharp fall in copper prices, which is compressing export proceeds and government revenue, and reducing capital inflows. From their peak in mid-2008, copper prices have fallen by about two-thirds. The reduced foreign exchange inflows from the mining sector and declining foreign demand for government securities have resulted in a steep depreciation of the Kwacha against the US dollar since early October 2008, at times necessitating sizeable sales of foreign exchange by the Bank of Zambia (BoZ) to maintain orderly market conditions and sustain confidence in the currency. As a result, gross international reserves increased by only US$29 million during 2008. Intense foreign exchange market pressure during the first months of 2009 required further sizeable intervention.

3. **Economic growth remained strong at 6 percent in 2008 as the effect of the global financial crisis on economic activity began to be felt only late in the year.** However, the surge in food and fuel prices put the 7 percent inflation target for end-2008 well beyond reach. Annual inflation reached 16.6 percent in December 2008, up from 8.9 percent a year earlier. It has since declined to 14 percent in February 2009 as food and fuel prices moderated.

4. **The overall fiscal deficit in 2008 was larger than programmed due to a large shortfall in mining taxes.** Total revenue fell short of the program target by 1 percent of GDP, reflecting lower tax revenue from mining (1.7 percent of GDP) which were partly offset by higher collections of personal income taxes and customs duties. In addition to the decline in copper prices in the second half of 2008, difficulties in implementing the new fiscal regime for mining that came into effect in April also adversely affected revenues. Total expenditure was lower than budgeted, but not by enough to offset the shortfall in revenue because of supplementary expenditures for a higher-than-budgeted wage bill, expanded fertilizer subsidies, the presidential elections, and a capital transfer to ZESCO to complete the rehabilitation of power stations. The overall fiscal deficit (including grants) of 1.7 percent of GDP exceeded the program target by 0.6 percentage points of GDP.

5. **Monetary expansion was on target through June, but subsequently picked up strongly, in part because policy sought to accommodate the first-round effects of the food and fuel price shocks.** Reserve money expanded by about 28 percent in 2008 compared to the programmed 11.5 percent. The reserve money expansion also reflected the bunching of government spending in the last few weeks of the year and declining demand for

government securities, particularly from foreign investors. Bank credit to the private sector grew by about 50 percent in 2008; however, credit growth has slowed down in recent months as banks have become more cautious in their lending to businesses and households that are negatively affected by the weakening in mining activity.

6. **The program was broadly on track during the first half of 2008, but slippages occurred towards the end of the year (Tables 1 and 2).** All quantitative performance criteria and indicative targets for June and September were met, except for the indicative targets for reserve money for June and September and for payment of domestic arrears for September. However, the December quantitative performance criteria for NDA and international reserves were not met, nor were the indicative targets for reserve money and the payment of domestic arrears. The reserve money and NDA targets were not observed because of the accommodation of food and fuel price shocks and because a sizeable portion of budgetary releases was not spent until the last few weeks of the year. The accumulation of international reserves was much smaller than targeted due to declining foreign exchange inflows from the mining sector and Bank of Zambia sales of foreign exchange to maintain orderly market conditions in periods of excessive exchange rate volatility. All structural performance criteria were met, as were all but one of the structural benchmarks.

II. Medium-Term Macroeconomic Framework

7. **Economic prospects have been adversely affected by the global economic downturn.** Real GDP growth is projected to slow from 6 percent in 2008 to 4 percent in 2009. Mining and mining-related activity and investment will be particularly hard hit. Many expansion projects have been postponed and one mine has shut down, while other mines have begun to lay off workers and curtail production. Other sectors will also be affected, including tourism, transportation, and construction. On the positive side, agriculture is expected to rebound from the relatively poor harvest in 2008, and electricity production should recover with the completion of the power rehabilitation project in the course of this year. However, the risks may still be on the downside and the strength of the recovery in 2010-11 will depend on how severely the Zambian mining sector will be affected by the downturn in global demand.

8. **The anticipated fiscal space will not materialize due to the decline in mining revenue.** With copper prices expected to recover only moderately over the medium-term, mining taxes in 2009-11 would be significantly lower than had earlier been expected under the program. The planned increase in spending on infrastructure and the social sectors aimed at diversifying the economy will thus have to take place at a slower pace.

9. **The balance of payments will weaken considerably with the decline in mining exports and foreign direct investment.** The trade balance, which registered a narrow surplus in 2008, is projected to record a sizable deficit in 2009 and the medium term. The current account deficit (including grants) is projected to widen to 7.1 percent of GDP in 2009, from 5.8 percent of GDP in 2008, and only improve modestly in subsequent years. Importantly, the earlier program objective of increasing reserve coverage to around 5 months of imports by the end of 2010 is now well beyond reach. Instead, the program will target an increase in gross international reserves of US$100 million in 2009 and US$78 million in

2010, which in view of the large fall in imports would correspond to about 3 months of imports in 2009-10. This assumes that the requested augmentation of access under the PRGF arrangement, amounting to about US$260 million for 2009-10, is approved. In the absence of such an augmentation, gross reserves would likely decline.

III. Policies For 2009

A. Fiscal Policies

10. **Within the framework of a narrower fiscal space, fiscal policy will aim to increase spending on infrastructure to encourage diversification of the economy while safeguarding macroeconomic stability and leaving room for private sector investment growth.** Revenue is projected to decline by 1.3 percentage points to 17.7 percent of GDP, mostly reflecting lower mining taxes and lower non-tax revenues (as the contribution of the one-time measures in 2008 wear off). This projection includes the introduction of some tax measures—the main one being an increase in the threshold at which personal income tax is paid—which on net will reduce tax revenue by 0.2 percentage points of GDP. Expenditures would rise by 0.9 percentage points to 25.3 percent of GDP, reflecting a 1.1 percentage point of GDP increase in spending financed by foreign grants and loans. Capital spending is budgeted to increase by 1.2 percentage points to 4.9 percent of GDP, while current spending remains fairly flat. The overall fiscal deficit (including grants) would widen by 0.9 percentage points to 2.6 percent of GDP, while domestic financing would rise somewhat less to 1.9 percent of GDP. This level of domestic financing would permit implementation of the monetary program with reasonable effort.

11. **The Government will amend the fiscal regime for the mining sector.** The changes, which are expected to become effective April 1, 2009, include the removal of the windfall tax and the restoration in the capital allowance for tax purposes to 100 percent. The variable income tax will be retained to ensure that Zambia will share in future windfalls. While these measures are expected to have little, if any, revenue impact in 2009, they would help to preserve Zambia's attractiveness for future investment in mining.

12. **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 is working towards formally adopting the Extractive Industries Transparency Initiative (EITI) in a participatory process, in line with EITI guidelines.

13. **The Government is committed to resolving the financial difficulties of the Public Service** Pension **Fund (PSPF).** The PSPF is a defined-benefit scheme that was closed to new entrants in 2000. The actuarial deficit is estimated at about 14 percent of GDP. With a rising number of pensioners, the annual cash-flow deficit is projected to increase in the medium-term before falling as the scheme winds down (the deficit is estimated at about ½ percent of GDP over the next few years). The long-term sustainability of the PSPF depends on constitutional amendments that are required to redesign the defined benefit scheme. In the meantime, the 2009 and subsequent budgets will allocate sufficient resources to the PSPF to ensure that current pension obligations are met in full. The Government will also abstain

from any measures that would accelerate the accumulation of unfunded liabilities of the public pension schemes, including the reopening of the PSPF for new entrants.

B. Monetary and Exchange Rate Policies

14. **The challenge for monetary policy is to ensure that inflation turns to a downward path while also leaving room for private sector credit growth.** While a greater-than-programmed monetary expansion was necessary to accommodate the first round effects of the food and fuel price shocks, monetary policy will stay firm enough to contain any second-round effects on inflation. The aim is to reduce inflation to 10 percent by end-2009. To achieve this, reserve money is targeted to grow by 14 percent, which, given the budget's domestic financing requirement, would allow for adequate expansion in credit to the private sector and a buildup of international reserves to 3.1 months of imports.

15. **Exchange rate policy will continue to be based on a market-determined floating exchange rate.** Since October 2008, the Kwacha has depreciated in keeping with the changed fundamental determinants of the exchange rate. However, persistent uncertainty about global economic prospects and their impact on the domestic economy, in a thin market with loosely held expectations, has resulted in an unusually volatile foreign exchange market. In these circumstances, the BoZ will continue to actively intervene, when necessary, to maintain orderly market conditions and to help anchor expectations.

C. Structural Policies

16. **The structural components of the program complement the medium-term macroeconomic framework.** The program will continue to focus on: (i) improving public financial management; (ii) strengthening monetary operations and supervision, and deepening the financial sector; and (iii) implementing policies to ensure an adequate and reliable supply of electricity.

Public Financial Management

17. **Stepped up implementation of public financial management reforms is critical for increasing the effectiveness and productivity of the public sector.** To this end, the Cabinet has adopted a proposal for the establishment of a Treasury single account (TSA). In the meantime, the Government has started to use the real time gross settlement system (RTGS) in place of checks for large transactions and will continue to consolidate multiple accounts operated by each ministry, province, and spending agency (MPSA). The MoFNP will prepare a comprehensive strategy for phased implementation of the establishment of the TSA by end-June 2009 (structural benchmark). The strategy will include a complete inventory of all existing government bank accounts; the type of accounts that will be functional under the TSA regime; the coverage and structure of the TSA (centralized or decentralized structure); and an outline of new receipt and payment circuits. Moreover, Government will approve all necessary amendments to the Public Finance Management Act specifying the general principles of the TSA system by end-September 2009 (structural benchmark). To harmonize treasury functions, the MoFNP will establish a Treasury Department within the MoFNP by year end.

18. **Other public financial management reforms are underway.** The Government intends to complete the full rollout of IFMIS by the end of 2010. Furthermore, to improve execution of capital projects, the Government will strengthen the three-year rolling budgets for capital projects under the Medium-Term Expenditure Framework. The coming into force of the new Public Procurement Act should further accelerate the execution of capital projects.

Tax Administration

19. **The modernization of the Zambia Revenue Authority (ZRA) is progressing well and the first phase of implementation has been completed.** Most recently, the change to a headquarters functional structure was completed and a Large Taxpayer Office (LTO) was established. The ZRA will, supported by TA from the IMF, continue implementing the reform program to further strengthen the effectiveness of tax administration. Specifically, the ZRA will absorb the mining unit into the LTO, in collaboration with other government agencies. To address concerns about VAT performance, the ZRA will integrate the VAT improvement initiatives within the broader Domestic Tax Division (DTD) program, strengthen the import deferral mechanisms, and address other structural issues. The Government intends to request assistance from the IMF to improve the performance of the VAT.

Financial Sector Development

20. **Considerable progress has been made to date with the implementation of the Financial Sector Development Program (FSDP), but a number of important challenges still remain.** The focus of financial sector reforms is on strengthening regulation and supervision, contingency planning and crisis preparedness, enhancing the effectiveness of monetary policy, and promoting enhanced access to finance and financial inclusion. To strengthen the interbank money market and promote the establishment of a benchmark short-term interest rate, the BoZ will introduce a flexible standing overnight facility for providing liquidity to the market by end-September 2009 (structural benchmark). This instrument—which would supplement the present, rarely used, rediscount facility—would foster a more stable interbank market and encourage commercial banks to hold lower levels of precautionary reserves at the BoZ. Regarding the need to further strengthen the framework for liquidity provision and contingency planning, measures will be defined on the basis of the recommendations of the forthcoming IMF TA mission, including with respect to the establishment of a Lender of Last Resort Facility for banks and possibly nonbank financial institutions. The BoZ also intends to integrate stress-testing exercises into the newly adopted risk-based supervisory framework, and establish formal communications with the supervisory authorities of parent banks of foreign-owned institutions on risks and crisis management issues. To further stimulate the growth of the secondary market, the Government will set up a supervisory regime for the secondary market in government securities by end-June 2009 (structural benchmark). This will entail the issuance of harmonized regulations to govern trading.

21. Steps are being taken to improve the reliability of the RTGS and ensure the timely completion of daily payments processing. The BoZ is undertaking measures to strengthen the operational reliability of the RTGS system and its ability to meet agreed service level standards. In this regard, the BoZ has established a suitable dial-up line as a backup, and is further investigating the possibility of using the Direct Debit and Credit Clearing system as another backup in the event of complete failure of the RTGS. It is also undertaking an upgrade of its SWIFT financial messaging network infrastructure in an effort to enhance RTGS connectivity.

22. **There is an ongoing effort to address Zambia's low level of financial inclusion.** Financial institutions' usage of the Credit Reference Bureau (CRB) has now been mandated, through a BoZ directive under the Banking and Financial Services Act, in an effort to improve the credit information framework and reduce credit risk, and thereby reduce bank costs. In addition, the effectiveness of Statutory Instrument No. 183 of 1995, which regulates bank charges, is under review, with a view to requiring financial institutions to report their bank fees and charges, and any modifications thereof, to the BoZ. Building on the successful pilot programs launched by a handful of financial institutions within Zambia and the experiences of other developing countries, consideration is being given to the broad introduction of "basic accounts", with no (or low) minimum balance, no fees, and limited transactions.

23. **The pension sector is important for financial sector development, as one of the largest domestic investors in financial instruments and an engine for mobilizing savings.** Regarding the regulatory and legal framework of the pension sector, the National Pension Scheme Authority (NAPSA) remains outside the supervisory mandate of the Pension and Insurance Agency (PIA). Given the growing size of NAPSA and its importance for future pension benefits, the Government intends to place the operational supervision of NAPSA under the PIA by end-December 2009. This will require, among other things, amendment of the provision in the Pension Scheme Regulatory Act (PSRA) which exempts NAPSA from extended supervision; the transfer of additional resources to PIA; and the establishment of a multi-year re-capitalization plan for NAPSA that would bring the pension to full funding, as mandated by the PSRA. Moreover, the Government intends to amend the PSRA to make sure that pension schemes employ custodians. Currently, the Act stipulates that custodians licensed by PIA must be commercial banks that are at least 51 percent domestically owned, but domestic banks have been reluctant to invest in the technology and staffing needed for custodial procedures and services.

Energy

24. **The Government is cognizant of the current shortage of electric power and the risk it poses to sustained growth.** The supply of electricity from power plants commissioned in the 1970s falls well short of demand because of strong economic growth in recent years. Although the completion of the power station rehabilitation project will restore generating capacity and reduce load shedding temporarily, new capacity is needed to meet increased demand over the medium term. Policies will be strengthened to ensure that sufficient electricity generation capacity is installed as quickly as possible. To this end, the Government has adopted a new electricity strategy with measures to (i) adjust electricity tariffs to reflect the cost of service; (ii) attract private investments and competition in the sector; (iii) increase the operational efficiency of ZESCO and strengthen its governance; and (iv) ensure that ZESCO has sufficient resources to implement the planned rehabilitation and

new generation projects. Specifically, a revised electricity tariff schedule that will raise the average tariff significantly for 2009 will be adopted and a public announcement will be made of the indicative tariff levels for 2010-11 consistent with the policy to reach cost-reflective levels by 2011 (end-June 2009 structural benchmark). The announced indicative tariff levels will reflect the cost of the planned large-scale investment in new generation and other electricity structure, and take into account the tariff setting for the mining sector.

25. **To encourage more private sector participation in electricity generation,** the Government will submit the necessary legislation to Parliament for the Zambian Grid Code, which will set out rules and procedures for the operation and pricing of the transmission network by end-December 2009. Further, the management of ZESCO will, by June 2009, enter into a performance contract with the Government designed to improve the efficiency and corporate governance of ZESCO. The contract will stipulate a number of efficiency-enhancing and cost cutting measures with the purpose of reducing ZESCO's operational expenditures, including on wages and salaries. It will also require ZESCO to submit semi-annual reports on its overall operations to the committee of Ministers tasked with implementing the electricity strategy, in order to monitor progress in implementing the agreed cost cutting measures.

26. **Implementation of the new projects to expand electricity generation will likely require borrowing on nonconcessional terms.** To this end, ZESCO and the Government are currently seeking financing to carry out two hydropower investment projects (the Kariba North Bank Extension and the Itezhi-Tezhi Power Station). Given the importance of raising electricity supply to achieve the medium-term growth objectives, as well as limited availability of grants or concessional financing, the Government and/or ZESCO may need to contract new nonconcessional external borrowing. Any nonconcessional borrowing for these projects would not exceed US$ 400 million in 2009.

Trade, Debt, and Aid

27. **The Government continues to pursue an open trade regime.** Zambia has fully implemented the tariff phase down commitment under the SADC Protocol and is actively participating in the harmonization of trade related agendas under SADC and COMESA. Further, Zambia has initialed the interim agreement on market access offer between Zambia and the European Union.

28. **The Government is committed to improving public debt management.** The main objective of the newly adopted debt management policy and strategy is to ensure a sustainable level of indebtedness (including contingent liabilities). In this regard, the strategy seeks to: improve risk management; ensure that financial obligations are settled as scheduled; control contingent liabilities; minimize the cost of financing the budget; support the development and deepening of financial markets; and facilitate effective coordination between monetary, fiscal and debt management policies. In this context, the Government will continue working on enhancing and unifying the legal framework, enhancing the monitoring of public sector debt, including debt contracted by public enterprises, and strengthening institutional capacity to manage and monitor debt. Efforts in these areas will be supported by

joint IMF-World Bank Medium-Term Debt Strategy (MTDS) technical assistance to enhance capacity and facilitate effective implementation.

29. **The Government will continue to strengthen the management of aid.** Priority will be given to further enhancing cooperation with the donor community, including with respect to the compilation of consistent and timely aid data. In an effort to reconcile data on grant financing across government ministries, it is necessary to facilitate a close dialogue between donors, the MoFNP, and the BoZ.

IV. Economic Statistics

30. **The Government is aware of the pressing need to strengthen Zambia's capacity to collect and timely disseminate economic data, especially the national accounts.** The Central Statistics Office (CSO) will boost efforts to complete the economic census without further delays. The census will provide important information about the structure of the Zambian economy and will be used to rebase the national accounts. The CSO is testing a new, rebased CPI, which will be published starting in June 2009. The Government will ensure that sufficient funding is available for CSO to purchase the necessary technology to compute and publish the new CPI on time.

V. Program Monitoring

31. **Semi-annual disbursements under the PRGF arrangement will be based on the observance of quantitative performance criteria.** Completion of the third and fourth reviews of the arrangement will be based on the observance of quantitative performance criteria through end-June 2009 and end-December 2009, respectively (Tables 3 and 4). The third review is expected to be completed by November 2009.

Table 1. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets, 2008[1]

(Billions of kwacha, unless otherwise indicated)

	2007	2008								
	Dec	Jun			Sep			Dec		
	Stock	Program	Actual	Status	Indicative	Actual	Status	Program	Actual	Status
Performance criteria:										
Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia [2, 3]	-1243	-208			-512			-776		
Adjusted ceiling		-366	-674	Met	-139	-327	Met	83	492	Not Met
Ceiling on the cumulative increase in net domestic financing (NDF) [2]	4,638	567			534			-64		
Adjusted ceiling		408	-499	Met	906	-449	Met	795	653	Met
Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars) [2]	947	154	295	Met	267			382		
Adjusted floor		195			170	240	Met	158	120	Not Met
Ceiling on new external payment arrears [4]	…	0	0	Met	0	0	Met	0	0	Met
Ceiling on contracting or guaranteeing short-term external debt by the central government, BOZ, ZESCO, ZAMTEL and Zambia Railways Limited [4]	…	0	0	Met	0	0	Met	0	0	Met
Ceiling on contracting or guaranteeing medium- and long-term nonconcessional external debt by the central government, BOZ, ZESCO, ZAMTEL and Zambia Railways Limited (millions of U.S. dollars) [5]										
Electricity sector projects [6]	…	450	0	Met	450	0	Met	450	0	Met
Other sectors	…	0	0	Met	0	0	Met	0	0	Met
Indicative targets:										
Floor on the cumulative payment of domestic arrears of the government		297	316	Met	527	357	Not Met	669	594	Not Met
Cumulative increase in reserve money	2500	22	35	Not Met	155	255	Not Met	289	721	Not Met
Memorandum items:										
Cumulative net budget support (millions of U.S. dollars)	74	101	140		154	155		141	142	
General budget support	136	115	165		200	203		200	203	
Central Government debt service obligations (excluding IMF)	-62	-14	-26		-46	-48		-59	-61	
Shortfall (-)/Excess (+)			39			0			1	
Cumulative revenue from mining (billions of kwacha)		351	360		1,055	681		1,640	776	
Shortfall (-)/Excess (+)			9			-374			-863	
Program exchange rate	3,845									

[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] Continuous performance criteria.
[5] Nonconcessional loans are those having a grant element of less than 35 percent.
[6] The projects are Kariba North Extension, Itezhi-Tezhi, and the rehabilitation of Kafue Gorge and Kariba power stations.

Table 2. Zambia: Structural Conditionality for 2008

Measure	Timing	Status
Submit to Cabinet a proposal to establish a treasury single account.[1]	End-June 2008	Met
Submit to Cabinet a proposal to establish a Treasury Department.[2]	End-June 2008	Met
Establish a headquarters functional structure at the Zambia Revenue Authority.[2]	End-September 2008	Met
Establish a single large-taxpayer office at the Zambia Revenue Authority.[2]	End-December 2008	Met
The Ministry of Finance and National Planning and the Bank of Zambia will establish a formal mechanism for coordination with key line ministries on liquidity management.[2]	End-June 2008	Met
The Bank of Zambia will restructure the operations of its rediscount window.[2]	End-June 2008	Met with delay
Set up a supervisory regime for the secondary market in government securities.[2]	End-December 2008	Not met. Reset for end-June 2009
Introduce risk based bank supervision.[2]	End-December 2008	Met
Submit to Cabinet a debt management strategy.[2]	End-September 2008	Met
Submit to Cabinet a policy for the electricity sector with specific strategies to (i) gradually adjust electricity tariffs to the cost of service; (ii) attract private investment and competition in the sector; (iii) increase the operational efficiency of ZESCO; and (iv) ensure that ZESCO has sufficient resources to implement the planned rehabilitation and new generation projects.[1]	End-June 2008	Met

[1] Performance Criterion.
[2] Benchmark.

Table 3. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets, 2009[1]

(Billions of kwacha, unless otherwise indicated)

	2008	2009		
	Dec	Jun	Sep	Dec
	Stock	Prog	Indicative	Prog
Performance criteria:				
Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia[2, 3]	-1449	397	642	996
Ceiling on the cumulative increase in net domestic financing (NDF)[2]	5,291	447	844	1,170
Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars)[2]	976	44	29	100
Ceiling on new external payment arrears[4]	…	0	0	0
Ceiling on contracting or guaranteeing short-term external debt by the central government, BOZ, ZESCO, ZAMTEL and Zambia Railways Limited[4]	…	0	0	0
Ceiling on contracting or guaranteeing medium- and long-term nonconcessional external debt by the central government, BOZ, ZESCO, ZAMTEL and Zambia Railways Limited (millions of U.S. dollars)[5]				
Electricity sector projects[6]	…	400	400	400
Other sectors	…	0	0	0
Indicative targets:				
Floor on the cumulative payment of domestic arrears of the government	…	161	264	352
Cumulative increase in reserve money	3211	-60	112	450
Memorandum items:				
Cumulative net budget support (millions of U.S. dollars)		141	126	106
General budget support		187	201	201
Central Government debt service obligations (excluding IMF)		-46	-75	-95
Program exchange rate	4,832	4,832	4,832	4,832

[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]Continuous performance criteria.
[5]Nonconcessional loans are those having a grant element of less than 35 percent.
[6]The projects are Kariba North Extension and Itezhi-Tezhi power station.

Table 4. Zambia: Structural Benchmarks for 2009

Measure	Timing	Macro Rationale
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. In particular, the measures will improve cash flow management and forecasts and thereby contribute to improved fiscal and monetary policy coordination.
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	
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.
Bank of Zambia will introduce a new standing overnight lending facility.	End-September 2009	Strengthen liquidity management, reduce volatillity in the money market, and enhance the effectiveness of monetary policy.
Raise the average electricity tariff in 2009 and publicly announce indicative tariffs for 2010-11consistent 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.

Attachment 2—

Technical Memorandum of Understanding for the 2008-10 Poverty Reduction and Growth Facility (PRGF) Arrangement

I. INTRODUCTION

1. This memorandum sets out the understandings between the Zambian authorities and the International Monetary Fund (IMF) regarding the definitions of the quantitative performance criteria and indicative targets for the program supported by the PRGF 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 net foreign assets of the BoZ calculated at kwacha 4,832.3 per U.S. dollar for 2009.[1] Net foreign assets of the BoZ are defined as gross international reserves (defined in paragraph 8) plus any other foreign assets, including US$109 million encumbered reserves at end-December 2008, minus foreign reserve liabilities (defined below). The kwacha values of net foreign assets are derived from the U.S. dollar values using the program exchange rate.

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

B. Reserve Money

4. Reserve money (monthly average based on daily data) 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.

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[1] Unless otherwise defined, program exchange rates for 2009 between the U.S. dollar and other (non-kwacha) currencies will be equal to the end-December 2008 values. The U.S. dollar/SDR rate for program purposes is 1.536 for 2009. All other assets (e.g. gold) would be revalued at their end-December 2008 market prices for 2009.

5. Data on reserve money, including its components, will be reported by the BoZ on weekly and end-month basis.

C. Net Domestic Financing (NDF)

6. Net domestic financing (NDF) is defined as the Central Government's net borrowing from the banking and non-banking sectors (See Table 1).[2] 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 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 issued against the government's indebtedness to BoZ as at end-2002; plus

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

7. 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, and will be reconciled with the monthly monetary survey.

D. 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; 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-

[2] The Central Government includes all the administrations identified by the budget heads listed in the Yellow Book for 2009.

party external liabilities, commercial bank reserve requirements on foreign currency deposits, and the US$25 million deposit in MBZ (in liquidation).

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

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

E. External Payment Arrears

12. 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.

13. 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.

F. Official External Debt

14. 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 having a grant element of no less than 35 percent. 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. Lending from the IMF will be excluded.

15. 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.

16. Official external non-concessional debt is defined as the contracting or guaranteeing of external debt other than concessional debt as defined in paragraph 14, owed or guaranteed by the central Government, BoZ, ZESCO, ZAMTEL and Zambia Railways Limited.

17. 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.

18. Official external short-term debt is defined as the contracting or guaranteeing of external debt with original maturity of less than one year, and includes forward commodity sales but will exclude normal trade credit for imports.

19. 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).

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 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.

III. Adjusters

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

General budget support (GBS) net of debt service[3]

(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.[4] [5]

[3] 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.

(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).

(iii) The total adjustment for shortfalls will be limited to US$30 million for January-June and US$35 million for January-December 2009.

Change in reserve requirements

(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) relative to the programmed levels.

BoZ short-term debt

(vi) The floor on GIR will be adjusted upward for any increase in BoZ short-term debt denominated in foreign currency, (see definition of short-term debt above).

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[4] 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.

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

Table 1. Net Domestic Financing
(Billion Kwacha)

	2008		2009
	End-December	End-December Program Base	
Total domestic financing (program)			
Adjustment			
Adjusted program financing			
Excess/shortfall (- = excess)			
Total domestic financing	5,290.6	5,290.6	
Bank financing	2,554.3		
Commercial banks	1,970.2		
Treasury bills[1]	1,195.7		
Bonds[1]	1,367.6		
Loans and advances	2,744.2		
less: Support to MBZ	-8.0		
less: Deposits	-587.5		
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).

Table 2. Zambia: Gross International Reserves[1]
(Millions of U.S. dollars)

	2008 December			2009 June, December					
	12/13/2008 = Base			Current			31/12/09		
	Amount	Exchange rate or price	U.S. dollars	Amount	Exchange rate or price	U.S. do	Amount	Exchange 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									
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 drain[5]									
Liabilities to IMF									
Other foreign currency loans and securities									
in U.S. dollars									
in U.K. pounds									
in other currencies									
Aggregate short & long positions in forwards, futures and swaps									
Other									
Contingent short-term net drains									
Contingent liabilities									
Securities with embedded options									
Undrawn, unconditional credit lines									
Aggregates 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 or on repo									
Financial derivatives (net, marked to market)									
Derivatives with residual maturity > 1 year, subject to margin call									

[1]As defined in the TMU or IMF, "Data Template on Intl'l Reserves and Foreign Currency Liquidity Operational Guidelines."
[2]Corresponds to gross international reserves for program performance.
[3]Excludes deposits at resident banks, unless assets held abroad by the bank are explicitly connected to the foreign exchange deposit of the BoZ.
[4]Includes foreign currency deposits are resident banks.
[5]The program target for gross international reserves will be adjusted as described in the TMU.