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Zambia: Ex Post Assessment of Longer-Term Program Engagement—Update

This Ex Post Assessment of Longer-Term Program Engagement on Zambia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on May 31, 2011. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Zambia or the Executive Board of the IMF.

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ZAMBIA

Ex Post Assessment of Longer-Term Program Engagement—Update

Prepared by an Inter-Departmental Staff Team[1]

Approved by the African Department and the Strategy, Policy, and Review Department

June 6, 2011

Key Messages

- Following the guidance in *Ex Post of Members with a Longer-Term Engagement—Revised Guidance Note*, this EPA Update focuses on: (a) whether staff drew on lessons of Zambia's 2004 EPA in designing more recent programs; (b) Zambia's macro economic performance and program results; and (c) priority areas for any future Fund-supported program.
- Strong macroeconomic performance since 2004 reflects both positive terms of trade and improved—if at times uneven—macroeconomic, financial, and structural policy implementation. Drawing on the lessons of the 2004 EPA contributed to the broad success of the more recent Fund-supported programs.
- Zambia should consolidate this performance with a well-articulated medium-term economic program leading to greater economic resilience and to strong poverty reduction and growth. The Fund could support such a medium-term program, with the choice of instrument depending on economic circumstances.
- A stable, sustainable macroeconomic position must be the foundation of an effective medium-term program. This EPA Update elaborates four additional policy themes important to building economic resilience and promoting growth:
    - Laying the groundwork to sustain low inflation
    - Increasing effective investment in public infrastructure
    - Mobilizing domestic revenues
    - Developing the financial sector
- This EPA Update was discussed with the Zambian authorities, whose views are presented in Appendix I.

[1] The team comprised Sarwat Jahan (SPR), Nils Maehle (AFR), and Brad McDonald (SPR, head).

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I. Introduction

1. **Since the 2004 EPA (IMF Country Report No. 04/214), Zambia has had two Extended Credit Facility (ECF)[2] arrangements under the IMF's Poverty Reduction and Growth Trust (PRGT).** The first (ECF-1) was in place from June 2004 to September 2007 and the second (ECF-2), approved in June 2008, is scheduled to expire in June 2011. Although problems in program implementation occasionally emerged, including with misreporting,[3] program reviews have been concluded on schedule or with only minor delays. During this period Zambia also received debt relief of about US$3½ billion under the HIPC Initiative, reaching the completion point in 2005, and additional relief of US$3 billion under the MDRI in 2006.

2. **This report covers:**[4]

- Zambia's macroeconomic performance under Fund-supported programs,
- Whether and how staff drew on lessons identified in the first EPA, and
- Priority areas for any future program.

The first two topics are closely related and are covered in Section II. Section III presents four themes for any future program that—pursued together with policies to ensure continued macroeconomic stability—would support greater economic resilience and more rapid growth.

II. Drawing on Priorities of the 2004 EPA Contributed to Macro Performance

3. **The 2004 EPA highlighted that, despite improved economic growth, poverty in Zambia remained "formidable."** The EPA identified several priority areas important to macroeconomic stability and enhanced medium-term growth and poverty reduction. The strategy of the medium-term programs launched in 2004 and 2008 (ECF-1 and ECF-2) closely reflected the EPA lessons and drew on the priority areas, with the support of IMF technical assistance (TA) (¶ 9). Several aspects brought clear success and help to

Priority Areas from the 2004 EPA

- Fiscal consolidation to reduce real interest rates and promote private domestic investment
- Limiting the wage bill to facilitate poverty-reducing spending and public infrastructure
- Upgrading public expenditure management
- Attracting more donor support with improved program implementation
- Stronger budget processes to improve governance
- A consistent policy for mining and tax exemptions
- Completing the privatization program
- Financial sector development

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[2] Formerly the Poverty Reduction and Growth Facility (PRGF).

[3] Two misreporting episodes came to light during ECF-2. Nonconcessional debt at end-2009 was slightly larger than reported originally; this was treated under the Fund's *de minimis* procedures (See IMF Country Report No. 10/383). Government net domestic financing at end-2009 was larger than reported originally, leading to a breach of that ceiling; this matter is now being addressed. The need for improved debt management is cited in Section III.

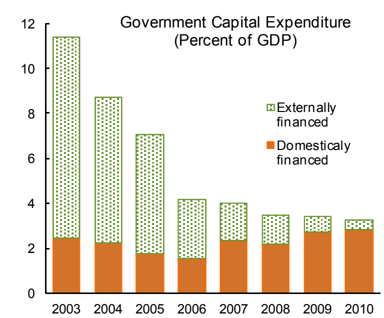
[4] Guidance on the coverage of EPA updates is presented in paragraph 8 of *Ex Post Assessments of Members with a Longer-Term Program Engagement—Revised Guidance Note*.

explain the strong economic performance during 2004-10. However, less progress in areas such as expenditure management and infrastructure development, the tax regime, and financial sector development have meant that Zambia's growth is not yet entrenched, benefits are narrowly shared, and the economy remains relatively concentrated and vulnerable. This leaves the authorities an important medium-term agenda, key elements of which are presented in Section III.

4. **ECF-1 (2004-7) called for fiscal consolidation to contain the domestic debt and interest payments that jeopardized macro stability and social spending.** As tax revenue performance was then considered strong, the focus was on limiting the wage bill and avoiding unplanned expenditures. Although issues in budget execution persisted, the fiscal discipline and reduced resort to domestic financing fostered price stability, particularly as the authorities became more adept at sterilizing inflows associated with high copper prices. Program conditionality was largely adhered to (Appendix Tables 1 and 3), and economic performance during this period was strong: growth and international reserves improved more quickly than anticipated; inflation declined; and government spending—including on wages and salaries—was contained (Figure 1). Government capital spending fell sharply, however, largely because of a sharp drop in project aid.

5. **The strategy of ECF-2 (2008-11) emphasized more strongly medium-term growth, with diversification to make this growth more broad-based and resilient.** Macroeconomic policies were to be geared toward creating space to increase spending on infrastructure and human resources by strengthening revenues. Reflecting the 2004 EPA priorities, this would be done in part by a new fiscal regime for mining and a more consistent approach toward tax exemptions. Improved budget and expenditure management and public procurement reform would enhance spending efficiency and encourage donor support.

6. **Macroeconomic outcomes during ECF-2 were particularly strong.** Growth increased further and reserves, supported by very strong copper prices, increased markedly. The wage bill and total expenditures were lower than initially projected; however, grants and revenues were also well below projections (in part due to the import compression following the global financial crisis). Thus, capital expenditures—rather than recovering—declined further. Inflation was higher than initially targeted (in part due to surges in food and fuel prices), and higher than in other African LICs (reflecting higher-than-targeted money growth and a high inflation legacy), and scope remains to improve monetary management. Financial sector reforms enhanced stability, including by addressing issues regarding insolvent non-bank financial institutions and by strengthening the Bank of Zambia's regulatory and supervisory functions.



Source: Zambian authorities.

Broad Money Forecasts and Outturns for Zambia, 2005-10
(Percent change)

	2005	2006	2007	2008	2009	2010
Forecast[1]	18.2	14.3	13.6	12.4	15.6	19.3
Outturn	3.3	44.0	25.3	23.2	7.7	29.9

Source: IMF staff estimates.
[1] One-year-ahead projections based on September/October WEO.

7. **The global financial crisis significantly affected Zambia through a sharp, but relatively brief, fall in copper prices.** Exchange rate appreciation partially offset the surge in food and fuel prices in 2008. The program responded to these shocks by augmenting access and adjusting targets: the 2007 inflation target was increased to take account of the first-round effects of higher food and fuel prices, while monetary and fiscal policies were loosened during 2009 to stimulate activity.

Zambia: 2004-07 ECF Program Performance: Targets[1] and Outcomes
(Percent of GDP unless otherwise indicated)

	2004		2005		2006		2007	
	Int. target	Act.	Int. target	Act.	Int. target	Act.	Int. target	Act.
Real GDP (percent change)	3.5	5.4	4.5	5.3	5.0	6.2	5.0	6.2
CPI, eop (percent change)	20.0	17.5	15.0	15.9	10.0	8.2	5.0	8.9
Reserves (months of imports)	1.0	1.1	1.5	1.5	1.7	2.2	1.9	2.5
Revenues	18.7	18.2	18.6	17.6	18.6	17.1	18.6	18.4
Overall balance (excluding grants)	-8.6	-8.4	-9.8	-3.4	-9.3	-5.4	-9.3	-4.8
Grants (excl. debt relief)	5.4	5.5	6.6	2.0	6.9	4.3	7.0	4.6
Total expenditure	27.3	26.6	28.4	21.0	27.9	22.5	28.0	23.2
Capital expenditure	9.2	8.7	10.0	2.4	10.5	3.8	11.5	4.4
Wages and salaries	7.9	7.7	7.9	7.9	7.9	7.4	7.7	7.8
Domestic financing (net)	2.2	-0.1	1.2	1.4	0.9	2.0	0.5	-0.1

Source: Zambian authorities and staff estimates.
1/ Program targets for 2004-07 are based on the request for three-year arrangement under the ECF (EBS/04/70).

Zambia: 2008-11 ECF Program Performance: Targets[1] and Outcomes
(Percent of GDP unless otherwise indicated)

	2008		2009		2010	
	Int. target	Act.	Int. target	Act.	Int. target	Act.
Real GDP (percent change)	6.2	5.7	6.3	6.4	6.5	7.6
CPI, eop (percent change)	7.0	16.6	5.0	9.9	5.0	7.9
Reserves (months of imports)	3.2	2.1	4.7	5.1	5.5	4.0
Revenues	21.2	18.9	22.1	16.0	21.5	17.8
Overall balance (excluding grants)	-6.5	-5.0	-4.5	-5.5	-5.0	-4.9
Grants (excl. debt relief)	5.3	4.1	5.4	2.9	5.3	1.8
Total expenditure	27.6	23.9	26.7	21.4	26.4	22.7
Capital expenditure	5.2	4.0	5.8	3.7	6.8	4.5
Wages and salaries	8.4	8.1	8.6	8.2	8.7	8.1
Domestic financing (net)	-0.1	1.2	-1.5	2.6	-0.9	3.0

Source: Zambian authorities and staff estimates.
1/ Program targets for 2008-10 are based on the request for three-year arrangement under the ECF (EBS/08/53).

8. **Despite strong growth and the overall success of Zambia's 2004-11 Fund-supported programs, extreme poverty remains high.** Information is incomplete, but while urban poverty declined markedly it appears that rural poverty declined only modestly. This may reflect the concentration of growth in highly capital-intensive or urban-based sectors like mining, construction and services, while per capita agricultural growth—a key factor for the rural population—lagged. Agriculture growth picked up in 2008-10, but policies that kept maize prices artificially high disadvantaged the urban poor and the one third of smallholders that are net buyers of maize.

Zambia: Selected Poverty and Income Indicators

	1998	2006	2009	2010
Incidence of extreme poverty	58	51		
Rural	71	67		
Urban	36	20		
Primary school enrollment (%)[1]	69	94	97	
Mortality rate, under-5 (per 1,000)[1]	166	155	141	
Unemployment (% of labor force)[2]		16	15	
Rural			6	
Urban			33	
Informal sector employment (% of total)			90	
Rural			96	
Urban			75	
Real income per capita (US$, 2010 prices)				
Gross domestic product	845	992	1027	1221
Gross national income	791	884	994	1079

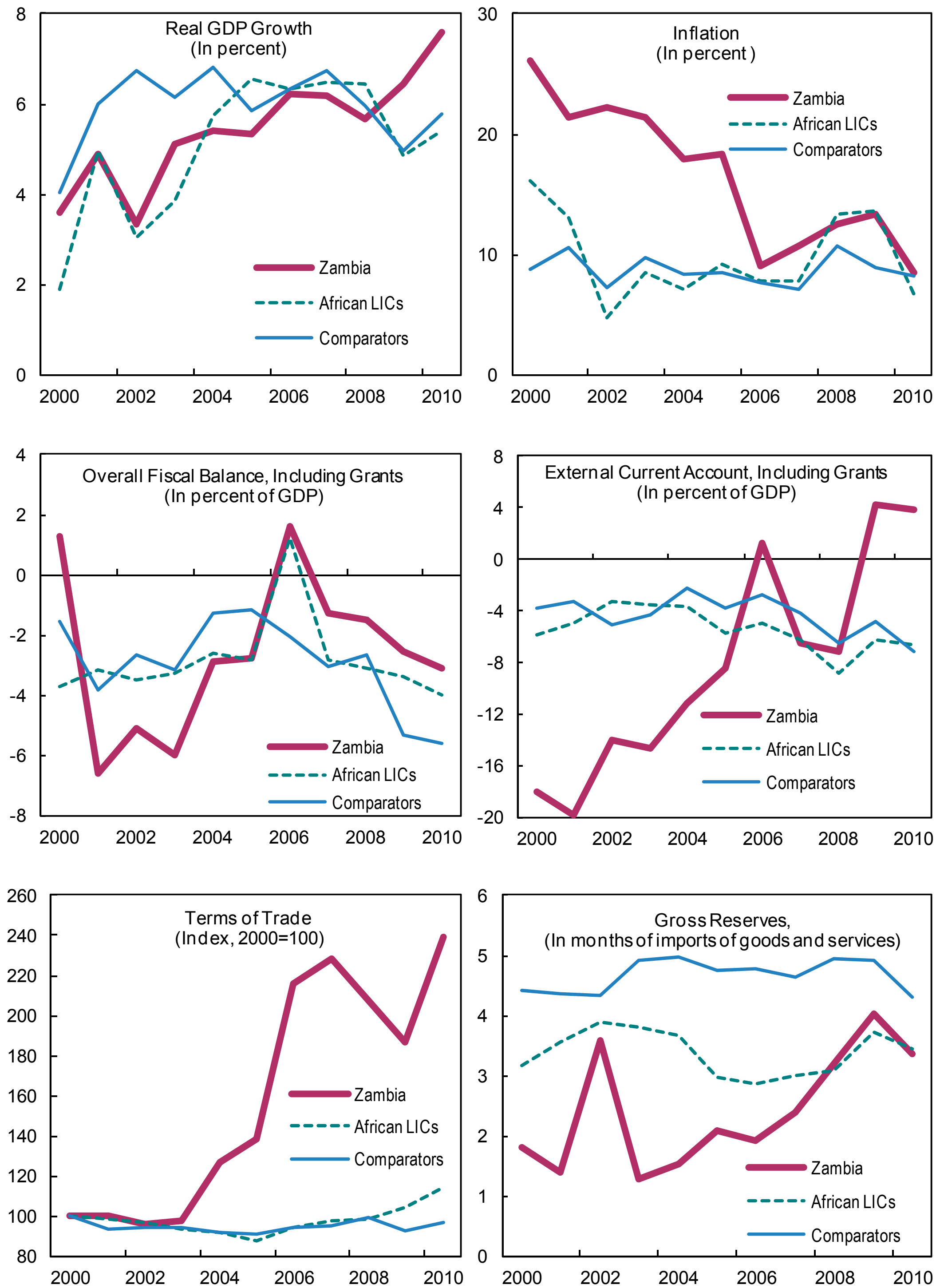
Sources: Zambia CSO, World Bank WDI, and IMF staff calculations.
[1] 2000, 2005, and 2009 respectively.
[2] 2005 and 2008 respectively.

Zambia: Per Capita GDP Volume Growth
(Percentage change)

	2000-03	2004-07	2008-10
GDP at market prices	2.2	3.8	4.6
GDP excluding mining sector	1.9	3.6	4.0
Agriculture, forestry, and fishing	-1.4	-0.3	3.5
Mining and quarrying	6.4	6.2	10.5
Manufacturing	3.2	2.1	0.8
Electricity, gas, and water	0.3	1.9	2.4
Construction	12.1	16.8	6.7
Services	1.7	3.0	4.2
Memo			
Sub-Saharan Africa	3.0	4.6	2.2
African LICs	0.8	3.6	2.8
Non-fragile African LICs	1.6	4.4	3.3
Comparators	2.9	4.0	3.2

Source: Zambia Central Statistical Office.
[1]Non-fragile African LICs are: Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Madagascar, Malaw i, Mali, Mozambique,Niger, Rw anda, Senegal, Tanzania, Uganda, and Zambia.
[2] Comparator countries are: Ghana, Kenya, Mauritius, Mozambique, Nigeria, Senegal, Tanzania,and Uganda.

Figure 1. Zambia: Cross Country Comparison, 2000–10 /1



Sources: IMF, African Department database, April, 2011; and World Economic Outlook (WEO) database April, 2011.

1/ Comparators countries are: Ghana, Kenya, Mauritius, Mozambique, Nigeria, Senegal, Tanzania, and Uganda.

III. Priority Areas for Any Future Program Engagement

9. **Zambia's key challenges resemble those of other LICs** (IMF staff, 2010)**.** Economic growth, although improved, has not reached the levels needed to attain the Millennium Development Goals (MDGs), nor adequately benefitted the areas and sectors where the poor are most numerous. And despite weathering quite well the recent global financial crisis, Zambia can do more to reduce vulnerabilities to future shocks. Reflecting both unfinished areas from the 2004 EPA (Section II) and some new issues, the authorities should give particular attention to four key challenges: (i) sustain the recently achieved low to moderate levels of inflation, (ii) reverse declines in capital spending and strengthen public infrastructure, (iii) mobilize domestic revenues, an area where Zambia has begun to lag comparator countries, and (iv) build on progress since the 2004 EPA to further develop the financial sector. The agenda for public financial management (where improvements are needed to support infrastructure development) and the tax regime can draw from TA already delivered by the IMF and other providers.[5]

A. Laying the Groundwork to Sustain Low Inflation

10. **Having achieved single-digit inflation, Zambia will need to consider how best to manage monetary policy in a low to moderate inflation environment.** Under the authorities' current regime, based on monetary targeting and exchange rate flexibility, monetary and fiscal restraint successfully reduced inflation. With lower inflation, however, exogenous shocks become relatively more important and the short-term trade-offs between price, output, and exchange rate stability become more difficult. Transitioning toward a monetary framework that best suits this environment is on the agenda throughout the region (IMF, 2008).

11. **The Zambian authorities plan to reform their monetary policy framework.** They are considering a gradual shift from strict monetary targets to a framework that would use interest rates as the main instrument to anchor inflationary expectations, perhaps leading eventually to an explicit inflation targeting (IT) regime. While inflation has been reduced under the current framework, the authorities remain concerned about persistently high bank lending rates. Inflation has also been higher than targeted, and highly volatile.

12. **Tailoring the monetary policy framework to Zambia's circumstances involves several considerations.** Responding appropriately to exogenous shocks will require greater monetary policy flexibility, increased reliance on multiple indicators and forward-looking

[5] The IMF has fielded several recent TA missions in the areas of tax policy, revenue administration, and public financial management. The pace of implementation has at times been affected by capacity limitations, political will, and, occasionally, differences of views.

structural analytical models, and a clear understanding of the transmission mechanism.[6] An appropriate policy framework lies on a continuum from strict adherence to intermediate targets to the constrained flexibility associated with formal inflation targets. In the middle are regimes that incorporate elements from both ends, many of which can be described as "IT-lite" (Stone, 2003). Structural characteristics influence this choice, and any shift in monetary arrangements should recognize that Zambia still has several structural characteristics that make some degree of money targeting desirable. These include (i) relatively larger fiscal and real economy shocks, including volatile terms of trade,[7] (ii) a remaining risk of fiscal dominance, (iii) still-developing central bank capacity, and (iv) thin financial markets and a relatively weak role for interest rates in the transmission channel.

13. **Several policy actions are needed to prepare Zambia for a shift toward more flexible monetary arrangements.** High central bank credibility is important in any regime, but particularly critical in the transition to more flexible arrangements. To build and maintain high credibility, conflicting monetary policy goals (e.g., low lending rates and price stability) must be avoided and clarity provided in policy objectives, operational frameworks, and communication strategies. Zambia's legacy of high inflation may still influence expectations and could also undermine credibility. In monetary operations, Zambia needs to avoid central bank financing of the budget and unplanned reserve accumulations that are unsterilized, which have led to volatile and excessive money growth; the resulting high and volatile excess reserves have weakened control over the money supply (Saxegaard, 2006). Financial sector deepening (see below) would enhance the effectiveness of monetary policy, particularly through the credit and interest rate channels. Without complementary actions in areas such as these, moving to more flexible monetary policy arrangements could jeopardize the attainment of price stability objectives and sacrifice hard-won policy credibility.

Laying the groundwork for enhanced monetary flexibility

- Ensuring high central bank credibility
- Liquidity management, fiscal-monetary coordination, and data sharing
- Improved interbank money markets to reduce interest rate volatility and the holding of excess reserves
- Financial sector development to strengthen the interest rate and credit channels of monetary transmission
- Increased capacity for modeling and inflation monitoring
- Enhanced central bank communications
- High frequency economic statistics

B. Infrastructure Development Presents Twin Challenges

14. **Low income countries require greatly enhanced public infrastructure to achieve sustained faster economic growth with economic resilience** (IMF and World Bank, 2011)**.** By increasing the stock and quality of their infrastructure to that of Mauritius, for example, it

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[6] Baldini and others, 2011; Berg and others, 2010; Peiris and Saxegaard, 2007.

[7] The advantages of money targeting versus interest targeting depend on the type of shocks faced (Poole, 1970; Berg and others, 2010).

is estimated that Sub-Saharan LICs could raise annual per capita income growth by 2 percentage points (Calderon, 2009). In Zambia, foreign-financed infrastructure spending has declined sharply, and domestic capital spending has consistently fallen short of plans (see chart in Section II)—perhaps contributing to rather narrowly-focused growth (paragraph 8). Scaling up infrastructure presents two key challenges: investing efficiently, and financing that investment in a manner that does not undermine debt sustainability.

15. **All countries face obstacles to efficient public investment, but in LICs these are a key constraint to growth.** As one observer has noted: "In these economies, development is fundamentally about raising the capacity to invest productively" (Collier, 2010). Strong operational frameworks are needed to translate public investment spending into effective capital accumulation. For public infrastructure, this requires strategic guidance to inform sector-level decisions; independent review and analysis of project feasibility; and transparent, effective processes for project selection, budgeting, implementation, project evaluation, and audit (Rajaram and others, 2010). While Zambia scores above many other LICs, a recent index of public investment management (PIM) indicates that much scope exists to improve the PIM process (Dabla-Norris and others, 2011); for Zambia, project appraisal capacity has been a particular concern. The two recent Fund-supported programs have promoted broader public financial management (PFM) reforms, but implementation has lagged and weaknesses continue to inhibit spending efficiency. Episodes of misappropriation of donor funds at the Ministry of Health and a range of discrepancies at the Road Development Agency have also discouraged some donors from participating in projects; governance reforms are underway in those areas.

16. **Sustainable financing is the second key challenge in infrastructure development.** Although strong macroeconomic performance and debt relief have returned Zambia's external debt to sustainable levels, Zambia, like other LICs, faces huge financing requirements and a need for large-scale grants and highly concessional loans. With only low debt vulnerabilities, however, Zambia can finance productive investments on market terms, within the limits of a sound debt management strategy. Further developing that strategy and supporting it with improved debt management is critical to infrastructure development.

C. Mobilizing Domestic Revenues

17. **Many LICs face continued needs for social spending, the possibility of reduced aid, and large financing needs for infrastructure and to address climate change** (IMF staff, 2010). Tax system reform to mobilize domestic revenues is critical to meeting these needs. Its design should consider tax fairness, how various taxes affect efficiency and growth, and the diversification of revenue sources in order to reduce revenue volatility. Effective tax system reform can also support institutional development and support formal sector activity. Cross-country experience (IMF, 2011) identifies several key elements applicable to most LICs (see text box), although the specific priorities vary in each country.

Elements of Tax Reform in Developing Countries

- Build effective revenue administrations
- Dedicate offices for large taxpayers and key sectors
- Pursue forceful, efficient strategies against non-compliance
- Levy VAT on a broad base, with a high threshold
- Avoid exemptions that jeopardize revenue and governance, are hard to reverse, or lack clear social benefits
- Enhance transparency and analysis of tax expenditures
- Employ a simple, broad-based corporate tax with effective tax rates that are low and uniform across investments
- Extend coverage of personal income taxes to professionals and smaller businesses; tax capital income coherently
- Balance natural resource (NR) royalties, auctions, and profit-related charges; manage NR revenues transparently
- Improve capacity to deal with multinationals' profit shifting
- Develop real property taxation to finance local services

18. **Well-designed tax system reform backed by sustained political support pays off.** Despite reduced trade taxes, over the past decade the median LIC tax revenue/GDP ratio has increased by 3 to 4 percentage points, with improvements in both resource-rich and non-resource countries. In some countries, tentative successes unraveled when political will softened, but experiences such as that of Tanzania, which raised its TR/GDP ratio by 6 points in nine years, demonstrate the benefit of sustained reforms.

19. **Zambia's revenue performance contrasts sharply with the experience of comparator countries.** Like many LICs with natural resources, it has not enhanced non-mineral fiscal revenue collections; unlike them, it has not, until perhaps very recently, received consistently higher mineral revenues (IMF, 2011). The reasons include narrow tax bases due to incentives, exclusions, and exemptions—a lesson emphasized in the 2004 EPA. As a result, Zambia's tax and revenue ratios stand at or slightly below their levels at the start of the review period. In mining, generous terms for new investment, locked in by fiscal stability agreements, translated into relatively little revenue when copper prices rose sharply (Hogan and Goldsworthy, 2010). Attempts to scrap the terms of these agreements

Zambia: Revenues
(Percent of GDP)

	2002-04	2005-07	2008	2009	2010 Est.
Tax	17.4	17.1	18.1	15.0	16.9
Income	7.8	7.9	9.0	7.9	9.4
VAT	5.1	4.9	4.0	3.8	4.1
Excise	2.4	2.4	2.6	1.6	1.8
Customs	2.1	2.0	2.4	1.7	1.6
Non tax	0.6	0.6	0.8	1.0	0.9

Sources: Zambian authorities; and IMF staff estimates.

brought litigation and uncertainty. Despite positive copper price developments, mining tax receipts reached only 2 percent of GDP by 2010, compared to 4 percent projected at the start of ECF-2. Recent reforms improved the system, and Zambia's voluntary progress toward validation under the Extractive Industries Transparency Initiative (http://eiti.org) should increase public interest and confidence in minerals revenues, and thus help to build support for reforms.

20. **Mobilizing domestic revenues should be a priority for the next several years.** For Zambia, areas that deserve particular attention include a gradual withdrawal of widespread existing tax incentives and the introduction of a tax expenditure budget; more attention to consumption taxes; and substituting non-tax revenues with property taxes—accompanied by strengthened fiscal decentralization legislation.

D. Financial Sector Development

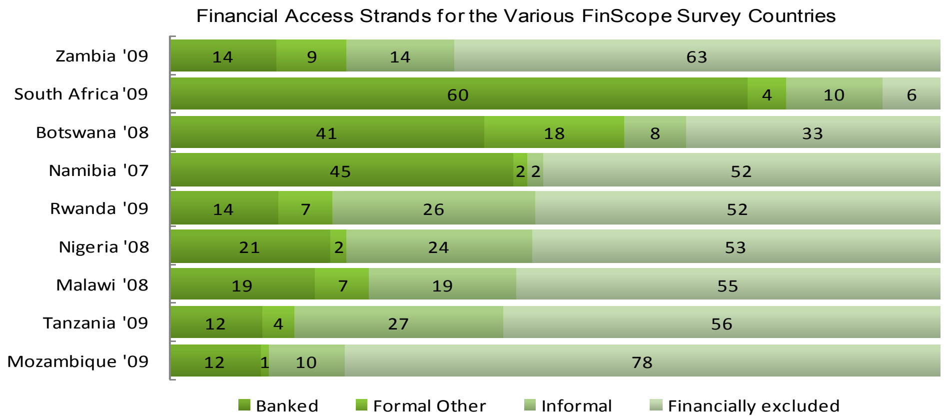
21. **Having improved financial sector stability, Zambia should now extend the focus of reforms to include financial sector development in order to enhance growth and resilience.** Gradual liberalization of the banking sector has facilitated competition and entry of foreign banks, but the banking sector remains shallow and concentrated, with real lending rates among the highest in the region and low levels of financial access. The home-grown financial sector development plan (FSDP) encouraged under the ECFs fostered stability,[8] but less progress has been made on financial development.

Zambia: Indicators of Financial Development, 1990-2010

	Zambia		LICs		SSA-LICs		SSA-MICs	
	1990-99	2005-10	1990-99	2005-10	1990-99	2005-10	1990-99	2005-10
Bank Deposits/GDP	14.7	18.5	21.6	49.7	16.0	62.8	33.1	42.9
Private Sector Credit/GDP	6.9	11.0	16.0	33.4	10.6	33.3	25.2	35.6
M2/GDP	17.7	21.6	27.7	38.4	22.7	30.6	35.5	49.1

Sources: IMF; World Economic Outlook; International Financial Statistics; and IMF staff estimates.
Note: Simple averages.

[8] See Financial Sector Stability Assessment (IMF, 2009).



Source: FINScope Zambia, 2009.

22. **Cross-country experience suggests that a more developed financial sector could strengthen resilience and stability.** Shallow financial markets limit monetary policy effectiveness, and financial development in Zambia can strengthen the interest rate and credit channels of monetary transmission and reduce the relative role of (often volatile) exchange rate movements (Laurens et al., 2005; IMF 2006, 2008). Reduced operating costs, including with regard to overhead, holdings of excess reserves, and collection of nonperforming loans, is also key to reducing lending rates.

23. **Financial sector development fosters economic development through several channels.**[9] Most studies confirm that countries with better-functioning financial systems grow faster and experience more rapid poverty reduction (Levine 1997; Beck et al., 2000, 2004). Finance helps economies grow faster through improvements in resource allocation and productivity growth. The link between finance and growth operates by relaxing firms' financing constraints and facilitating expansion—especially for small firms (Rajan and Zingales, 1998; Beck et al., 2005). These effects can be especially important in highly-concentrated economies such as Zambia's, which requires diversification to strengthen resilience and to support more broad-based growth.

24. **Regional financial integration may be one strategy to overcome the high costs that now limit the scope and volume of financial services.** Some steps toward harmonizing regulatory frameworks, for example, could effectively expand market size, exploit economies of scale, and foster competition that would reduce margins and promote the delivery of a broader range of services to wider segments of the economy. Doing this in a manner that

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[9] Although there is some debate about the causality between financial sector development and growth, there is increasing evidence in favor of financial sector development causing growth, reducing poverty and inequality.

promotes financial development while also ensuring stability is a complex undertaking; the IMF and Zambia's development partners can provide policy advice and technical assistance.

25. **Financial sector development can also be fostered through other channels**. Phase II of the Financial Sector Development Plan (FSDP-II) identifies several reforms where the Fund has an active role to play, including in pursuing the goal of increasing competition and stability through a stronger regulatory framework, the orderly exit of failing institutions, and a sound crisis management framework. Other channels of development could include innovative technologies such as mobile banking, which is used in Kenya and elsewhere to enhance market access. Improvement in the operating environment, such as strengthened contractual frameworks and property rights, can also reduce costs, promote competition, and reduce spreads (Honohan and Beck, 2007). Similarly, development of non-bank financial institutions can encourage lending products suited to Zambia's legal and institutional setting. In these areas as well, the Fund can support the authorities in promoting financial sector development to enhance economic resilience and growth, and can play a direct role in those areas most closely related to stability.

IV. Future Fund Engagement

26. **A well-articulated medium-term economic program would help Zambia to strengthen resilience and raise growth rates.** The authorities should anchor their program on policies to promote continued macroeconomic stability, while emphasizing sustained medium-term reforms, particularly in the areas discussed above. The Fund could provide support for such a medium-term program, with the choice of instrument depending on economic circumstances. A successor arrangement could be prepared under the Extended Credit Facility (ECF), which could provide further concessional financing. If the qualification criteria for a PSI are met, including on institutional capacity, the Policy Support Instrument (PSI, a non-financial arrangement) could be appropriate. A PSI could be complemented by financial support under the Standby Credit Facility (SCF) in case of an actual or potential balance of payments need. A Fund-supported program would provide a strong framework for policy support and frequent assessments of Zambia's economic and financial policies, which have an important signaling role for donors, creditors, and the general public.

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Appendix Table 1. Performance on Quantitative Performance Criteria and Benchmarks under the 2004-07 PRGF

	2004		2005				2006				2007	
	Sept.	Dec.	Mar.	June	Sept.	Dec.	Mar.	June	Sept.	Dec.	Mar.	June
Net domestic assets of Bank of Zambia	PC	PC	PC	PC	PC	PC	Ind	PC	Ind	PC	PC	PC
Government net domestic financing	PC	PC	PC	PC	PC	PC	Ind Not met	PC Not met	Ind Not met	PC Not met	PC	PC
Gross international reserves	PC	PC	PC	PC	PC	PC	Ind	PC	Ind	PC	PC	PC
Nonaccumulation of government external payment arrears	PC	PC Not met	PC	PC	PC	PC	Ind	PC	Ind	PC	PC	PC
Short-term and nonconcessional debt ceiling	PC	PC	PC	PC	PC	PC	Ind	PC	Ind	PC	PC	PC
New concessional borrowing ceiling	PC	PC	PC	PC	PC	PC						
Payment of government domestic arrears	PC Not met	PC	PC	PC	PC	PC	PC	PC	Ind Not met	PC	PC	PC
Central Government wage bill ceiling	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind
Central Government wage arrears ceiling	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind	Ind
HIPC account deposits floor	Ind	Ind										

Source: IMF staff reports
Note: PC indicates performance criteria and Ind indicative targets.

Appendix Table 2. Performance on Quantitative Performance Criteria and Indicative targets under the 2008-11 ECF

	2008			2009			2010			
	June	Sept.	Dec.	June	Sept.	Dec.	Mar.	June	Sept.	Dec.
Net domestic assets of Bank of Zambia	PC	Ind	PC Not met	PC	Ind	PC	Ind	PC	Ind	PC
Government net domestic financing	PC	Ind	PC	PC	Ind Not met	PC Not met	Ind	PC	Ind	PC Not met
Gross international reserves	PC	Ind	PC Not met	PC	Ind Ind	PC	Ind Not met	PC	Ind	PC
Nonaccumulation of government external payment arrears	PC	Ind	PC	PC	Ind Ind	PC	Ind	PC	Ind	PC
Short-term external debt ceiling	PC	Ind	PC	PC	Ind	PC	Ind	PC	Ind	PC
Medium- and long-term nonconcessional external debt ceiling	PC	Ind	PC	PC Not met	Ind Not met	PC Not met	Ind	PC	Ind	PC
Payment of government domestic arrears	Ind.	Ind Not met	Ind Not met	Ind	Ind Not met	Ind Not met	Ind	Ind Not met	Ind	Ind Not met
Increase in reserve money	Ind Not met	Ind Not met	Ind Not met	Ind	Ind	Ind	Ind	Ind.	Ind Not met	Ind Not met
Government social spending							Ind	Ind	Ind	Ind

Source: IMF staff reports
Note: PC indicates performance criteria and Ind indicative targets.

Appendix Table 3. Zambia: Performance on Structural Performance Criteria and Structural Benchmarks Under the 2004–07 ECF

Measure	Type of conditionality	Initial Test Date	Implementation	Area
Cabinet approval of the PEMFA program	Prior action	Program approval	Completed as planned	Public Expenditure Management
Submission to Cabinet, for consideration and approval, of an action plan for initial implementation of the Financial Sector Development Plan	Prior action	Program approval	Completed as planned	Financial Sector Reform
The government will refrain from paying any amounts for which it is not legally liable and which are not included in the budget	PC	Continuous		Public Expenditure Management
Publication of quarterly budget execution reports using the activity-based budgeting classification, within 45 days of the end of each quarter	SB	Continuous		Public Expenditure Management
Award a contract for the supply and installation of the hardware and software needed to implement the IFMIS	SB	End-June 2004	Completed with delay (September 2004)	Public Expenditure Management
Start negotiations for settlement of domestic arrears identified in the multiyear plan for clearing domestic arrears	SB	End-July 2004	Completed as planned	Public Expenditure Management
Initiate the pilot implementation of the IFMIS in at least three line ministries	PC	End-September 2004	Reset to end-June 2005, then end-Sept.2006, pilot began in Jan. 2007	Public Expenditure Management
Define a policy for the granting of tax concessions	SB	End-September 2004	No information on implementation	Tax Policy
Cabinet approval of a proposal to repeal the sections of the Building Societies Act, the National Savings and Credit Bank Act, and the Development Bank of Zambia Amendment Act that are in conflict with the Banking and Financial Services Act	PC	End-November 2004	Transformed into prior action for the second review	Financial Sector Reform
Adoption by the Government and the Bank of Zambia of action plans, finalized in consultation with the World Bank and IMF staff, for the resolution of the National Savings and Credit Bank and the Development Bank of Zambia	Prior action	First Review Prior action	Completed as planned	Financial Sector Reform
Unforseen expenditures will be funded only to the limits of the budget contingency or after Cabinet approval including the identification of savings elsewhere in the budget	SB	Continuous		Governance and Transparency
Adopt a work program covering the first year of the implementation of the PEMFA reform program	PC	End-January 2005	Completed as planned	Public Expenditure Management
Adopt a definition of poverty reducing spending corresponding to the priorities of the government PRSP and use this in the preparation of the budget for 2005	SB	End-January 2005	Completed as planned	Public Expenditure Management
Report on the findings of a preliminary review of the piloting of the IFMIS in at least three line ministries	PC	End-December 2005	Reset to end-March 2007 and then postponed.	Public Expenditure Management
In consultation with the PEMFA Technical Working Group, design a cash-flow framework for all line ministries	SB	End-May 2005	Completed with delay (August 2005)	Public Expenditure Management
In consultation with the PEMFA Technical Working Group, finalize a framework for monitoring and evaluating the PEMFA program	SB	End-May 2005	Completed with delay (July 2005)	Public Expenditure Management
Prepare and publish the first draft ("Green Paper") of the MTEF for 2006-2008	SB	End-August 2005	Completed with delay (November 2005)	Public Expenditure Management
Issue new regulations and revised accounting manuals for the new Finance Act	SB	End-September 2005	Completed with delay (December 2006)	Public Expenditure Management
Complete review of the implementation of the PEMFA program	SB	End-November 2005	Completed as planned	Public Expenditure Management
Beginning with the second quarter of 2005, validate end-quarter external debt stock data and, within 45 days, provide updated 3-year schedule of debt service falling due to the budget director	PC	Continuous		Debt Management
The NSCB and the DBZ submit to the BoZ plans for their incorporation in 2006 under the Companies Act.	SB	End-December 2005	Completed as planned	Financial Sector Reform
Adoption by the government and the Bank of Zambia of action plans finalized in consultation with the World Bank and IMF staff, for the resolution of the Zambia National Buiding Society (ZNBS)	SB	End-April 2005	Completed with delay (August 2005)	Financial Sector Reform
The Investment and Debt Management Department (IDM) of the MoFNP will validate the stock of onlending agreements with a view to effectively enforcing these agreements. The IDM will report to the Secretary of Treasury on the validation of these agreements	PC	End-June 2006	Completed as planned	Debt Management
The IDM will validate the stock of government contingent external liabilities, including loan guarantees, and pension obligations. The IDM will report to the Secretary of Treasury on the validation of these liabilities.	PC	End-December 2006	Completed as planned	Debt Management
Issue summary tables, developed in consultation with the PEMFA Joint Technical Working Group (JTWG), using activities based budgeting classification and identifying poverty reducing programs	SB	End-March 2006	Completed with delay (May 2006)	Public Expenditure Management
In consultation with the PEMFA JTWG, issue (i) accountability rules and procedures under the new cash management framework and (ii) corresponding administrative procedures for enforcement, to ensure the timely release of funds by the Ministry of Finance and National Planning	SB	End-March 2006	Completed with delay (May 2006)	Public Expenditure Management
Submit to Cabinet the first draft ("Green Paper") of the Medium-term Expenditure Framework (MTEF) for 2007-2009.	SB	End-August 2006	Completed as planned	Public Expenditure Management
Complete a diagnostic review of tax policy and administration	PC	End-December 2006	Completed as planned	Public Expenditure Management

Appendix Table 3. Zambia: Performance on Structural Performance Criteria and Structural Benchmarks Under the 2004–07 ECF (Continued)

The Accountant General will, within 60 days of the end of each quarter, submit to the Secretary of the Treasury quarterly reports on compliance with the commitment control system by ministry, province, and spending agency	SB	Continuous		Public Expenditure Management
The MoFNP will issue an annual report on external debt management operations during 2005	SB	End-June 2006	Completed as planned	Debt Management
Execute the action plan adopted by the Government on the resolution of the Zambia National Building Society	SB	End-June 2006	Postponed to 2007. Impl unclear	Financial Sector Reform
Submit to cabinet a proposal for the legal framework establishing a credit reference bureau, including the necessary amendments to privacy laws	SB	End-June 2006	Completed as planned	Financial Sector Reform
Incorporate the National Savings and Credit Bank (NSCB) and the Development Bank of Zambia (DBZ) under the Companies Act	SB	End-December 2006	Posponed until the finances of the institutions are sounder. Impl unclear	Financial Sector Reform
ZESCO's management will provide all the necessary financial, technical, and managerial information to the World Bank and the IMF for an assessment of Zesco's performance in line with the conditions for reaching the evaluation point under the commercialization process	SB	End-April 2006	Reset to end-July 2006, observed with delay	Private Sector Development
The Central Statistics Office will complete a comprehensive economic census for the full rebasing of the national accounts	SB	End-May 2007	No information on implementation available in staff report	Statistics
Submit to the Minister of Finance a comprehensive debt management strategy	PC	End-June 2007	No information on implementation	Debt Management

Source: IMF staff reports.
Note: PC indicates performance criteria and SB indicates structural benchmarks.

Appendix Table 4. Zambia: Performance on Structural Performance Criteria and Structural Benchmarks Under the 2008–11 ECF

Measure	Type of conditionality	Initial Test Date	Implementation	Area
Submit to Cabinet a proposal to establish a treasury single account	PC	End-June 2008	Completed as planned	Public Expenditure Management
Submit to Cabinet a policy for the electricity sector with specific startegies 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; has sufficient resources to implement the planned rehabilitation and new generation projectsand (iv) ensure that ZESCO	PC	End-June 2008	Completed as planned	Private sector legal and regulatory environment reform
Submit to Cabinet a proposal to establish a Treasury Department	SB	End-June 2008	Completed as planned	Public Expenditure Management
Establish a headquarters functional structure at the Zambia Revenue Authority	SB	End-September 2008	Completed as planned	Public Expenditure Management
Establish a single large-taxpayer office at the Zambia Revenue Authority	SB	End-december 2008	Completed as planned	Public Expenditure Management
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	SB	End-June 2008	Completed as planned	Public Expenditure Management
The Bank of Zambia will restructure the operations of its rediscount window	SB	End-June 2008	Completed with delay	Financial Sector Reform
Set up a supervisory regime for the secondary market in government securities	SB	End-December 2008	Completed with delay (March 2010)	Financial Sector Reform
Introduce risk based bank supervision	SB	End-September 2008	Completed as planned	Financial Sector Reform
Submit to cabinet a debt management strategy	SB	End-September 2008	Completed as planned	Debt Management
Prepare a comprehensive strategy for phased implementation of the establishment of the treasury single account system	SB	End-June 2009	Completed as planned	Public Expenditure Management
Approval by Cabinet of all necessary amendments to the Public Finance Management Act specifying the general principles of the treasury single account system	SB	End-September 2009	Completed as planned	Public Expenditure Management
Bank of Zambia will introduce a new standing overnight lending facility	SB	End-September 2009	Completed with delay (December 2009)	Financial Sector Reform
Raise the average electricity tariff in 2009 and publicly announce indicative tariffs for 2010-11 consistent with the policy to reach cost-reflective levels by 2011	SB	End-June 2009	Completed as planned	Private sector legal and regulatory environment reform
Approval by Cabinet of the pay policy reform	SB	End-June 2010	Completed as planned	Public Expenditure Management
Establish a Lender-of-Last Resort Framework and draft legislation and procedures for a financial sector contingency plan in the event of a crisis	SB	End-June 2010	Partially Met. Draft legislation expected by end-May 2011	Financial Sector Reform
Adoption of Treasury Single Account by six ministries, provinces, and spending agencies	SB	End-December 2010	Not met. Expected to be met by end-June 2011	Public Expenditure Management
Submit to parliament the Planning and Budgeting Act	SB	End-June 2010	Reset to end-December 2010 then end-January 2011. Delayed further	
Prepare a review of tax administration and policy	SB	End-September 2010	Completed as planned	Public Expenditure Management
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	SB	End-June 2010	Completed with delay (July 2010)	Private sector legal and regulatory environment reform
Submit to Cabinet a report on maize pricing policy	SB	End-March 2011	Completed as planned	Private sector legal and regulatory environment reform
Adoption of Treasury Single Account so as to cover 60 percent of budgetary expenditures	SB	End-december 2010	Delayed	Public Expenditure Management

Source: IMF staff reports.
Note: PC indicates performance criteria and SB indicates structural benchmarks.

Annex 1. Response of the Zambian Authorities

The draft EPA Update was discussed with authorities of the Ministry of Finance and the Bank of Zambia in Lusaka on May 26-27. The authorities considered the EPA report timely and useful; they welcomed the presentation of Zambia's key economic issues in a cross-country context and broadly agreed with the conclusions of the report.

- The authorities emphasized the role of disciplined economic policies in Zambia's strong economic performance since 2004, including strong disinflation, but also expressed concern that market interest rates remained high. Looking ahead, they saw their overarching objective as translating sustained rapid growth into faster rates of poverty reduction.

- The authorities agreed that the report's four forward-looking themes represented key economic issues for Zambia. They noted that steps were already underway in most of these areas, including an agenda for regional financial integration involving SADC. In addition, they emphasized the importance of reforms that would improve agricultural productivity and investment in the social sector to develop human capital. They highlighted that they also intend to focus on improving the quality of statistics produced in Zambia.

- The authorities felt that the very positive relationship with the Fund and Fund staff had contributed to Zambia's improved economic policymaking. They highlighted the special role of the Fund's Resident Representatives in providing on-the-ground advice and "wise counsel." Regarding program design, they appreciated the flexibility of staff and the Fund in shifting the monitoring of non-concessional debt from a project-by-project basis (which the authorities characterized as micro-managing) to a sectoral basis.