Report No. 29105

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Background

1. In July 2002, GRZ launched its first ***Poverty Reduction Strategy Paper (PRSP)*** for the period 2002-2004. The PRSP highlights the following barriers to poverty reduction: lack of economic growth, high inequality, excessive dependence on foreign aid, poor prioritization of public resources, inadequate safety nets, and HIV/AIDS. Therefore, the PRSP seeks to achieve poverty reduction through promoting (i) economic growth and diversification of production and exports; (ii) improved access and quality in the provision of social services; and (iii) the mainstreaming of crosscutting issues of governance, HIV/AIDS, gender, and the environment. In addition to the PRSP, the Government prepared the ***Transitional National Development Plan (TNDP)*** covering the period 2002-2005. The TNDP, which was launched in December 2002, complements the PRSP by bringing in some sectors of the economy that were not included in the PRSP.

2. Macroeconomic stability is seen as a prerequisite for private sector-led, export-oriented growth, and the PRSP gives prominence to the issue of good governance and zero tolerance of corruption. It states that the Government is very committed to improving public expenditure management, strengthening the Anti-Corruption Commission, and implementing the National Capacity Building Program for Good Governance. A number of structural measures aimed at stimulating private investment and improving the regulatory and financial environment are discussed in the PRSP. It emphasizes the enforcement of a hard budget constraint on the remaining parastatals with a view to reducing or eliminating the quasi-fiscal deficits that have added to inflationary pressures, which in turn have underlined the prevailing high real interest rates. It also places great emphasis on agriculture, tourism, agro-processing, small-scale mining, and supporting infrastructure, which would benefit the rural areas where poverty levels are above average.

3. To support the implementation of the PRSP and TNDP and to incorporate lessons learned from the failures and successes of previous Bank interventions in Zambia, the Bank prepared a ***results based Country Assistant Strategy (CAS)***, which was discussed with the Bank's Executive Board in March 2004. The CAS is explicitly rooted in a results framework, which links Zambia's overall goals of the PRSP and TNDP to specific strategic objectives, which are measured by long-term outcomes and monitored, where appropriate and possible, by quantitative intermediate progress indicators that are directly affected by Bank interventions. The focus of World Bank activities is structured around three strategic priorities[1]:

> 1. *Sustained Economic Growth Anchored in a Diversified and Export-Oriented Economy;*
> 2. *Improved Lives and Protection of the Vulnerable;*
> 3. *Efficiently and Effectively Managed Public Sector;*

[1] See CAS document (Report No. 27654-ZA) for a detailed description of each of the strategic priorities.

4. Zambia's economic development has been dominated by the secular decline in the production and the purchasing power of its copper resources, which has been accompanied by a decline in per capita income from US$752 in 1965 to US$351 in 2002. During the 1990s, the Government embarked on a process of transition away from a centrally planned economic system and implemented a sweeping program of liberalization and deregulation, eliminating most major market distortions. However, Government commitment to reform weakened in the mid-to late-nineties when macroeconomic stabilization led to an initial contraction.

5. Since 1999, the economy is experiencing a modest recovery with positive per capita GDP increases of 1.4% annually. Poverty reduction, however, remains a challenge due to a heavy debt burden, weak institutional capacity, and ineffective spending. In 1998, an estimated 73% of the population lived below the official poverty line compared to 70% in the early nineties. The impact of the HIV/AIDS pandemic further undermines steps to reduce poverty and over the past decade the trend in the majority of the Millennium Development Goals (MDGs) has moved in the wrong direction.

6. Macroeconomic stability has been elusive for Zambia despite several IMF programs and a number of structural adjustment credits in support of this objective from the Bank. This notwithstanding, the current economic environment of positive growth undoubtedly provides opportunities to make the tough choices needed to reach and sustain macroeconomic stability. An agreement with the IMF on a macroeconomic transition path towards a growth conducive macroeconomic environment of low and stable inflation, low and stable real interest rates, which is supported by an affordable fiscal policy that refrains from domestic borrowing, would unleash significant budgetary support by other IFIs and bilateral donors, which if put to good use could improve progress towards the MDGs.

7. An agreement with the IMF on a new PRGF and subsequently the ability to stay within the agreed PRGF benchmarks for a period of six month, accompanied by meeting the so-called HIPC triggers would allow Zambia to reach the ***HIPC completion point*** by the end of 2004. This would make the interim debt relief under the enhanced HIPC initiative permanent and irrevocable, and greatly enhance the sustainability of the current growth spurt that Zambia is experiencing.

8. The CAS classifies the current economic situation in ***Zambia as being in the low case, which does not allow for adjustment operations***. Therefore, it is very important that the Government makes significant progress towards meeting the base case triggers as defined in the CAS document (see table 8 in the CAS document) to ensure a timely presentation of the proposed EMGC to the Bank's Executive Board of Directors. The preparation and identification mission has therefore proposed specific measures to be taken prior to appraisal that are directly related to reaching the base case: (i) progress in meeting the HIPC Completion point triggers and (ii) an agreement with the IMF on the macro economic framework under an PRGF approved by the IMF's Executive Board.

Description and Objective

9. ***The focus of the proposed EMGC*** supported program (see also para 1) is (i) to strengthen public sector management, including debt management, to regain control over fiscal expenditures; (ii) to resolve the issues surrounding state–owned non bank financial institutions to stop the drain of public resources and strengthen the independence of the Bank of Zambia; (iii) to put the (public) pension system on a financial sound footing; and (iv) to improve the business environment in Zambia by further defining the role of Government with respect to private sector development and its engagement in this area.

10. Hence, the actions in areas (i) to (iii) directly support the CAS outcomes, which are to support the strategic longer-term country outcome of *a growth conducive macro-economic environment*, while area (iv) would support the strategic and longer-term country outcome of a *diversified and export oriented economy*. Both strategic and longer-term country outcomes are part of the CAS strategic priority area 1 of *sustained economic growth anchored in a diversified and export oriented economy*. Actions in area (i) also directly support reaching the CAS outcome indicators of strategic priority area 3 of *an efficiently and effectively managed public sector*. Note that the proposed actions will indirectly also support Strategic priority 2 by reducing waste of public resources, while allowing for accountable and rational allocation of public resources. In addition, higher growth should directly facilitate poverty reduction.

Financing

11. The proposed amount for operation will be US$40 million. As a balance of payments operation, the proposed credit will finance 100% of the foreign exchange costs of eligible imports.

Benefits and Risks.

12. The benefits of the proposed operation are basically two-fold. First, it will assist the Government through policy and institutional changes to better manage the economy and better direct resources to those programs that will have the highest economic and social return as a means to increase growth and reduce poverty. Most of the process changes aim to support durable (fiscal) adjustment while preparing for tomorrow's growth. Second, the financial resources themselves will reduce the need for additional domestic borrowings that would further crowd out resources available for investments by the private sector and as a consequence also negatively affect interest rates.

13. In light of Zambia's track record in implementing reform programs, the proposed credit is of significant risk. The main risks overlap directly with the risks identified in the CAS and are (i) political; (ii) governance related; (iii) macro economic nature; (iv) inability to realize the need for private sector led growth; (v) regional turmoil, (vi) failure to contain the further spread of the HIV/AIDS pandemic. See the CAS report for a detailed description of the CAS risks identified.

14. In addition to the risks identified in the CAS, limited Government administrative capacity and coordination could lead to delays in the implementation of key measures not in the least because of the need to reach an agreement with the Fund and the Government's intention to reach HIPC completion point by year's end. The latter two will require a significant effort on the side of GRZ and as such could absorb most of the limited implementation capacity of GRZ.

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