International Monetary Fund

Zambia and the IMF

Press Release:
IMF Executive Board Completes Third Review Under the PRGF Arrangement with Zambia and Approves US$ 81.2 Million Disbursement
December 14, 2009

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

December 3, 2009

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

Letter of Intent

December 3, 2009

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

Dear Mr. Strauss-Kahn,

The attached Memorandum of Economic and Financial Policies (MEFP) reviews recent economic developments and progress in implementing the Government of Zambia's macroeconomic and structural program under the country's three-year Poverty Reduction and Growth Facility (PRGF), approved by the IMF Executive Board on June 4, 2008. It also sets out macroeconomic policies and structural reforms that the government will pursue for the remainder of 2009, in 2010 and over the medium term.

All of the performance criteria for the third review under the PRGF were met. There was good progress overall in terms of structural reforms, though there were modest delays in the implementation of two of the structural benchmarks. The Government requests that the fourth disbursement be made available upon completion of the third review by the Executive Board of the IMF.

The Government believes that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of the program. Our economic program for the remainder of the year has been revised to take into account recent developments, and we request modifications to the end-December 2009 performance criteria on net domestic assets, net domestic financing, and gross international reserves. Given the Government's commitment to these objectives, it will promptly take any additional measures necessary for their achievement. The Government will consult with the IMF—at its own initiative or whenever the Managing Director of the IMF requests such a consultation—on the adoption of these measures and in advance of revisions to policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

The Government will provide the Fund with such information as the Fund may request in connection with the progress made in implementing the economic and financial policies and achieving the objectives of the program.

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

Yours sincerely,

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

Attachments (2)

ATTACHMENT I

Memorandum of Economic and Financial Policies

1. This memorandum reviews recent economic developments and outlines policies and targets that the Government of the Republic of Zambia will pursue for the remainder of 2009, in 2010, and in the medium-term under the Poverty Reduction and Growth Facility (PRGF) arrangement.

I: RECENT ECONOMIC DEVELOPMENTS

2. **The impact of the global financial crisis on the Zambian economy has been less severe than was expected earlier this year**. The projection for real GDP growth has been revised upwards to 5.3 percent for 2009, as a result of historically high growth in mining and agriculture. Copper prices, which had dropped rather sharply in the second half of 2008, recovered steadily during 2009, reducing the impact of the crisis on the mining sector, and the economy as a whole. Copper production reached thirty-year highs as a result of a large new mine commencing operations, while the agricultural harvest was the highest recorded in ten years. Notwithstanding the strong performance of the primary sector, overall growth has been offset by a sharp decline in tourism and a deceleration in other tertiary sectors. Accounting for increases from the SDR allocation and earlier augmentation under the PRGF, gross international reserves rose by US$714 million in 2009 to reach a projected US$1.74 billion at end-2009 (equivalent to 4.5 months of import cover). Whereas the kwacha depreciated sharply in the first half of the year, it subsequently recovered. The end-year inflation target of 10 percent is unlikely to be met as a result of somewhat persistent food inflation and a rise in energy prices. Inflation is currently projected to decline to 12 percent by end-2009.

3. **Fiscal developments have been characterized by a shortfall in tax collections and in pledged inflows from** cooperating **partners in 2009.** The shortfall in total revenues and grants relative to the program is projected to reach 0.8 percent of GDP by the end of the year. Significant declines in import-related tax collections, amounting to an estimated 1.3 percent of GDP, were the main contributing factor. Pledged cooperating partner resources amounting to US$60 million (0.5 percent of GDP) are yet to be disbursed, leading to further potential shortfalls. The government has committed to contain administrative expenditures to reduce budgetary pressures and protect the monetary program. Simultaneously, it is committed to safeguarding poverty reducing capital and social expenditures. As a result, the overall fiscal deficit is expected to widen marginally to 2.5 percent of GDP, supported by an increase in net domestic financing.

4. **The monetary program was in line with the program's targets for the year to June 2009.** This largely reflected the net sales of foreign exchange by the Bank of Zambia early in the year to dampen excessive volatility in the exchange rate on account of elevated

demand pressures. These demand pressures emanated from the continued effects of the global financial crisis on the domestic economy as well as bunched agricultural input and oil import requirements. Reserve money declined by 3 percent in the six-month period through June 2009, compared to the programmed decline of 13 percent. Consistent with the development in the monetary aggregates, credit to the private sector also slowed sharply from 50.2 percent annual growth in December 2008 to 34 percent growth in June as financial institutions continued to tighten lending standards as credit quality deteriorated. This deterioration was evidenced by an increase in non-performing loans in the banking system from 7.2 percent in December 2008 to 13.8 percent in September 2009.

5. **Having been impacted negatively by the global financial crisis in the first half of 2009, the balance of payments position is expected to improve in the second half of the year.** Imports contracted, as demand from households and firms responded to the movement in relative prices associated with the sharp depreciation of the exchange rate earlier in the year. The robust rebound in copper prices from the second quarter of 2009 will also contribute to the narrower current account deficit (including grants) of 4.7 percent of GDP in 2009 compared to 7.8 percent in 2008. The trade balance is expected to narrow to 1.3 percent of GDP in 2009 from 2.8 percent of GDP in 2008.

6. **The program was on track through the first half of 2009, with all of the quantitative performance criteria and indicative targets being met.** Two of the three structural benchmarks were met through end-June, with some delays occurring on the efforts to set up a supervisory regime for the secondary market in Government securities. This delay was due to the need to complete a wider consultation process in order to allow for effective implementation. The intention is now to put the framework for the secondary market in place by end-March 2010.

7. **Significant strides have been made in poverty reduction efforts, and Zambia is progressing well towards attaining its millennium development goals.** Revised data from the 2006 Living Conditions Monitoring Survey indicate that the proportion of Zambians living below the poverty line fell to 59.7 percent from 68 percent in 2004. While there has been significant progress in urban poverty reduction, the challenge for the government remains to tackle rural poverty and service delivery in the medium term. Data from the 2007 Zambian Demographic Health Survey has also shown significant reductions in maternal, infant, and child mortality rates, and in the incidence of major diseases. In addition, Zambia is well on track to meeting its millennium development goal of universal primary education.

II: MEDIUM-TERM MACROECONOMIC FRAMEWORK

8. **Economic growth is expected to strengthen over the medium term.** Real GDP growth is expected to rise marginally to 5.5 percent in 2010 and further to 6.5 percent over the medium term. Growth in 2010 will be driven by a recovery in the tertiary sector, and continued increases in mining and construction activities. Mines that had been closed down as a result of the crisis are expected to reopen in 2010, and a rebound in tourism activity is expected in connection with the 2010 Football World Cup in South Africa. Downside risks, however, still remain amidst uncertainties about a full-fledged global recovery in 2010 and steadily rising oil prices. Growth over the medium term is premised on the realization of policy initiatives and structural reforms aimed at economic diversification and enhanced competitiveness. Additionally, growth will be boosted by new investments in mining and electricity generation.

9. **The creation of fiscal space will continue to be an important goal of the government, in order to provide space for increased expenditures on infrastructure and social sector spending.** Despite a favorable medium-term outlook for economic growth, there are some near-term fiscal challenges relating to containing the rise of public service wage bill as well as reversing the decline in tax revenues as a proportion of GDP that has been experienced over the past few years. In addition, there will be some one-time outlays that will need to be financed, such as statutory expenditures relating to the national census and the forthcoming presidential elections in 2011.

10. **Over the medium term, mining and non-mining imports are expected to rise strongly as mines prepare to ramp up production in 2010 and beyond, foreign direct investment (FDI) inflows rebound, and economic growth gathers pace.** Furthermore, large new import-intensive infrastructure projects, particularly in the energy sector, will require sizable financing. In most of these projects, the Government is likely to have some equity participation in order to attract private sector investment.

III: POLICIES FOR 2010

A: Fiscal Policy

11. **Fiscal policy will continue to remain focused on supporting the government's diversification agenda.** Domestic revenues are expected to rise modestly to 15.7 percent of GDP, premised on tax administration gains and the introduction of some tax measures, such as the increase in the excise tax on diesel from 7 to 10 percent. Current expenditures will be curtailed by 1.2 percentage points of GDP, due to declines in cooperating partner support and in order to provide some fiscal space for capital spending which is expected to reach 4 percent of GDP. The overall fiscal deficit is expected to remain broadly unchanged at 2.4 percent of GDP, and domestic financing is expected to be about 2 percent of GDP. This

fiscal framework is consistent with the inflation target and provides reasonable scope for private sector credit growth.

12. **Strengthening revenue performance will be an important component in medium-term policy.** Income tax revenues have remained fairly steady over the years. While the mining tax regime has received significant attention in recent years, there is need to improve the performance of non-mining corporate tax collections. VAT collections are also a source of concern for the Government. In order to address these challenges, the Government will undertake a comprehensive review of tax policy and administration this year, drawing on past and prospective IMF technical assistance (structural benchmark for end-September 2010).

13. **Tax administration reforms are expected to continue, following the successful completion of the first phase of implementation.** Work is underway to further register the medium and small taxpayer population, re-engineer business processes, institute new systems and to reform tax administration legislation. Data quality continues to be a challenge in that it limits the evaluation of the effectiveness of the recently launched Large Taxpayer Office (LTO), and also delays the establishment of Medium and Small Taxpayer Offices (MSTOs). The implementation of a new information communications technology (ICT) system and the legislation reform are among the key components of the modernization of the ZRA in the near term.

14. **The high and increasing cost of personal emoluments as a proportion of domestically generated revenues are another source of concern in the medium-term.** Wages and salaries currently account for slightly over 50 percent of domestic revenues, which has curtailed fiscal space for infrastructure spending. The government, cognizant of the need to curb this trend, undertook a review of pay policy and the recommendations of this review are being considered. It is expected that a new performance based pay policy will be approved in 2010 (structural benchmark for end-June 2010), and implemented over the medium term. This reform will go hand-in-hand with the right-sizing exercise, as well as the payroll management and establishment control (PMEC), which has been rolled out to all provinces and will be extended to ministries during 2010.

B: Monetary and Exchange Rate Policies

15. **The global financial and economic crisis and the commodity price shocks of 2008 have provided an important stress test for Zambia's monetary policy framework.** These shocks increased inflation beyond single digits and created a more volatile exchange rate. However, the maintenance of a flexible exchange rate regime and the implementation of a monetary program that provided the Bank of Zambia with the flexibility to intervene in the foreign exchange market to address excess volatility enabled the Zambian economy to adjust

to the external shocks, particularly the decline in copper prices. This has helped in preserving a viable external sector over the medium-term.

16. **The crisis also exposed the fragile nature of Zambia's financial markets**, as price adjustments were volatile over an extended period of time and the market for primary auctions of government securities came under stress. The reversal of short term capital flows also proved disruptive, despite a level of foreign exchange reserves that was more than adequate to meet these outflows.

17. **Looking ahead, monetary policy will aim to restore inflation to single digits in 2010, and to strengthen the framework that minimizes exchange rate volatility without targeting the level of the exchange rate**. The government and the Bank of Zambia will aim to reduce inflation to 8 percent by end-2010 and aim to contain reserve money growth to 19 percent over the same period. After several years of rapid private sector credit expansion, domestic credit is projected to moderate to 20 percent in 2010.

18. **The Bank of Zambia is actively reviewing its monetary policy framework, with a view to shift to using interest rates as the main instrument to anchor inflationary expectations.** This could help better entrench the goal of singe-digit inflation. To this end, work is underway on the institutional, analytical, and communication elements that would be necessary.

19. **The Government will continue to maintain a fully flexible exchange rate regime**. Interventions in the foreign exchange market by the Bank of Zambia will be limited to the smoothing of fluctuations, while allowing for a gradual buildup of international reserves. We welcome the recent SDR allocation of US$627 million from the IMF, the bulk of which we intend to keep as international reserves.

20. **In an effort to improve the efficiency of public debt, the Government is considering a restructuring of public debt to reduce costly domestic borrowing and increase concessional external financing.** Domestic debt dominates the current public debt portfolio, and has served as an expensive source of development financing for Zambia. While remaining fully respectful of debt sustainability indicators, the Government is actively examining the possibility of redeeming domestic debt securities, financed through a drawdown in reserves. It is expected that this portfolio swap will lead to lower debt service burdens, and create additional room for private sector credit through lower government borrowing in domestic markets. By reducing government demand for domestic debt, lower interest rate spreads are also expected. Such an arrangement would be undertaken within the agreed monetary framework for 2010.

C: Structural Policies

Public Financial Management

21. **Considerable progress has been made in implementing public financial management reforms.** After consultation with stakeholders, the government has altered its budget cycle to ensure parliamentary approval of the budget in advance of the fiscal year. This is expected to improve budget execution and the legislature's participation in the budgeting process. In addition, the government is expected to introduce a planning and budgeting act in 2010 in order to clearly define the budgeting process and key deliverables by the government as part of the budget (structural benchmark for end-June 2010).

22. **The government is in the advanced stages of finalizing its implementation strategy for the establishment of a Treasury Single Account** (TSA)**.** A draft strategy was approved in early 2009 and various modalities of implementation have now been addressed. The implementation will commence with trial runs at the Ministry of Finance and National Planning, followed by a full pilot in early 2010, with other Ministries, Provinces, and Spending Agencies (MPSAs) being added to the pilot in due course. The full introduction of the Treasury Single Account will be phased, commencing in 2010 when six MPSAs will adopt the TSA (structural benchmark for end-December 2010), and all MPSAs expected to use the TSA subsequently.

23. **The implementation of the integrated financial management information system (IFMIS) will gather significant momentum in 2010, with the first full pilot commencing in January 2010.** Comprising of thirteen technology modules, the IFMIS project will create substantial efficiencies across government institutions, providing for greater financial information flows and improved accountability and control. The first pilot site will be the Ministry of Finance and National Planning, which will operate all thirteen modules starting in January 2010. Over the course of the year, additional MPSAs will be included, with a full rollout expected by end-2011.

Financial Sector Development

24. **The government remains committed to a comprehensive and inclusive mechanism of developing the financial sector through the implementation of the second phase of the Financial Sector Development Plan (FSDP II).** The successful implementation of the FSDP II is expected to: (i) support the achievement of low and stable inflation by enhancing the efficiency of monetary policy; (ii) strengthen the supervision of the financial sector and build its resilience to system shocks; (iii) continue to develop the payment system; (iv) enhance the secondary market trading for government securities and corporate debt; and (v) promote financial inclusiveness. The objectives of the FSDP will be to improve access to credit, as well as reduce the high cost of borrowing.

25. **In order to enhance the efficiency of monetary policy, an overnight lending facility will be introduced by end-November 2009.** It is anticipated that the introduction of this facility will provide for lower volatility in short term interest rates as well as an easing of structural rigidities relating to market segmentation amongst financial institutions.

26. **The Bank of Zambia will also revise the lender of last resort policy to align it with accepted international standards and ensure that it remains effective and relevant.** In addition, a financial sector contingency plan will be drafted to address the impact of a system-wide crisis in the financial sector and broader economy (structural benchmark for end-December 2010).

Energy

27. **The government remains committed to addressing medium-term capacity constraints in electricity generation.** While the completion of rehabilitation projects by the public utility ZESCO has improved the reliability of electricity supply, the medium-term focus remains to increase generating capacity through the commissioning of new generation projects. Commencing in 2009, a multi-year tariff framework was announced to raise electricity tariffs to cost-recovery levels by 2011. A first adjustment of 35 percent has been implemented in 2009 and concurrently an indicative increase of 26 percent was announced for 2010. The exact percentage of the next increase will be announced after statutory public consultation (structural benchmark for end-June 2010). Efforts are under way to improve the efficiency and effectiveness of the utility. Plans to expand the installation of pre-paid electricity meters across the country are progressing, and performance on the key performance indicators[1] is expected to improve in 2010.

28. **Several sizable electricity generation projects are underway or are being considered.** Work has commenced at the Kariba North Bank extension project, which will add 360 MW of additional capacity in the medium term. In addition, the government is close to finalizing technical discussions and will soon commence financial negotiations for the Kafue Gorge Lower (KGL) project, which is expected to add another 600-750 MW of capacity by 2017. Given the size of the KGL project, expected to be one of the continent's largest public private partnerships in the electricity generation sector, the government may have to contract new non-concessional external financing. It is now expected that this non-concessional financing will be undertaken in 2010.

[1] Each quarter, ZESCO reports on its performance of select indicators that are specified by the Energy Regulation Board. These Key Performance Indicators (KPIs) are used as part of the tariff review process to ensure that any tariff awards are measured against performance by the public utility.

Debt and Aid Management

29. **The government is committed to improving public debt management**. The debt management 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 have been supported by technical assistance from the IMF and World Bank.

30. **There is a growing demand for resources to finance large infrastructure projects of high economic return in Zambia.** Given the constraints of limited concessional financing, the government has moved to develop a Public Private Partnership (PPP) framework through which the private sector can be engaged to participate in the process of national development. In certain cases, however, it may be necessary for the government to participate as an equity partner in such projects. In order to engage in these infrastructure initiatives, the there may be a need to raise non-concessional debt to finance such participation. Any such need would be measured against the economic return of such projects (after consulting with the World Bank or other relevant institutions, and only high quality projects yielding substantially high economic returns will be candidates for such financing. The government expects that such financing needs shall be considered for inclusion into the program on a case-by-case basis.

31. **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, a closer dialogue between cooperating partners, the Ministry of Finance and National Planning, and the Bank of Zambia is being facilitated. The government is committed to addressing concerns that cooperating partners may have on governance issues that may hold back the disbursement of donor funds, as agreed under the Poverty Reduction Budget Support Memorandum of Understanding with cooperating partners.

Economic Statistics

32. **Improving Zambia's statistical data collection and dissemination, particularly with regard to the quality of national accounts and consumer price data, will be a priority for the Government in 2010.** Resources will be made available to finalize the economic census, which began in 2008, with the aim to rebase national accounts from the current 1994 base year. Simultaneously, there will be a comprehensive review of methodologies that are used to calculate national accounts, with the aim to align them to best

practices. A corresponding rebasing exercise is needed for the consumer price index. The government is also working with cooperating partners to finalize the 2006 Living Conditions Monitoring Survey, and to undertake a full national census of population in 2010.

IV: Program Monitoring

33. **Semi-annual disbursements under the PRGF arrangement will be based on the observance of quantitative performance criteria.** Completion of the fourth and fifth reviews of the arrangement will be based on the observance of quantitative performance criteria through end-December 2009 and end-June 2010, respectively (Tables 1 and 2). The fourth review is expected to be completed by June 2010 and the fifth and sixth reviews are expected to be completed, respectively, by end-November 2010 and end-May 2011.

MEFP Table 1. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets, 2009[1]
(Billions of kwacha, unless otherwise indicated)

	2008	2009						
	Dec	June			September		December	
	Level	Prog.	Act.	Status	Indicative	Est.	Prog.	Rev. Prog.
Performance criteria:								
Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia[2,3]	-1,449	397	515	Met	642	658	965	1670
Adjusted ceiling		542						
Ceiling on the cumulative increase in net domestic financing (NDF)[2]	5,291	447	35	Met	844	622	1,170	1,443
Adjusted ceiling		605						
Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars)[2,4]	976	44	16	Met	29	634	100	714
Adjusted floor		14						
Ceiling on new external payment arrears[5]	0	0	0	Met	0	0	0	0
Ceiling on short-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars)[5,6]	…	0	0	Met	0	0	0	0
Ceiling on medium- and long-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars)[6]								
Electricity projects	0	400	0	Met	400	0	400	400
Other sectors	0	0	0	Met	0	0	0	0
Indicative targets:								
Floor on the cumulative payment of domestic arrears BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars)[6]		161	199	Met	264	…	352	352
Cumulative increase in reserve money	3,211	-60	-92	Met	112	…	450	610
Memorandum items:								
Cumulative net budget support (U.S. dollars, unless otherwise specified)	142	110	80		126	…	106	160
General budget support up to allowed limits	203	110	80		201	…	201	212
Central Government debt service obligations (excl. IMF)	-61	0	0		-75	…	-95	-52
Domestically financed capital expenditure	1271	…	…		…	…	…	1810
Program exchange rate (Kwacha per U.S. dollar)	4,832.3	4,832.3	…		4,832.3	4,832.3	4,832.3	4,832.3

Sources:

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

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

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

[4] Reserves are calculated at program exchange rates.

[5] Continuous performance criteria.

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

MEFP Table 2. Zambia: Quantitative Performance Criteria (PC) and Indicative Targets, 2010[1]
(Billions of kwacha, unless otherwise indicated)

	2009	2010			
	Dec	Mar	Jun	Sep	Dec
	Proj. Stock	Indicative	Prog.	Indicative	Indicative
Performance criteria:					
Ceiling on the cumulative increase in net domestic assets (NDA) of the Bank of Zambia[2,3]	221	405	376	663	773
Adjusted ceiling					
Ceiling on the cumulative increase in net domestic financing (NDF)2	6,734	321	735	1,211	1,487
Floor on the cumulative increase in gross international reserves (GIR) of the Bank of Zambia (Millions of U.S. dollars)[2,4]	1,690	-2	71	45	80
Ceiling on new external payment arrears[5]	0	0	0	0	0
Ceiling on short-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars)[5,6]	…	0	0	0	0
Ceiling on medium- and long-term external debt and on contracting or guaranteeing of nonconcessional debt by central government, BoZ, and ZESCO, ZAMTEL, and Zambia Railways Limited (millions of U.S. dollars)[6]					
Electricity projects[7]	…	600	600	600	600
Indicative targets (cumulative):					
Floor on payment of domestic arrears of the government	…	59	153	157	269
Increase in reserve money	3,821	239	415	584	726
Floor on social spending by the government of Zambia	…	930	1,875	2,838	3,938
Memorandum items:					
Cumulative net budget support (U.S. dollars)		61	133	123	140
General budget support up to allowed limits		78	160	174	194
Central Government debt service obligations (excl. IMF)	…	-17	-26	-51	-54
Program exchange rate (Kwacha per U.S. dollar)	4,832	4,622	4,622	4,622	4,622

Sources:

1 The definitions of the items in the quantitative program are contained in the Technical Memorandum of Understanding (TMU)
2 Adjustors, including for general budget support, are defined in the TMU.
3 The ceiling will be adjusted for changes in the legal reserve requirements as specified in the TMU.
4 Reserves are calculated at program exchange rates.
5 Continuous performance criteria.
6 Nonconcessional loans are those having a grant element of less than 35 percent.
7 The projects are: Kariba North bank extension, Itezhi-Tehzi power station, Kafue Gorge Lower.

Table 3 MEFP. Zambia: Structural Benchmarks for 2009

Measure	Timing	Macro Rationale	Status
Prepare a comprehensive strategy for phased implementation of the establishment of the treasury single account system.	End-June 2009	Strengthen public expenditure management and budget execution. In particular, the measures will improve cash flow management and forecasts and thereby contribute to improved fiscal and monetary policy coordination.	Met
Approval by Cabinet of all necessary amendments to the Public Finance Management Act specifying the general principles of the treasury single account system.	End-September 2009		Met
Set up a supervisory regime for the secondary market in government securities.	End-June 2009	Financial sector deepening which is vital to achieving the growth objectives of the program.	Not met -- Reset to end-March 2010
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.	Met with delay (December 1, 2009)
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.	Met

Source: Zambian authorities and IMF staff estimates.

Table 4 MEFP Zambia: Structural Benchmarks for 2010

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

Source: Zambian authorities and IMF staff estimates.

ATTACHMENT II. TMU

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 4,622.0 per U.S. dollar for 2010.[1] Net foreign assets of the BoZ are defined as gross international reserves (defined in paragraph 8) plus any other foreign assets, including US$120 million encumbered reserves at end-December 2009, 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.

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

[1] Unless otherwise defined, program exchange rates for 2010 between the U.S. dollar and other (non-kwacha) currencies will be equal to the end-December 2009 values. The U.S. dollar/SDR rate for program purposes is 1.557 for 2010. All other assets (e.g. gold) would be revalued at their end-December 2009 market prices for 2010.

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 (5th edition) and elaborated in the reserve template of the IMF's special data dissemination standards (SDDS). They exclude, for example, foreign assets not readily available to or controlled by the monetary authorities, and foreign currency claims on Zambian residents.

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-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.

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[2] The Central Government includes all the administrations identified by the budget heads listed in the Yellow Book for 2010.

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, since the beginning of the calendar year. 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 EBS/08/53), 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, incurred since the beginning of the calendar year.

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.

H. Floor on Social Spending

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

III. Adjusters

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

General budget support (GBS) net of debt 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]

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[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.

(a) The total adjustment for shortfalls will be limited to US$30 million for January-June and US$60 million for January-December 2009.

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

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

Change in reserve requirements

(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).

Domestically-financed capital expenditure

(vii) The ceilings on NDA and NDF in 2009 will be adjusted downwards by the full amount of the shortfall in domestically-financed capital expenditure relative to the programmed levels specified in Table 1 of the MEFP.

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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.