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Report No. 29294 ZA

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED CREDIT

IN THE AMOUNT OF SDR 27.4 MILLION

(US$ 40 MILLION EQUIVALENT)

TO

THE REPUBLIC OF ZAMBIA

FOR AN

ECONOMIC MANAGEMENT AND GROWTH CREDIT

November 12, 2004

Department: AFTP1
Country Management Unit: AFCO3
Region: Africa

ZAMBIA – ECONOMIC MANAGEMENT AND GROWTH CREDIT

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of November 9, 2004)

Currency Unit = Kwacha

US$1.00 = K 4,835

GOVERNMENT FISCAL YEAR

January 1- December 31

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

ABB	Activity Based Budgeting	LASF	Local Authorities Superannuation Fund
BoZ	Bank of Zambia	MoFNP	Ministry of Finance and National Planning
BFS	Banking and Financial Services	MTEF	Medium-Term Expenditure Framework
CAE	Zambia's Country Assistance Evaluation	NAPSA	National Pension Scheme Authority
CAS	Country Assistance Strategy	OED	Operations Evaluations Department
CEM	Country Economic Memorandum	PE	Personal Emoluments
CSO	Central Statistical Office	PEMFAR	Public Expenditure Management and Financial Accountability Review
DFID	Department of International Development (UK)	PIA	Pension and Insurance Authority
EMGC	Economic Management and Growth Credit	PMEC	Payroll Management and Establishment Control
ERB	Energy Regulatory Board	PRGF	Poverty Reduction and Growth Facility
FIAS	Foreign Investment Advisory Services	PRSP	Poverty Reduction Strategy Paper
FMS	Financial Management System	PSCAP	Public Service Capacity Building Project
FSAP	Financial Sector Assessment Program	PSD	Private Sector Development
GDP	Gross Domestic Product	PSDI	Private Sector Development Initiative
GRZ	Government of the Republic of Zambia	PSRF	Public Service Pension Fund
HIP	Harmonization in Practice	PSRP	Public Sector Reform Program
HIPC	Heavily Indebted Poor Countries	SAC	Structural Adjustment Credit
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome	SME	Small and Medium Enterprise
IBRD	International Bank for Reconstruction and Development	SMP	Staff Monitored Program
ICA	Investment Climate Assessment	SWAP	Sector Wide Approach
ICT	Information and Communication Technology	TA	Technical Assistance
IDA	International Development Association	TNDP	Transitional National Development Plan
IFI	International Financial Institution	ZNBC	Zambia National Building Society
IMF	International Monetary Fund	ZRA	Zambia Revenue Authority
ISP	Internet Service Provider		

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REPUBLIC OF ZAMBIA
ECONOMIC MANAGEMENT AND GROWTH CREDIT
CREDIT AND PROGRAM SUMMARY

Borrower: Republic of Zambia

Amount: SDR 27.4 million (US$ 40.0 million equivalent)

Terms: Standard IDA terms with 40 years maturity and a 10-year grace period.

Objectives and Description:

The Economic Management and Growth Credit of US $40 million is the first structural adjustment operation to support policy and institutional reforms as outlined in the Country Assistance Strategy (CAS) (Report No. 27654-ZA). The CAS envisages that over the three-year period of CAS implementation, there could be two adjustment credits to support its implementation in the base-case lending scenario. This credit assists Zambia to:

- Return to a macroeconomic framework conducive to robust growth;
- Strengthen the role of the financial sector;
- Strengthen the credibility and institutional capacity of the public sector;
- Improve Zambia's business environment.

IDA and the Government of the Republic of Zambia agree that achieving these objectives in part depends on the implementation of specific reforms in the areas of: (i) pensions and payment culture among Government agencies; (ii) state owned non-bank financial institutions; (iii) public expenditure management, debt management, and civil service reform; and (iv) private sector development including regulation of public utilities and private business.

Benefits:

The actions under the adjustment operation will aid fiscal adjustment and will contribute to the sustainability of the reform process by strengthening the institutional infrastructure needed to improve the public sector's capacity to carry out its expenditure policies more effectively and efficiently. At the same time the actions supported by the EMGC will improve the institutional environment for private sector development. The reforms will enhance Zambia's prospects for successful implementation of its Poverty Reduction Strategy through its support for sustainable growth and poverty reduction. The EMGC measures will also provide a positive signal to international institutions and bilateral donors regarding the Government's commitment to reform and transition towards a full-fledged market economy.

Risks:

In light of Zambia's track record in implementing reform programs, the proposed credit could face significant risks. The main risks overlap directly with the risks identified in the CAS, and include (i) political; (ii) macro economic issues; (iii) external developments; (iv) failure to contain the further spread of the HIV/AIDS pandemic; and (v) implementation capacity.
►*Political Risk*: Even though the next general elections are planned for 2006, it is expected that 2005 will show the beginning of the election campaign. This can take away the needed attention to stay the course with the ongoing

economic reform efforts to further strengthen the effectiveness of the public sector and the commitment to work towards a resolution of state-owned non-bank financial institutions. To mitigate these challenges some areas supported by the proposed operation are also supported, though often from a different angle, by the IMF's PRGF arrangement and its capacity building challenges through financial support by other donors, in particular the Harmonization in Practice (HIP) group. In addition, for some milestones to have their expected impact, the Government would need to follow up with amendments to the existing constitution. Even though a Constitutional Review Commission has been working on a general constitutional revision, these changes, constitutional changes cannot be guaranteed.

▶*Macroeconomic stability*: Pressure by civil service unions for increases in wages and allowances and demands for additional resources from other non-priority sectors such as defense could potentially risk the execution of the fiscal program.

▶*Shocks to Growth*: The country is vulnerable to terms of trade shocks and droughts. The upsurge in copper prices might re-ignite the hope that Zambia once more can count on the copper sector for economic success. A reoccurrence of a drought would harm the recent gains in food security and could see a surge in the need for food imports.

▶*HIV/AIDS pandemic*: HIV/AIDS remains the most significant health threat to Zambia's population and hence to its prosperity. The impact of the disease is increasingly visible in all spheres of Zambia's society and economy. With prevalence remaining in double-digit figures, the potential damage is enormous.

▶*Implementation capacity*: In addition to the risks identified in the CAS in this area, weak policy implementation and limited Government administrative capacity and coordination, could lead to delays in the implementation of key measures partly because of the overarching goal of this Government to reach HIPC Completion as soon as possible. The latter will require a significant effort on the side of GRZ and as such could absorb a significant portion of the limited implementation capacity of GRZ. To mitigate these risks, IDA will continue to assist the Government in mobilizing technical assistance to adopt and implement the reforms and will also deepen the ongoing dialogue with the Government on structural reform, working closely with other cooperating partners to provide this technical assistance. This dialogue is facilitated by the continuity that the results focused CAS brings to the interaction with Government.

Schedule of Disbursements:	The proposed Credit will be disbursed through the Bank of Zambia. Disbursement will be in two tranches. The first tranche (US$ 20 million) will be released at effectiveness. The second tranche (US$ 20 million) will be released when the second tranche conditions are met, which is expected to be around June 2005.
Poverty Category:	Not applicable
Rate of Return:	Not applicable
Project ID Number:	ZM-PE-P040631

INTERNATIONAL DEVELOPMENT ASSOCIATION
PROGRAM DOCUMENT
FOR A PROPOSED ECONOMIC MANAGEMENT AND GROWTH CREDIT
TO THE REPUBLIC OF ZAMBIA

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I. INTRODUCTION

1. This program document presents a proposed development credit to The Republic of Zambia for SDR 27.4 million (US$ 40 million equivalent), to finance an Economic Management and Growth operation (EMGC) to support the Government's structural reform program and implementation of Zambia's Poverty Reduction Strategy Paper (PRSP).

2. The proposed credit is the first structural adjustment operation to support policy and institutional reforms as outlined in the new Country Assistance Strategy (CAS) (Report No. 27654-ZA), which was discussed by the Board on March 9, 2004. At that time Zambia was judged to be in the low case scenario of the CAS. Since the discussion at the Board, improvements have been made in macroeconomic management as reflected by conclusion of an IMF Poverty Reduction and Growth Facility (PRGF) plus progress towards HIPC completion and key governance issues (see annex 2.1). As a consequence, Zambia has moved from the low case scenario into the base case scenario of the CAS.

3. In the base-case lending scenario, the CAS envisages that over the four-year period of its implementation, there could be two adjustment credits to support the implementation of the Government's reform strategy.[1] The credit would provide fast-disbursing support to meet Zambia's external financial needs and support its reform program that focuses on achieving durable improvement in the country's macro economic environment while preparing Zambia for robust growth as stipulated in its PRSP. To support these objectives, the adjustment credit aims at assisting the Government to reach specific milestones in the areas of (i) macroeconomic management; (ii) financial sector; (iii) public sector management; and (iv) business environment.

[1] In case Zambia would reach the high-case lending scenario the economic reform program could be supported by annual Poverty Reduction Support Credits (PRSC).

4. The reforms supported by the adjustment credit are laid out in the Government's letter of Development Policy [annex 4] and reflected in the policy and institutional reform matrix [annex 5] with monitorable indicators and expected outcomes for the proposed operation.

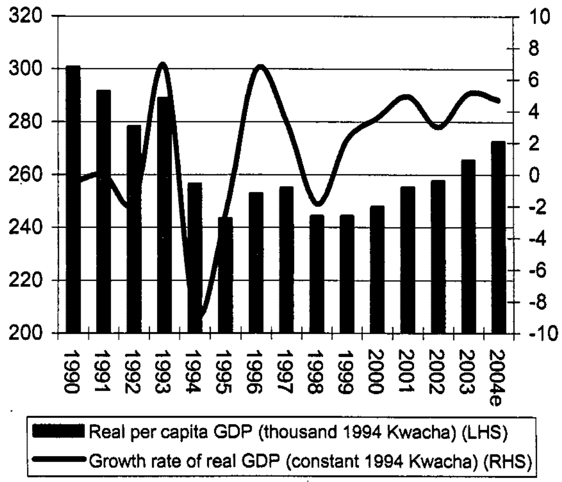
II. BACKGROUND

5. Zambia has experienced profound challenges during its transition from a planned to a market economy. Zambia had an inefficient economic structure when it adopted a multi party democratic system in 1991 and initiated a transition from a state-led economic system to a market-based system. The economy was still heavily dependent on copper revenues, which were shrinking and the previous Government had not adequately recognized the need for economic and export diversification. Zambia's market based reform program did not initially produce the expected results in part because of the initial reluctance to privatize the copper mines, which were a major drain on Zambia's (fiscal) resources. Once the fiscal drainage was contained growth resumed and currently Zambia is in its 5th year of consecutive positive per capita growth (see figure 1).

6. In July 2002, the Government of the Republic of Zambia (GRZ) launched its first PRSP for the period 2002-2004. The PRSP highlights the following barriers to poverty reduction: lack of sustainable 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 infrastructure, 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, extends the PRSP by bringing in additional

sectors of the economy that were not included in the PRSP.

Figure 1. GDP per capita developments (90-04)



Source: CSO; 2004 is estimated

7. Macroeconomic stability is seen as a prerequisite for private sector-led and export-oriented growth, and the PRSP gives prominence to the issue of good governance and zero tolerance for 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. The PRSP 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 growth of agriculture, tourism, agro-processing, small-scale mining, and supporting infrastructure, which would benefit the rural areas where poverty levels are higher.

8. To support the implementation of the PRSP and TNDP as well as to incorporate lessons learned from the failures and successes of previous IDA interventions in Zambia, IDA prepared a results-based CAS, which was discussed by IDA'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 IDA interventions.

9. Taking on board, lessons from the past is important as several lessons can be learned from evaluations of IDA programs in Zambia. A key evaluation is the Country Assistance Evaluation by Operations Evaluations Department (OED) of which the main recommendations for adjustment lending are summarized in Box 1. While developing the program to be supported by the EMGC over the last several months, particular attention has been paid to:

- Keeping a clear focus on efficiency of the public sector and strengthening of governance;
- Making sure that the elements of the program can be implemented within the proposed timeframe, are internally consistent and mutually supportive;
- Ensuring that the operation depends on upfront actions and results; and
- Taking on board lessons learned from past policy based lending.

10. A major objective of the Government is to reach HIPC completion point in early 2005. An agreement with the IMF on a new PRGF arrangement was approved by the IMF Executive Board on June 14, 2004 and subsequently the ability to stay within the agreed PRGF benchmarks for a period of six months, accompanied by meeting the HIPC completion program triggers as specified in the HIPC decision document[2] would allow Zambia to reach the HIPC completion point. This would make the interim debt relief under the enhanced HIPC initiative permanent and irrevocable, and enhance the sustainability of the current growth spurt that Zambia is experiencing.

[2] See Box 2 in the HIPC decision document, Report No. P7410-ZA.

Box 1: Lessons learned from Past IDA Adjustment Programs in Zambia

Zambia's Country Assistance Evaluation (CAE) (Report No. 25075) completed in November 2002 gives a sober picture of IDA's ability to guide development in Zambia.

On Adjustment lending it states: *The five structural adjustment credits that exited between FY96-01 represent three-quarters of closed commitments. During Board discussion of the FY94 and FY96 CASs, the Executive Directors highlighted the need for greater specificity in adjustment lending conditions and a clearer definition of satisfactory performance. Two of the past three structural adjustment credits have been rated in the unsatisfactory range for outcomes. In hindsight, even those adjustment operations initially rated marginally satisfactory have had less robust outcomes than expected. While conditions were fulfilled, pressure for timely balance of payments support led to less results-oriented, weak, or vaguely worded conditions. Often, the relevance of the conditions to fulfilling the stated objectives was poor.*

The CAE Evaluation of the FY96-01 period leads to the following recommendations relevant for adjustment operations:

Debt management and adjustment lending:

- Enhance the impact of structural adjustment lending through operational designs that focus on results, with a clearer link between objectives and conditions.

Aid coordination and macroeconomic stabilization:

- Strengthen coordination with the IMF and donor community to provide consistent support for macroeconomic stabilization and sufficient burden sharing to enhance the impact of IDA resources.

Structural reforms.

- In line with Zambia's PRSP, give priority to public expenditure management and improving governance, enhancing the investment climate to promote diversification (including infrastructure and energy reform and regional trade issues) and scaling-up the response to HIV/AIDS.

11. The proposed credit would further support PRSP implementation and complement the stabilization and fiscal measures forming part of the IMF PRGF arrangement, which covers the period June 2004 until June 2007 (see annex 7: Fund Relations Note). In addition, the actions also build on and expand upon past achievements and lessons learned in the area of economic management that were supported by a three-tranche Fiscal Sustainability Credit of US$170 million approved in May 2001 and fully disbursed in June 2002. Other critical inputs to the proposed operation are provided through the ongoing Public Service Capacity Building Project approved in February 2000 and a variety of economic sector work that includes the Public Expenditure Management and Financial Accountability Review (PEMFAR, Report no. 26162-ZA), Financial Sector Assessment (FSAP, Report no. 27289-ZA), Country Economic Memorandum (CEM, Report no. 28069-ZA), Investment Climate Assessment (ICA, Report no. 29741-ZA), and Foreign Investment Advisory Services' Administrative Barriers to Investment report.

III. THE ECONOMY

12. ***Introduction.*** 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 K 474 thousand in 1965 to K 244 thousand in 1999 measured in constant 1994 prices. 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.

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

14. Macroeconomic stability has been elusive (see annex 1) for Zambia despite several IMF programs and a number of structural adjustment credits in support of this objective from IDA. The current economic environment of positive growth undoubtedly provides opportunities to make the tough choices needed to reach and sustain a growth conducive macroeconomic environment. Lack of fiscal discipline, reinforced by ineffective budget processes, is at the root of many of the macroeconomic problems in Zambia.

15. The new PRGF arrangement with the IMF on a macroeconomic transition path towards a growth conducive macroeconomic environment of low and stable inflation and real interest rates, would unleash additional budgetary support by other International Financial Institutions (IFIs) and possibly other bilateral donors. These additional resources, if put to good use, could improve progress towards the MDGs.

16. ***Recent Economic Developments.*** Zambia's positive GDP growth trend that started in 1999 continued, at a higher rate, in 2003, exceeding the 5 percent mark for the first time since 1996 at 5.1 percent. GDP growth is estimated to equal 4.6 percent for 2004 with all major sectors of the economy contributing positively.

17. The Government's failure to keep its 2003 domestically financed budget deficit within the limit agreed with the IMF of 1.5 percent of GDP compared to 2.9 percent of GDP, resulted in the need to extend the IMF's Staff Monitored Program (SMP) from end December 2003 to end June 2004. As a result the Government missed the opportunity to have a formal PRGF in place that could have facilitated the country reach the HIPC completion point by the midst of 2004. The new IMF's PRGF aims to halt the unsustainable cycle of rising domestic debt and interest payments, so as to make room for increased spending on poverty-reducing programs. The programmed adjustment to the domestic primary balance is 2.3 percent of GDP in 2004. This would allow for a reduction in domestic borrowing by 3 percent of GDP to 2 percent of GDP in 2004, down from 5 percent in 2003. The overall budget deficit is projected to reduce from 6.0 percent of GDP in 2003 to 3.0 percent in 2004. As tax revenues are projected to basically remain unchanged in 2004, the domestically financed expenditure adjustments are spread almost equally over all expenditure categories (see annex 1) with the wage bill providing a significant contribution i.e. 0.6 percent of GDP.

18. It should be noted that despite the strong fiscal adjustment in 2004, growth is estimated to slow down by a mere 0.5 percent. The expected negative impact of the fiscal adjustment has been almost completely offset by favorable external and domestic developments. Once more the rainfall in 2004 ensured good agricultural developments, and strong improvements in Zambia's terms of trade provided additional incentives for the traditional i.e. mining, and non traditional export sectors to expand. Zambia's terms of trade are estimated to improve by 22 percent for 2004 as a whole.

19. The exports sector recorded a strong recovery in 2003: both the export volume and US dollar values, respectively, increased by 9.4 percent and 23.4 percent. This was on account of the increased price of copper on the international market as well as the increase in the value of non-traditional exports. This trend is continuing in 2004, with exports for the first 9 months already higher in value than for the full 12 months of 2003. The total value of exports is expected to increase by a staggering 50 percent for 2004 driven in particular by strong demand for copper.

Imports are increasing as well, but not at the same pace as exports. As a result the trade balance is projected to improve to -4.3 percent of GDP in 2004. Note that in 2001 the trade balance stood at –9.4 percent of GDP. Hence, the improved external environment has decreased Zambia's dependence on external inflows.

20. With regard to price developments, increased agricultural production in 2003 contributed to the lowering of the rate of inflation, from 26.7 percent at the end of 2002 to 17.2 percent at the end of 2003. At the end of October, inflation stood at 18 percent. Hence, with the fiscal overhang reduced and the positive external developments, inflation has become the main challenge to achieving macro economic stability. Compared to its high volatility in the recent past, the nominal exchange rate of the Kwacha remained relatively stable and registered a depreciation of about 14 percent in 2003 in nominal terms when compared to 19 percent in 2002. This stability has been achieved partly through the introduction of an inter-bank market for foreign exchange. The real effective exchange rate, however, remained largely unchanged in 2003, but has appreciated during 2004.

21. The Treasury Bills interest rates and the Bank of Zambia discount rates declined from January 2003 to November 2003 from about 35 percent to about 16 percent--reflecting Government's reduced borrowing requirements from the domestic market. The commercial banks' weighted lending rate declined as well from 53 percent to about 37 percent. However, the real lending rate remains quite high, while interest rates on Tbills have become negative in real terms, reflecting a high level of liquidity in the market.

22. ***Medium Term Prospects and Creditworthiness.*** Macro economic and growth performance in the short term clearly depend on Zambia's ability to reduce further its fiscal imbalance, reduce inflation, and to continue the structural reforms supported by the proposed EMGC and the IMF's PRGF program. In the short term growth will be particularly contingent on the reforms aimed at strengthening of public sector operations and fiscal consolidation, while in the medium term GRZ's ability to improve the business environment for private sector led growth will be critical as will be the containment of the HIV/AIDS pandemic and investment in infrastructure. Infrastructural investment would facilitate growth of agriculture and tourism in particular. See Box 2: Zambia's growth – Retrospect and Prospects for a more detailed discussion.

23. The Government's fiscal program as stipulated in its MTEF and the IMF's PRGF for 2005-07 aims to further reduce the overall fiscal deficit to 2.6 percent in 2007, reducing the need for domestic financing to approximately 1.5 percent of GDP. This would allow interest payments on domestic debt to decrease to below 2 percent of GDP in 2007 from an estimated 2.9 percent in 2004. Such adjustments allow spending on priority poverty reducing programs[3] to increase from an estimated 1 percent of GDP in 2003 to 3 percent in 2007. (See annex 1 for a detailed breakdown).

24. Implementation of the reform program will support the continuation of the current economic growth momentum, even though initially GDP growth is expected to slow down to 4.6 percent in 2004 partly because of the need to reduce the unsustainable fiscal stimulus of the last few years. Growth is, however, expected to accelerate in 2005 to 5 percent and to remain at that level in 2006 and 2007.

25. Growth in the outer years will depend on the Government's ability to maintain fiscal discipline, while rationalizing its expenditure composition towards growth conducive and poverty reducing expenditure programs, to reach HIPC completion, and to improve its interaction with the private sector, especially in terms of the

[3] Note that GRZ has used so far a rather restrictive definition of poverty reducing expenditures as defined by its HIPC program. Since the introduction in 2004 of activity based budgeting a wider definition of poverty reducing expenditures has been introduced and will be used for the 2005 budget.

Box 2: Zambia's Growth – Retrospect and Prospects

Growth Retrospect

Zambia's growth record during 1991-2003, a period during which the Government followed stabilization and adjustment programs, is mixed with different outcomes for the periods 1991-1998 and 1999-2003.

During 1991–98, Zambia's real GDP fell by an average rate of 0.2 percent a year. Poor performance can be traced mainly to the decline in the mining sector, which contracted at an average annual rate of 8.7 percent, and poor performance in the agricultural sector, which contracted by 0.2 percent a year. Industry was stagnant (manufacturing grew 0.9 percent, utilities grew 1 percent, and construction contracted 4.8 percent), and services grew 2.7 percent a year. With no growth in industry, the service sector was the only significant sectoral source of growth offsetting the huge contraction in mining and agricultural output. Total factor productivity—the efficiency with which capital and labor are combined to produce output—declined at an average annual rate of 1.9 percent a year during 1991–98, suggesting that the reform process which moved Zambia towards a market-based economy was by no means smooth and costless.

During 1999–2003 real GDP grew at an average rate of 4.0 percent a year. This period is unique in Zambia's economic history since independence, as it represents the first period of uninterrupted positive real per capita GDP growth since 1965 and the only period during which almost all sectors experienced growth each year. The decline in the mining sector was reversed and the sector actually grew, at an average annual rate of 2.1 percent. Growth came from two sources: higher growth rates across all sectors, perhaps suggesting that the reforms of the early and mid-1990s had begun to pay off, and the reversal of the declining mining sector, as a result of the privatization of the Zambia Consolidated Copper Mines in 2000. Since 1999 total factor productivity is estimated to have grown by an average of 1.4 percent a year—the first time such improvements have been seen in Zambia since independence.

Growth Prospect

Zambia's prospects for growth and poverty reduction over the next decade depend on both exogenous factors and policy and institutional measures. The recently completed Country Economic Memorandum (CEM) simulates the growth and welfare impact of both exogenous changes and alternative government policies over the next decade (2004-2015). To do such simulation, a base-case growth scenario is projected, which is based on key assumptions about population and labor force growth, government spending, current account deficit, interest on foreign debt, and copper prices. Population and labor force grow at around 2 percent and take into account the impact of HIV/AIDS. Under this base case scenario, Zambia is projected to growth at an annual average rate of 4.1 percent in the base-case.

The implications for growth and poverty reduction of exogenous changes as well as alternative government policies are then simulated around the base-case growth path using a Zambia CGE model. For exogenous changes, the impact of alternative copper prices as well as the impact of HIPC debt forgiveness are simulated. For policies that are under the control of the government, the impact of increased spending on HIV/AIDS, increased spending on education, increased productivity in subsistence and export agriculture, and increased investment in transportation and rural roads are simulated.

The simulation results provide several useful insights. First, targeting traditional and nontraditional crops, which have strong links to foreign markets, is the best way to enhance growth and household welfare. The pro-poor outcomes of agricultural expansion would be greatly enhanced if market access were widened on a large scale. Improving the condition of the road network and extending the network to remote areas is a key step not only to increasing growth but also to reducing rural poverty significantly. Second, rural households will be cushioned from the negative effects of a likely decline in copper prices (and output) over the next decade, while urban households will face increased poverty. Finally, unless the funds released by HIPC are used to finance policies that favor the poor, the impact of debt relief on poverty reduction is likely to be very modest.

The simulation results also show that Zambia is unlikely to achieve the Millennium Development Goal of halving poverty by 2015. Under the base case growth scenario, Zambia will not be able to halve poverty until after 2040. However, if the government "breaks with the past" by implementing various pro-poor policy measures as mentioned above the headcount poverty rate can be reduced by two to three additional percentage points over the next decade. Still, this is not sufficient; Zambia needs to move to a much higher growth path—estimated to be between 8-10 percent per annum—to reach this particular MDG.

regulatory and legal frameworks that are key to sustaining investor confidence as the country can not rely on the continuation of the increases in its terms of trade that it has experienced over the last two years. In particular, extending and improving the quality of infrastructure will play an important role in enhancing diversified economic growth that reaches out to the rural communities.

26. A significant impulse towards higher and robust growth will need to come from an improved trade regime, one that increases incentives for the private sector to produce goods for (regional) export markets. Zambia's external environment currently witnesses strong export gains, because of an improvement in its terms of trade, which is brought about in large part by the current rise in copper prices in the world market. This, together with strong export growth of non-traditional exports, has led to a decline in the current account balance including grants to an estimated –6.4 percent in 2004.

27. Zambia will need substantial foreign exchange inflows to finance its current account balance. Even though, it is expected that Zambia will be able to further reduce its current account deficit including grants to below 4 percent by 2007, by taking advantage of the high copper prices and a continuation of strong growth of non-traditional exports. Financing needs between 2005 and 2007 are estimated at about US$ 3 billion (see table 1).

Table 1. Zambia's External Financing Needs

Financing Plan 2004-2007					
Indicative Scenario Scenario	*Estimated*	*Projected*			*Cumulative*
In millions US$	2004	2005	2006	2007	2005-07
Financing Requirements	1,171	1,141	915	988	3,044
Current Account Balance before grants and Debt relief	697	662	711	764	2,137
Amortization (incl. IMF)	470	433	153	181	767
Reserves build-up	4	46	52	43	140
Financing Sources	1,171	1,141	915	988	3,044
Grants	282	367	401	411	1,179
Offical loan Disbursements, incl. IMF	375	166	136	114	416
Debt Relief	276	435	167	170	772
Private inflows and other Capital	237	173	212	293	678

28. These resources are necessary to finance US$ 2.1 billion in current account deficits, US$ 140 million in increases in international reserves and the remainder of US$ 767 million to fulfill debt repayment obligations. Private inflows are expected to finance about 22.3 percent of these needs, driven by improvements in the investment climate. Concessional resources will finance 13.7 percent of these financial needs, while debt relief, including HIPC will contribute 25.4 percent. The remainder, 38.7 percent of the needed foreign financing, is to become available in the form of (bilateral) grants.

29. The fiscal consolidation to take place with the assistance of the EMCG and the PRGF of the IMF will reduce the Government's need to borrow. Nevertheless, a reduction in Zambia's public and publicly guaranteed medium term and long term debts hinge critically on GRZ's ability to reach HIPC completion. Zambia's net present value of debt as a percentage of exports was equivalent to 212 percent at the end of 2002.[4] This ratio is projected to drop to 115 percent by 2007, well below the threshold of 150 percent, deemed sustainable. The ratio of total debt service to exports is projected to decrease to 5.4 percent of exports of goods and services by 2007 again as a result of decreased borrowing needs relative to GDP and exports, and the impact of reaching HIPC completion (see also annex 1).

IV. ZAMBIA'S REFORM PROGRAM

30. ***Introduction***. As mentioned above, Zambia's PRSP aims to reduce poverty through achieving economic growth and diversification of economic activities and exports combined with improving public sector service delivery, while mainstreaming crosscutting issues e.g. infrastructure and HIV/AIDS. The EMGC program will facilitate implementation of the PRSP through supporting reforms in four interrelated areas i.e. macroeconomic environment, financial sector performance, public sector management, and Zambia's business environment. The remainder of this

[4] See Appendix 6: Debt Sustainability Analysis of the CAS for a more detailed description.

Table 2. Zambia's Reform Program Supported by EMGC and Alignment with the Strategic Priorities of the CAS

Reform Areas	Priorities	CAS Outcome Indicators to which the policy actions contribute	Longer Term Country Outcomes
A. Returning to a macroeconomic framework conducive to robust growth			
• Fiscal and monetary policy. • Pensions.	▪ Correcting macro imbalances. ▪ Working towards a financially sustainable pension system	▪ Reduced domestic borrowing requirements from an estimated 3% of GDP in 2003 to less than 1% of GDP annually by 2006. ▪ Reduced arrears of Government (including parastatals) from an estimated 2% of GDP in 2003 to zero.	GROWTH CONDUCIVE MACROECONOMIC ENVIRONMENT • Stable net present value of external debt to exports of below 140 after HIPC completion point • Stable domestic public debt to GDP ratio less than 20% • Inflation rate reduced to single digits from 18.7% as of 2002 (5% Gov. target) • Real interest rate reduced to single digits from 27% as of 2003 • Maintain stable and competitive real exchange rate
B. Strengthening the role of the financial sector			
• Financial sector	▪ Resolution of the state owned non-bank financial institutions. ▪ Building a better governance structure for the Bank of Zambia. ▪ Promoting a better credit culture.	▪ Resolution of state owned financial institutions.	GROWTH CONDUCIVE MACROECONOMIC ENVIRONMENT • Same as above
C. Strengthening credibility and institutional capacity of the public sector;			
• Public expenditure management • Civil service	▪ Upgrading government's debt management capacity to support fiscal sustainability ▪ Improving public expenditure management and financial accountability practices. ▪ Streamlining ministerial structures and improving incentives for service delivery	▪ Variation between planned budget and actual expenditure at sector level no greater than 10% ▪ Budget presentation reflects summary of proposed budget alongside with actual expenditures in previous years (Y/N) ▪ Allowances are consolidated into base salary ▪ X % of management staff are eligible for performance pay ▪ Composition of staffing shifts toward support of service delivery functions	ECONOMIC GROWTH AND SERVICE DELIVERY IS UNDERPINNED BY GOOD GOVERNANCE AND PUBLIC SECTOR MANAGEMENT • Increased Accountability and Transparency of Government • Perceptions of changes in current levels of corruption • Perception as to the levels of participation, democracy and transparency in decision making is improved • Achievement of [80%] of annual performance targets at a sector level in ministries/ sectors
D. Improving Zambia's business environment			
• Private sector development • Infrastructure regulation	• Improving the investment climate • Reduce administrative barriers to investment • Developing a comprehensive national energy sector policy • Developing telecommunication policy framework conducive to ICT development	• Improved perception of foreign and domestic investors of the investment climate • Pay refund for duty drawback are of an acceptable speed for the private sector • Exporters are informed of the opportunities available under AGOA and EBA	SUSTAINABLE, DIVERSIFIED AND EXPORT ORIENTED ECONOMY • Positive contributions to GDP growth of all sectors • Export growth outpaces GDP growth • Greater % of imports used to produce good for exportation • Increase private investment in non-traditional sectors. • Increase in FDI

section will discuss the Government's reform program that deals with reforms in these four areas. Each subsection systematically discusses the outstanding issues, the Government's reform program, and the EMGC supported measures, which are summarized in Table 2. Subsection A briefly reiterates the IMF's PRGF program and the need for pension reform. Subsection B will describe the reform program that relates to the Government's Financial Sector Development Program (FSDP), while subsection C focuses on the Government's Public Sector Reform Strategy (PSRP). Subsection D concludes this section with a discussion of GRZ's Private Sector Development Initiative (PSDI).

A. Returning To A Macroeconomic Framework Conducive To Robust Growth

Correcting macroeconomic imbalances

31. *Issues.* The macro economic framework conducive to growth is outlined in section II, paragraphs 20-27, on Medium Term Prospects and Creditworthiness. It is recognized by the Government that establishing macroeconomic stability will provide a firm basis for economic growth and diversification but that maintaining and increasing economic growth will need a swift implementation of the structural and public sector reform agenda described in subsection B, C and D.

32. *Reform Program and EMGC measures.* The macroeconomic environment has improved, which allowed a new three-year PRGF arrangement to be put in place in June 2004. In addition to the fiscal and economic growth targets discussed above, the Government aims, with support from the PRGF, to reduce inflation to around 10 percent in 2006 and single digits thereafter and to increase gross international reserves of the Bank of Zambia (BoZ) to about 1.7 months of import cover by 2007. These developments together with the reduction of the fiscal deficit to 2.6 percent by 2007 should also contribute to a reduction in real interest rates, therefore, improving Zambia's investment climate and investment opportunities. The EMGC will closely monitor compliance with the macro economic targets specified in the PRGF in coordination with the IMF.

33. An important related issue is the need to eliminate the build up of budgetary arrears and arrears by parastatals with utilities as this threatens the financial viability of the utilities themselves and their ability to operate, but often will require budgetary transfers in the end to settle them. The Ministry of Finance and National Planning (MoFNP) has recognized this problem and has taken measures to ensure that the Government, including its parastatals, is paying its utility bills as well as its insurance premiums on time and if necessary will work out a time bound restructuring plan of these arrears with the utility companies.

Working towards a financially sustainable pension system

34. *Issues.* In Zambia, three major institutions provide pensions to retirees. Civil service members hired before February 1, 2000 belong to either the federal-level public service pensions fund (PSPF) or the Local Authorities Superannuation Fund (LASF). In February 2000, the National Pension Scheme (NAPSA), which was created by a 1996 act, was implemented. At that time, members of the successor private sector scheme, the National Provident Fund, were transferred to NAPSA. Almost all new civil servants after February 2000 are enrolled in NAPSA, so that over the next 30 to 40 years the civil service schemes will be phased out.

35. Although the public service schemes are being slowly phased out, they still cover the vast majority of the public service. Together the two schemes, PSPF and LASF, have 130,000 active members, about a quarter of the formal workforce, and pay pensions to about 50,000 retirees. NAPSA currently covers about 350,000 workers. In 2007 it will begin to pay old age retirement pensions.

36. The financial status of pension schemes in Zambia is mixed. The two public sector schemes, PSPF and LASF, are insolvent, although both hold some assets and are owed considerable amounts in contribution arrears. If the plans could collect all contribution arrears, their financial position would not be substantially

strengthened. Benefits are simply too high relative to current contribution rates. The hidden pension liabilities of the two public service funds alone are almost 3 trillion kwacha, an amount greater than 1/3rd of external debt, and since benefit levels in these schemes are protected in the Constitution, reform is all but impossible without constitutional amendment. See appendix 1 for a more detailed description of the pension issues in Zambia.

37. *Reform program and EMGC measures.* The Government has accepted the need to reform the PSPF and LASF and has recognized that without a constitutional amendment it will be unable to put the PSPF and LASF on a sound financial footing. Therefore it will approve by second tranche a financial reform program for PSPF and LASF, which include a proposal to change the relevant article in the constitution with regard to pensions as well as parametric and structural reforms. To control the financial situation of the funds in the interim, cost reducing measures have been adopted and starting 2005 new PSPF entrants face different benefit formula and contribution rates that are financially sustainable and actuarially fair.

38. The issues facing NAPSA are largely operational rather than financial, since it currently pays few benefits and has a contribution rate that will exceed benefit payouts for the next 10 to 15 years. During that time, however, it will accumulate a buffer fund that is likely to be the single largest pool of capital in Zambia. Therefore, the most urgent need is for procedural reform, tooling up, and capacity building in asset management. Currently NAPSA's investment guidelines do not adequately protect the principle of its assets or promote diversification, nor support development of Zambia's capital markets without unreasonable cost. In addition, NAPSA will benefit from reducing its high administrative cost by allowing Zambia Revenue Authority (ZRA) to collect NAPSA contributions.

39. To tackle potential risks with regard to its current investment practices NAPSA will adopt new investment guidelines, which includes the appointment of a global custodian, redefine the role of its Board, and agreement on a training program to support these changes. In addition, amendments are being prepared to amend the ZRA act such that it will allow ZRA to collect NAPSA contributions.

40. Although pension regulation exists, it is ineffective. The Pension and Insurance Authority (PIA), which is housed within the Ministry of Finance, regulates employer-sponsored private sector schemes and the two public sector schemes. Ambiguities exist in the Pension Scheme Regulation Act that prevents effective supervision and monitoring. PIA has neither the capacity nor the resources to tackle enforcement and compliance with the law. Since the size of pension assets is over 5 percent of GDP, it is imperative for the Government to ensure PIA has the capacity so that (international) fiduciary standards in relation to performance, monitoring, and supervision are adhered to.

41. The Government's FSDP recognizes the challenges that the PIA faces in the light of the growing pension asset that are being accumulated in particular by NAPSA. It therefore recommends that the Pension Scheme Regulation Act is amended to address issues of PIA's authority over all pension schemes, the PIA is given independence, and adequate funding is provided to PIA to enable it to fulfill its functions of regulation and supervision.

B. Strengthening The Role Of The Financial Sector.

42. *Issues.* The Financial Sector Assessment Program (FSAP) report of 2003 and self-assessments undertaken by the Bank of Zambia (BoZ)[5] have identified several weaknesses in Zambia's financial sector. Low financial intermediation; insolvent public financial institutions, including Zambia National Building Society (ZNBC), Development Bank of Zambia (DBZ), and the National Savings and Credit Bank (NSCB); high interest margins and ratio of fee income to average assets; limited capacity with regard to financial sector supervision; and multiple and conflicting roles by government in

[5] These include an assessment of the Basle Core Principles for effective Banking Supervision and the Monetary and Financial Policies Transparency Codes

the financial sector; as well as a poor credit culture.

43. *Reform Program and EMGC Strategy.* In the light of these concerns financial sector stakeholders in collaboration with the BoZ prepared the Financial Sector Development Plan (FSDP) in order to address the weaknesses identified and to provide for a systematic and coherent action plan that would lead to the realization of a well functioning financial sector in Zambia. The Cabinet has formally adopted the FSDP and more specifically agreed to strengthen the supervisory powers of the BoZ through e.g. harmonization of legislation such that (state-owned) non-bank financial institutions (NBFIs) can be incorporated under the Company's Act and supervisory powers over NBFIs by the BoZ are strengthened. It is expected that by second tranche of the EMGC these changes have become effective and that an action plan for the resolution of the three state-owned NBFIs is being implemented.

44. To strengthen the operational Governance arrangements of the BoZ, the Government plans to review and revise the provisions of the Government's credit facility at the BoZ and to change the procedures by which the board members of the BoZ are appointed by the time of second tranche release. In addition, it is also expected that the BoZ will undertake an evaluation of available options with regard to business models for a credit bureau before deciding on which option to implement. This is to improve Zambia's credit culture, which so far has been undermined by non-timely servicing of financial obligations by its debtors. It is expected that this will also be completed before the release of the second tranche.

C. Strengthening the credibility and institutional capacity of the Public Sector

45. *Background.* The Government embarked on its Public Sector Reform Program (PSRP) in 1993 with the overall goal of improving the quality, delivery, efficiency, and effectiveness of public services. It was recognized that this would require significant institutional changes and capacity building over a medium term. Therefore, the Government with external assistance designed and started implementing its Public Service Capacity Building Project (PSCAP) in 2001.[6] Much of the support under PSCAP is for capacity building in public expenditure management and accountability. As a result, the Government prepared its first Medium Term Expenditure Framework (MTEF) in 2003, based upon the priorities laid out in the TNDP and the PRSP, introduced an Activity Based Budgeting (ABB) system, and approved a pay reform strategy in 2003 as well. Another outcome of the PSRP was that the job grading structure has been simplified and some allowances eliminated, consolidated or folded into salaries and an integrated personnel and payroll system is being implemented to improve management and control of the Government payroll. In addition, new general orders for staff were prepared that include a code of ethics.

46. *Issues.* Notwithstanding these improvements, the PEMFAR document[7] showed that significant shortcomings in many public sector reform areas remain: the laws and institutions for public expenditure and accountability in Zambia are weak; the budget lacks credibility as actual spending differs considerably from the planned amounts; budget execution is weak due to lack of enforcement of expenditure controls, lack of proper recording of commitments, and weak procurement practices and regulations; and the weak oversight and scrutiny of the Executive's financial management by the Office of the Auditor General and the parliament has undermined transparency and accountability.

47. *Reform Program and EMGC Strategy.* In view of the conclusions of the PEMFAR document and the need to update the 1993 PSRP, the Government in collaboration with the cooperating partners embarked on a comprehensive revision of its PSRP. The priority areas in the revised PSRP are: (i) public expenditure management and financial accountability; (ii) right sizing and pay reform; and (iii) decentralization and strengthening of

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[6] PSCAP is financially supported, by Britain, Norway, The Netherlands, and IDA.

[7] See the Public Expenditure Management and Financial Accountability Report (Report No. 26162-ZA) for details.

Local Government. The Government, with extensive assistance from collaborating partners, has prepared and adopted the new PSRP, which includes a time bound and phased implementation plan for each of the three priority areas.[8] The main areas identified here for support are (i) Government's debt management; (ii) public expenditure management and financial accountability practices; (iii) streamlining of ministerial structures and improving incentives for service delivery.

Upgrading Government's Debt Management Capacity to Support Fiscal Sustainability.

48. *Issues.* Current arrangements, institutional as well as for monitoring and evaluation of Government debt, make it difficult to formulate a consolidated strategy as responsibilities are split between MoFNP and BoZ. The latter is actually responsible for domestic debt management and this implies a risk that monetary policy and debt management cannot be efficiently separated.

49. *Reform Program and EMGC Strategy.* To assist the Government in designing and implementing an appropriate debt management system where responsibilities are clearly assigned and do not lead to overlapping responsibilities, a debt management assessment was undertaken. As a result, the MoFNP has taken two important initial steps, of which one is to lead to an up to date database of Government debt that can be used for monitoring and evaluation and the other to the formulation of a debt management strategy post-HIPC completion and strengthens the role of the MoFNP in the process of debt issuance.

Improving Public Expenditure Management and Financial Accountability Practices.

50. *Issues.* The PEMFAR document shows that Zambia must significantly improve its public expenditure management and financial accountability practices in order for public expenditures to have a significant impact on poverty. It is clear that the introduction of a MTEF based upon an ABB system in 2003 and used for the 2004 budget improves the Government's ability to monitor and evaluate the impact on poverty of its expenditure programs. The introduction in 2004 of activity based budgeting allows for monitoring of public expenditures by functional and program classification. This will allow, inter alia, for a more effective tracking of inputs towards poverty reducing programs and therefore of the PRSP. This increased ability to monitor resource use will help to direct funds towards PRSP programs and henceforth should facilitate a more growth conducive composition of expenditure.

51. However several issues, related to budget preparation and execution, remain an obstacle to improving Government's credibility with regard to the budget process. In particular the Government has used supplemental appropriations liberally as a way to make major shifts in the budget during the year – from one ministry to another or from one subhead to another. At times the supplemental appropriations have been much bigger than even the original budget estimate. Parliament's approval of the supplemental appropriations is merely pro-forma after the spending has already occurred, and it has no bearing on the next year's budget.

52. Indeed, the budget lacks credibility if the actual spending differs considerably from the planned amounts. Yet, some of the large variances are foreseeable because the budget estimates are sometimes much lower than the historical level of expenditure. This suggests poor or unrealistic budgeting, partly because information on past expenditures is not used effectively. Currently, the budget presented to Parliament only shows the proposed estimate and the total authorized budget from the prior year. However, data on the prior budget and the supplemental appropriation are not necessarily consistent with the actual expenditures.

53. Another issue is that although the Government has succeeded in introducing ABB to enhance budget preparation in line ministries

[8] The technical and financial assistance needed to implement each component of the revised PSRP is to be provided through a comprehensive pooling of funds by several like-minded donors, including IDA, which is to allow for earmarking towards a specific component without delaying implementation of the overall PSRP.

for the 2004 budget, cash releases to ministries and expenditure reporting back to Ministry of Finance continued to rely on the old system. For ABB to have any real impact, expenditure reports also need to use the ABB format. The Financial Management System (FMS) software currently used to prepare monthly expenditure returns should, therefore, be retooled to use the ABB classification instead.

54. The Office of the Auditor General has a critical role to play in providing oversight and scrutiny of the Executive's financial management. Although the Zambian Constitution gives it nominal independence with which to conduct its work, at a practical level the OAG has been constrained by regulations that limit its ability to operate optimally. Its recruitment and remuneration policies are linked to the broader public service regulations and its budget is subject to approval from Ministry of Finance and National Planning.

55. *Reform Program and EMGC Strategy.* The Government has recognized these concerns and has proposed the following solutions for them in the revised and adopted PSRP. First, Government has proposed to the constitutional review committee constitutional amendments that will: (i) enable its budget to be approved by parliament before the start of the fiscal year; (ii) enhance accountability and permit additional strengthening of the current Finance Act; (iii) enhance the autonomy of the Office of the Auditor General. Second, Cabinet has approved for submission to Parliament a revised Finance Act that strengthens financial management and accountability within the current limitations set by the constitution, including provisions that: (i) define the role and functions of the Treasury; (ii) strengthen the role of internal audit through establishment of audit committees; (iii) define the responsibilities of the Accountant General's department; (iv) enhance provisions for oversight of statutory corporations, and (v) prohibits expenditures from being incurred that exceed the appropriation.

56. Third, Cabinet has agreed that it will approve any supplemental to the budget, if any, prior to the spending occurring and that such supplemental would show not only where spending will increase, but also where it will be reduced as a result. Fourth, MoFNP has submitted a Green Paper to Cabinet in the third quarter of 2004 with three-year indicative budget ceilings for each ministry, inclusive of ceilings for personal emoluments (PE's), in order to facilitate consultations with Parliament and other stakeholders. In addition, it has installed new FMS software in each ministry, which permits reporting in ABB format and all central ministries have indeed generated monthly reports through the new FMS using the ABB format.

57. The following improvement to the budget process is expected to take place prior to the second tranche release of the EMGC: MoFNP has submitted the annual budget to Parliament for 2005 showing not only the proposed budget, but also a comparison to the estimated spending for the current year (2004) and the actual audited spending from the prior year (2003). It is planned that this will be presented in summary format, but at least for each budget head by PE versus non-PE domestic expenditures and will be institutionalized.

Streamlining Ministerial Structures And Improving Incentives For Service Delivery.

58. *Issues.* Until recently the Government's payroll has been managed by the MoFNP's Data Center using an outdated system that was inaccessible to key decision-makers and lacks adequate controls on data quality. For example, the payroll database was completely separated from management of the establishment registry, meaning that the Cabinet Office responsible for the management of the civil service was generally unaware if ministries had recruited people for unauthorized positions. The proliferation of allowances has also become unmanageable under this system, and many people received allowances for which they were or are not qualified. In addition, as people have been separated from the public service, the Cabinet Office has had difficulty assuring that they are indeed removed from the payroll.

59. The medium term pay reform strategy adopted by the Cabinet in 2002 included the elimination of cash allowances in favor of improvements in base salary. This was intended to improve transparency and equity in pay policy

and enhance Government's ability to make accurate cost adjustments to the salary system. The current system includes dozens of allowances for fixed amounts, which have lost value over the years. In other cases, civil servants receive flexible allowances, which are a percent of base salary. These allowances have created significant distortions in the pay system, where job responsibility and educational background have less to do with one's total remuneration. In 2003 negotiations between the Government and the public services unions failed to follow-through on the policy of eliminating allowances, and the total cost of the wage bill exceeded the agreed targets.

60. The above-mentioned issues have contributed to an unsustainable growth in the wage bill from 5.3 percent of GDP in 2000 to 8.4 percent in 2003. The uncontrolled growth in wages and salaries has crowded out, in particular, expenditures for recurrent departmental charges, which include expenditures for poverty reduction programs, harming the ability of Government to effectively implement its PRSP.

61. *Reform Program and EMGC Strategy.* With funding from DFID for the past few years, the Government has made development of a new human resource information management system a priority. The Payroll Management and Establishment Control (PMEC) system has been installed at a few central ministries. It is expected that by second tranche the MoFNP has: (i) transferred the payroll to the PMEC system; (ii) trained users for all central ministries; (iii) PE releases are based on PMEC. As a result, each public servant is matched to a specific post on the establishment and all positions beyond the establishment are accounted for and abolished. The Cabinet office is committed to have implemented before the release of the second tranche of the EMGC a policy for consolidating most allowances into base salary in 2005 and 2006. Priority is given to those allowances that create accrued liabilities and thereby increase the cost of separations from the public service.

62. To come to closure with regard to the initial restructuring exercise of Government ministries initiated under PSCAP, the Cabinet has approved the new structures of the remaining ministries and has removed any excess staff from their payroll. In addition, a new annual performance appraisal system (APAS) is to be implemented by second tranche for all management positions and civil servants have been informed that annual salary increments are no longer automatic but instead will be based on employee performance.

D. Rationalizing the Interaction between the Public and Private Sector

63. *Background.* Until Zambia emerged in the early 90ties as a multiparty democracy, its economic system was basically of a centrally planned nature. During the early nineties Zambia embarked on an impressive program of economic liberalization, which has significantly contributed to the current growth momentum. Even though major utilities, e.g., electricity and telecommunications, remain state owned their drain on the economy has subsided and in the case of the energy utility, ZESCO, its governance structure has been improved as well. With price liberalization and privatization almost completed Zambia now faces the difficult last stages of transition where the Government's own efficiency and effectiveness have become the main impediment to completing the path to a dynamic market economy in which private initiative can flourish and provide the much needed sustainable high growth.

Improving Zambia's business environment

64. *Issues.* Several studies by IDA[9] have been undertaken to identify bottlenecks to accelerate private sector development (PSD). The five most critical constraints identified by IDA's analytical work are: (i) inadequate infrastructure; (ii) Government's inability to engage in a productive dialogue with the private sector; (iii) provide a growth conducive macroeconomic environment; (iv) inadequate provision of business

[9] IDA has prepared a range of private sector-related analytical reports Zambia: the Challenge of Competitiveness and Diversification; Zambia Privatization Review – Facts, Assessments and Lessons; Financial Sector Assessment; Zambia Copperbelt Diversification Strategy; Agribusiness Sector Development; A Framework for Tourism Sector Development; Gemstone Sector Development; Country Economic Memorandum; Investment Climate Assessment and the Administrative Barriers to Investment Study.

development services to the small and medium enterprises (SME) sector; and (v) Zambia's small market size and hence its need for an outward orientation. There is a significant gap between the current level and quality of infrastructure provision and where it needs to be to adequately support a competitive, export oriented, and growing economy.

65. *Reform Priorities and EMGC Program.* The Government has recognized the need to engage the private sector to further identify measures that address the main bottlenecks to private sector development and to prioritize these measures and actions in the light of GRZ's limited resources and implementation capacity. Therefore, GRZ, in collaboration with IDA has organized a private sector development forum to build consensus among key stakeholders. The areas identified during the forum for immediate action are: (i) to create an enabling institutional environment for PSD by consolidating the many public sector agencies involved in PSD into one; (ii) to improve regulatory framework for network utilities (see below) and the investment code; (iii) enhance the infrastructural platform for PSD by encouraging private investment in infrastructure; (iv) remove administrative barriers to business entry and their operation; (v) create greater opportunities for access to regional and international markets for Zambia; and (vi) unlock the growth potential of the SME sector. In addition the forum also decided on a process through which the proposed measures should be implemented, which involves regular meetings between the public and private sector representatives.

Improving the Legal and Regulatory Environment for Network Utilities.

66. *Issues* The utility sectors, energy (ZESCO), telecommunications (ZAMTEL), and water, which are a critical part of Zambia's business climate, are seen by investors as inefficient and unreliable. Even though the financial performance and governance structures in the case of ZESCO have improved, it is important to acknowledge that the monopoly powers granted to ZESCO as well as ZAMTEL will require appropriate oversight by a strong and independent regulator. To attract large-scale investments in these sectors the Government needs to commit to regulatory stability. Without such a commitment investors feel vulnerable to arbitrary administrative intervention, require large risk premiums, and make disproportional low investments.

67. ***Energy.*** In the energy sector, the main policy and institutional issues are: (i) the absence of a comprehensive document of Policy Statement for the energy sector that clearly articulates the Government's vision for the development of the sector over the medium to long-term. Such a policy document will provide the basis of legislation and regulation; the manner and nature of regulation; and the development of medium to long-term strategy for the sector. Current legislations and regulatory framework are inadequate for the eminent changes that are going to take place in the medium to long-term influenced in-part by expected developments in the regional energy market, and an expected greater role of the private sector; (ii) weak regulatory capacity and independence of the Energy Regulatory Board (ERB); (iii) need to revamp electricity tariff policy to ensure efficiency and viability of sector entities and to enable ERB to establish a transparent basis of setting, and periodic adjustment of the tariffs to meet objectives of the energy sector policy. The current policy of uniform tariffs for same consumer class regardless of location and cost of service calls for inter-consumer cross-subsidies. Such a situation is difficult to be maintained in a competitive environment, in which services are unbundled, and would come under considerable strain when rural electrification becomes extensive.

68. ***Telecommunications.*** In the telecommunication sector the issues are quite similar to the energy sector with regard to the need to develop a new sector policy that takes adequately into account the new technology realities that the sector faces. Therefore, key policy, regulatory and institutional issues include: (i) absence of a comprehensive policy statement for the sector that articulates the Government's vision for the development for this sector; (ii) development of new telecommunications act, which ensures autonomy of the regulator and separation of policy and regulatory functions; (iii) commercialization of ZAMTEL to include tariff-rebalancing, operational and financial

separation of its ISP and Mobile operations from fixed line services, liberalization of the international gateway; (iv) development of rural ICT sector strategy and establishment of Rural Telecom Development Fund with appropriate institutional mechanisms for fund management; as well as (v) strengthening of the regulator in key issues such as licensing, price setting, interconnection and frequency management.

69. *Reform Program and EMGC Strategy.* The government has recognized that effective and efficient provision of infrastructural services by network utilities is important for PSD. In energy as well as in telecommunications the Government has embarked on developing a sector policy strategy, which will provide a vision of how to develop the sector over the medium term. Once the sector policy frameworks have been adopted, an obvious next step is to adjust the legislation and regulation that serve the two sectors. At that time, it is expected that a review of the institutional and regulatory capacity and frameworks will need to guide the implementation of the sectoral polices and legislation as identified above. It is also important for ZESCO that it continues to show satisfactory progress in the implementation, and successful completion by June 30, 2005 of the ZESCO commercialization roadmap.

V. THE PROPOSED CREDIT

A. Rationale and Objectives

70. The proposed operation will support the Government program described above, and in the attached Letter of Development Policy [Annex 4] and the Policy Reforms Program Matrix [Annex 5]. The main objective of the proposed Credit would be to help sustain the current economic recovery through reforms that (i) strengthen the macroeconomic environment; (ii) advance financial sector performance, (iii) improve public sector management, as well as (iv) Zambia's business environment.

B. Links to the Country Assistance Strategy.

71. To support the implementation of the PRSP and TNDP and to incorporate lessons learned from the failures and successes of previous IDA interventions in Zambia, IDA prepared a results based CAS, which was discussed with IDA'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 IDA interventions. The focus of IDA activities is structured around three strategic priorities:

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;

72. The proposed operation is envisaged in the base-case lending scenario of the CAS to support macroeconomic stabilization in parallel with a PRGF and other donors' policy-based support. It states that a macroeconomic support operation would depend on upfront actions and results, and be the backbone of support to policy and institutional reforms in support of the first strategic priority in particular. See also Table 2 on page 8. The Policy Reforms Program Matrix [Annex 5] identifies explicitly how the key areas of reform are linked to the results matrix of the CAS and which CAS outcome is impacted by the proposed EMGC.

C. Board Conditions and Tranche Triggers

73. Table 3: EMGC – Credit Milestones presents the key measures that the Government will undertake in order to have the EMGC funds released. The EMGC financing will be made available in two tranches: US$ 20 million to be disbursed immediately after credit effectiveness and the second tranche of US$ 20 million upon implementation of the key measures and results identified in the second column of Table 3.

D. Poverty Implications

74. The proposed EMGC will have an important, though indirect, effect on poverty reduction, since it will support the Government's effort with regard to PRSP implementation. It will facilitate poverty reduction mainly through two channels. The first channel is by assisting the Government

to put in place a growth conducive macroeconomic environment, which will aid the robustness of the current growth momentum. The second channel is through the improvement in public management processes that will enhance the Government's ability to direct its scarce resources to those expenditure programs that will reduce poverty more efficiently and more effectively.

Table 3: EMGC-Credit Milestones

By Board presentation	Milestones for release of the second Tranche (expected June 2005)
A. Returning to a macroeconomic framework conducive to robust growth	
Cabinet has issued a decision to empower utilities and insurance companies to treat government institutions as any other client including that the utilities and insurance companies would be expected to discontinue their services to Government institutions in similar fashion as any other customer; The Accountant General has instructed accounting officers to pay their utility and insurance bills on time; The Secretary of the Treasury has issued a letter to the utilities and insurance companies reiterating the decision made by Cabinet.	The MoFNP, if necessary, has adopted a time bound restructuring plan for payment of the Government's arrears to utility and insurance companies.
PSPF Board has approved amendments to reform pensions including the benefit formula, commutation factors, and contribution rates for new PSPF members since the year 2005 and PSPF has completed a draft three year implementation plan to reduce administrative expenses to 12 percent of 2003 annual accrued contributions as approved by its Board.	Cabinet has approved (i) a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reforms to be applicable to existing participants in PSPF and (ii) a reform program that ensures the financial sustainability of the fund. The National Pension Scheme Authority (NAPSA) has (i) adopted a revised investment policy, appointed a global custodian, and selected a pension fund manager; (ii) drafted an operations manual on corporate governance; and (iii) developed a program for training trustees.
B. Strengthening the role of the financial sector	
Cabinet has approved the Financial Sector Development Plan, which stipulates the repeal of those sections of the Building Societies Act, the National Savings and Credit Bank (NSCB) Act, and the Development Bank of Zambia (DBZ), such that (i) these institutions can be incorporated under the Company's Act, (ii) inconsistencies with the Banking and Financial Services (BFS) Act are removed; and (iii) supervisory powers over NBFIs by the Bank of Zambia are strengthened. The Bank of Zambia, MoFNP, and the Development Bank of Zambia have signed a Memorandum of Understanding, which specifies the supervisory role of the Bank of Zambia and the MoFNP with regard to the Development Bank of Zambia until DBZ falls under the BFS Act.	The Borrower has made progress in the process of adopting the necessary legal changes to the Building Societies Act, the National Savings and Credit Bank Act, and the Development Bank of Zambia Act The Borrower has commenced implementing its Financial Sector Development Plan pertaining to the reform of state-owned NBFIs including NSCB, ZNBS, and DBZ, to ensure that no public funds will be used without a business plan acceptable to IDA. DBZ shall not (i) accept deposits and (ii) raise any loan requiring Government guarantee.
C. Strengthening the credibility and institutional capacity of the Public Sector	
The MoFNP has submitted recommendations to the constitutional review committee that would (i) enable the budget to be approved by parliament before the start of	MoFNP has tabled in the Borrower's legislature the annual budget for 2005 including an annex, which compares the estimated expenditures for the year 2005

By Board presentation	Milestones for release of the second Tranche (expected June 2005)
the fiscal year; (ii) enhance accountability for public expenditure by restricting retroactive approval of supplementary appropriations; and (iii) the Office of the Auditor General has submitted its recommendations to the CRC on enhancing its autonomy and expanding its duties. Cabinet has approved for submission to Parliament a revised Finance Act that strengthens financial management and accountability, including provisions that:·(i) Define the role and functions of The Treasury; (ii) Strengthen the role of internal audit through establishment of audit committees; (iii) Define the responsibilities of the Accountant General's Department; (iv) Enhance provisions for oversight of statutory corporations, and (v) prohibits expenditures from being incurred that exceed the appropriation. Cabinet has agreed that it will approve any supplemental to the budget, if any, prior to the spending occurring and that such supplemental would show not only where spending will increase, but also where it will be reduced as a result. MoFNP has submitted a Green Paper to Cabinet in the third quarter of 2004 with three-year indicative budget ceilings for each ministry, inclusive of ceilings for personal emoluments (PE's).	with the budget releases for the years 2004 and2003. This would be presented in summary table aggregated by budget head, showing the PE and non-PE spending from GRZ resources. PSMD in the Cabinet office has consolidated most allowances into base salary and reduced the overall ratio of allowances to base salary subject to negotiations with Public Service Unions and the identification of their fiscal implications. MoFNP has (i) transferred the payroll to the PMEC system; (ii) trained users for all central ministries; (iii) based Personal Emoluments releases on PMEC; (iv) matched each public servant to a specific post on the establishment; and (v) ceased to pay public servants whose post is not on the establishment except those identified for retrenchment but not yet paid off.
D. Improving Zambia's Business Environment	
No Credit release milestones.	

E. Coordination with the IMF and Donors

75. The achievements of the proposed EMGC goals are strengthened by IDA's close collaboration with the IMF and other donors. The supported macroeconomic program is fully consistent with the Fund's PRGF. The measures designed to improve the management of public expenditure through greater financial discipline and accountability complement the IMF's support for revenue mobilization and expenditure control. The IMF's structural policy benchmarks are developed in close consultations with IDA and also stress the complementarities between the two programs. In addition, the reform components of the EMGC are linked to several TA projects funded by the donors. For example, the TA needs for the implementation of the PSRP and the FSDP is supported by several other donors in particular by those that have signed up with the wider Harmonization in Practice (HIP) initiative.

F. Credit amount, Disbursement Procedures, and Implementation Arrangements

76. ***Borrower and Credit amount***. The proposed EMGC will be made to the Republic of Zambia. The credit in the amount of US$ 40million will be on standard IDA terms with 40 years maturity and a grace period of 10 years.

77. ***Disbursement***. Upon approval of the credit and notification by IDA of credit effectiveness, the Government will submit a withdrawal application. The Ministry of Finance will open and maintain a deposit account in the Bank of Zambia. IDA will deposit the proceeds of each

tranche of the credit in this account at the request of the Ministry of Finance. If, after deposit in this account, the proceeds of the credit are used for ineligible purposes (for example, to finance items imported from non-member countries, or goods or services on IDA's standard negative list), IDA will require the borrower to either: (i) return that amount to the account for use for eligible purposes; or (ii) refund the amount directly to IDA, in which case IDA will cancel an equivalent un-disbursed amount of the Credit.

78. ***Accounts, Auditing, and Closing Date.*** IDA reserves the right to require an audit of the deposit account. MoFNP will arrange for the audit of the deposit account upon request by IDA in accordance with auditing standards and terms of reference acceptable to IDA and by auditors acceptable to IDA. The MoFNP will make the report on the audit of such available to IDA within four months of the close of the Government's fiscal year when requested by IDA. The closing date of the Credit will be December 31, 2005.

79. ***Implementation arrangements.*** To facilitate program implementation and the coordination of activities, the Government has appointed an inter-ministerial steering committee responsible for preparing the EMGC. This committee, which is charged with overseeing the implementation, is led by the Secretary to the Treasury of the MoFNP. IDA will monitor the general progress of Zambia's reform program, in particular the implementation of the agreed measures, through regular reviews. This will require regular monitoring and supervision led by IDA in close collaboration with the World Bank Office in Zambia. A set of agreed performance indicators will guide the assessment of the EMGC and can be found in the Policy Reforms Program Matrix [Annex 5].

G. Benefits and Risks

80. ***Benefits.*** 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 move GRZ towards durable (fiscal) adjustment while laying the foundations for higher and sustained 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.

81. ***Risks.*** In light of Zambia's track record in implementing reform programs, the proposed credit could face significant risks. The main risks overlap directly with the risks identified in the CAS, and include (i) political; (ii) macro economic nature; (iii) external developments; (iv) failure to contain the further spread of the HIV/AIDS pandemic; and (v) implementation capacity.

82. *Political Risk.* Even though the next general elections are planned for 2006, it is expected that 2005 will show the beginning of the election campaign. This can take away the needed attention to stay the course with the ongoing economic reform efforts to further strengthen the effectiveness of the public sector and the commitment to work towards a resolution of state-owned non-bank financial institutions. To mitigate these challenges some areas supported by the proposed operation are also supported, though often from a different angle, by the IMF's PRGF arrangement and its capacity building challenges through financial support by other donors, in particular the HIP group. In addition, for some milestones to have their expected impact, the Government would need to follow up with amendments to the existing constitution. Even though a Constitutional Review Commission has been working on a general constitutional revision, these constitutional changes cannot be guaranteed.

83. *Macroeconomic stability.* Weak fiscal discipline caused in part by ineffective public expenditure management processes can generate risks for macroeconomic performance. In addition, pressure by civil service unions for

increases in wages and allowances and other non-priority sectors such as defense could potentially risk the execution of the fiscal program.

84. *External Developments.* The country is vulnerable to terms of trade shocks and droughts. The upsurge in copper prices might re-ignite the hope that Zambia once more can count on the copper sector for economic success. A reoccurrence of a drought would harm the recent gains in food security and could see a surge in the need for food imports.

85. *HIV/AIDS pandemic.* HIV/AIDS remains the most significant health threat to Zambia's population and hence to its prosperity. The impact of the disease is increasingly visible in all spheres of Zambia's society and economy. With prevalence remaining in double-digit figures the potential damage is enormous.

86. *Implementation capacity.* In addition to the risks identified in the CAS in this area, weak policy implementation record and limited Government administrative capacity and coordination could lead to delays in the implementation of key measures not in the least because of the goal of the Government to reach HIPC Completion as soon as possible. The latter will require a significant effort on the side of GRZ and as such could absorb most of the limited implementation capacity of GRZ.

ANNEXES

Annex 1: Key Indicator Tables

Table 1: Zambia: Key Economic Indicators, 1998-07

Indicative Scenario	Actual						Estimated	Projected		
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
General										
GDP per Capita Growth (constant prices)	-4.1	0.0	1.5	2.9	1.3	3.1	2.5	3.0	3.0	3.0
GDP Growth (constant prices)	-1.9	2.2	3.6	4.9	3.3	5.1	4.6	5.0	5.0	5.0
Inflation CPI (end of period, year-on-year, % change)	30.6	20.6	19.0	30.1	26.7	17.2	20.0	15.0	10.0	5.0
91 day TB yield (end of period, %)	33.2	36.2	34.1	50.5	32.0	31.9	-	-	-	-
Weighted Base Lending rate (end of period, %)	37.4	42.6	37.6	46.7	42.5	39.6	-	-	-	-
Public Finances (cash basis)										
Central Government Revenues (% of GDP) of which	25.4	25.7	25.1	24.9	26.2	24.9	23.5	24.7	25.1	24.8
Grants (% of GDP)	6.6	8.0	5.7	5.8	8.3	6.9	5.3	6.5	6.8	6.5
Central Government Expenditures* (% of GDP) of which	30.0	29.3	31.0	32.2	31.3	30.9	26.5	27.5	28.1	27.4
Central Government Overall Balance* (as % of GDP) of which	-4.6	-3.6	-5.9	-7.3	-5.1	-6.0	-3.0	-2.8	-3.0	-2.6
Foreign Loan Financed (% of GDP)	0.8	3.0	5.3	3.6	4.3	1.5	1.1	1.1	1.2	1.1
Central Government Primary Balance* (as % of GDP)	-1.3	-0.8	-2.9	-4.8	-1.0	-2.1	0.7	0.5	-0.1	-0.2
Domestic Debt (% of GDP)	..	..	7.7	22.1	21.0	21.8	17.4	16.0	15.1	13.7
Savings & Investment										
Gross Domestic Investment (% of GDP)	16.4	17.6	17.1	20.1	23.0	26.2	23.3	21.8	22.0	22.0
Gross National Savings (% of GDP)	-3.6	-6.6	-2.1	-0.7	5.7	10.0	10.2	10.2	10.0	10.0
Foreign Savings	17.7	15.4	19.2	20.8	17.3	16.2	13.1	11.6	12.0	12.0
External Developments										
Exports of Goods & Services Growth (current US$)	4.9	4.9	-14.4	29.0	2.4	23.4	44.8	8.8	2.7	-0.7
Import of Goods & Services Growth (current US$)	4.6	1.6	-20.1	27.2	2.5	13.3	28.2	-1.1	5.0	0.8
Current Account Balance incl. all grants (% of GDP)	-11.6	-8.8	-11.4	-10.8	-6.5	-7.5	-6.4	-4.1	-3.8	-4.0
Reserves as months of imports of goods and services	0.9	0.7	1.0	0.9	2.2	1.3	1.1	1.3	1.5	1.7
External Creditworthiness										
External Debt (% of GDP)	261.8	229.0	264.7	179.2	165.7	161.5				
Debt Service due (% of Exports of Goods and Services)	38.5	38.1	46.6	59.4	57.4	50.0				
Net present value of debt, percent of exports	..		213	211	212	192	164	132	117	115

* Not including changes in domestic arrears or balances

a/ This indicative scenario is based on GRZ's MTEF and the IMF's PRGF projections.

1/ World Bank and IMF Staff estimates, annual estimates or latest observation;

Sources: GRZ; IMF; and Bank Staff estimates

Table 2. Zambia: Central Government Overall Operations, 1998-07
(In percent of GDP, unless otherwise indicated)

Indicative scenario a/	Actual						Projected			
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Revenue and grants	24.9	25.7	25.1	24.9	26.2	24.9	23.5	24.7	25.1	24.8
Revenue	18.4	17.7	19.4	19.2	17.9	17.9	18.2	18.3	18.3	18.3
Tax revenue	17.8	17.2	19.2	18.7	17.5	17.3	17.5	17.6	17.6	17.6
Nontax revenue	0.6	0.5	0.2	0.5	0.4	0.6	0.7	0.7	0.7	0.7
Grants	6.5	8.0	5.7	5.8	8.3	6.9	5.3	6.5	6.8	6.5
Program	0.0	1.9	1.0	0.8	2.0	1.1	0.7	1.5	1.1	0.7
Project	6.5	6.1	4.7	4.9	6.3	5.8	4.6	5.0	5.6	5.8
Expenditures	30.0	29.3	31.0	32.2	31.3	30.9	26.5	27.5	28.1	27.4
Current expenditures	18.9	16.8	16.9	19.7	19.4	19.5	17.7	18.6	18.9	17.6
Wages and salaries	5.3	5.4	5.3	6.8	8.0	8.4	7.8	7.9	8.1	7.9
Public service retrenchment	1.3	0.7	0.7	0.1	0.5	0.0	0.0	0.2	0.2	0.2
Recurrent departmental charges (RDCs) 1/	2.6	2.6	3.0	6.1	3.6	3.2	3.0	3.7	4.2	3.4
Transfers and pensions	2.4	2.4	2.2	2.7	2.5	1.8	1.6	1.6	1.6	1.6
Domestic interest	1.3	1.4	1.4	1.6	2.8	2.7	2.9	2.7	2.3	1.9
External interest 2/	2.0	1.4	1.7	0.9	1.3	1.1	0.8	0.6	0.6	0.5
Other current expenditures	2.0	1.3	0.9	1.4	0.6	2.2	1.5	1.7	1.9	2.1
Contingency	0.0	0.0	0.8	0.1	0.2	0.0	0.1	0.0	0.0	0.0
Capital expenditure	11.1	10.5	10.0	11.9	11.8	11.4	8.8	8.9	9.3	9.7
Domestically financed	1.8	1.7	2.3	3.8	2.6	2.5	2.1	2.2	2.3	2.7
Foreign financed	9.2	8.9	7.8	8.1	9.3	8.9	6.7	6.8	6.9	7.0
Net transfers to ZCCM 3/	0.0	2.0	4.1	0.6	0.5	0.0	0.0	0.0	0.0	0.0
Overall balance 4/	-5.1	-3.7	-5.9	-7.3	-5.1	-6.0	-3.0	-2.7	-3.1	-2.6
Financing	5.0	3.7	5.9	7.3	5.1	6.0	3.0	2.7	2.4	2.6
Domestic 5/	3.5	1.0	1.8	4.5	2.1	5.1	2.1	1.6	1.2	1.5
Bank	3.6	0.5	1.4	3.7	0.6	4.8	1.6	1.1		
Nonbank	-0.1	0.5	0.4	0.8	1.5	0.3	0.5	0.5		
Change in balances and statistical discrepancy (- = overfin.)	0.7	-0.3	-1.1	-0.8	-1.3	-0.6	-0.3	0.0	0.0	0.0
External	0.8	3.0	5.3	3.6	4.3	1.5	1.1	1.1	1.2	1.1
Program loans	0.0	3.6	4.8	1.3	1.8	0.2	0.6	0.6	0.5	0.3
Project loans	2.8	2.8	2.9	3.3	3.0	3.1	2.1	1.7	1.3	1.2
Amortization 2/	-2.0	-3.3	-2.4	-1.0	-0.5	-1.8	-1.5	-1.2	-0.5	-0.5
Memorandum items:										
Overall balance excluding grants	-11.6	-11.6	-11.6	-13.0	-13.4	-12.9	-8.3	-9.2	-9.8	-9.1
Domestic balance	0.4	0.4	-3.3	-4.6	-2.8	-2.9	-0.8	-1.8	-2.3	-1.5
Domestic primary balance		1.8	-1.9	-3.1	-0.1	-0.2	2.1	0.9	0.0	0.3
Stock of domestic debt (end period) 6/			7.7	22.1	21.0	21.8	17.4	16.0	15.1	13.7

Data sources: Zambian authorities; Fund and World Bank staff.

a/ This indicative scenario is based on GRZ's MTEF and the IMF's PRGF projections.

1/ Recurrent Departmental Charges include purchases of goods and service, some allowances and training expenses.

2/ The last Paris Club agreement, providing Zambia with debt relief on Cologne terms, expired at end-March 2003. Zambia will continue to accumulate arrears on reschedulable debt until a new agreement can be reached when a new PRGF arrangement is approved. Projected government debt service payments reflect obligations to Paris Club and other bilateral creditors after the accumulation of these arrears.

3/ Zambia Consolidated Copper Mines

4/ Cash basis.

5/ Until 2003 at face value. From 2004 at cost value. Exclude bonds issued in 2001 in favor of the Bank of Zambia (K 1,646 bn) and in 2002 n favor of the

6/ At cost value. Include bonds issued in 2001 in favor of BoZ (K 1,646 bn) and in 2002 in favor of the Zambia National Commercial Bank (K 248 bn).

Table 3: Zambia: Balance of Payments, 1998-07
(In millions of U.S. dollars, unless otherwise indicated)

Indicative scenario a/	Actual				Estimated	Projected		
	2000	2001	2002	2003	2004	2005	2006	2007
Current account balance 1/	-622	-758	-652	-699	-697	-662	-711	-764
Trade balance on goods and nonfactor services	-446	-570	-504	-549	-507	-324	-384	-415
Merchandise trade balance	-221	-342	-259	-311	-227	-40	-92	-127
Exports, f.o.b.	746	884	916	1,052	1,588	1,725	1,761	1,738
Imports, f.o.b.	-978	-1,253	-1,204	-1,393	-1,845	-1,797	-1,887	-1,900
Services, nonfactor (net)	-225	-228	-245	-238	-280	-284	-291	-289
Income (net)	-158	-168	-155	-148	-165	-187	-241	-257
Current transfers (net)	-18	-20	7	-2	-25	-151	-86	-92
Capital and financial accounts	202	466	286	380	434	384	445	537
Project grants	153	222	236	240	246	284	335	367
Official loan disbursement (net)	-140	-96	-122	-141	-114	-79	-62	-64
Change in NFA of commercial banks (-increase)	-89	40	-5	48	-7	-11	-10	-10
Private capital (net)	278	301	178	233	309	190	182	244
Errors and omissions, short-term capital	4	-107	-17	-2	15	0	0	0
Overall balance	-416	-399	-383	-321	-247	-278	-265	-227
Financing	416	399	383	321	247	278	226	168
Change in net int. reserves of BoZ (-increase)	-49	-124	-225	-164	-20	-275	-36	-66
Gross official reserves of BoZ (-increase)	-68	0	-169	87	-4	-46	-52	-43
IMF (net)	26	-119	-50	-244	-9	-223	17	-23
Debt relief	217	436	437	391	276	435	167	170
Non-HIPC 2/	217	170	171	154	120	67	19	21
HIPC, including IMF 3/	...	266	266	237	156	338	118	120
Possible additional debt relief after HIPC CP 6/	...	...	...	...	...	...	30	30
Other debt related items 5/	42	-19	21	-10	-14	0	0	0
Net change in arrears (+ increase) 4/	-10	31	12	48	-60	0	0	0
Program support	185	75	138	55	66	118	94	63
Financing Gap (+ deficit)	0	0	0	0	0	0	39	59
Memorandum items:								
Current acc't bal. excl. grants (percent of GDP)	-19.2	-20.8	-17.3	-16.2	-13.1	-11.6	-12.0	-12.0
Current acc't bal. incl. grants (percent of GDP) 7/	-11.4	-10.8	-6.5	-7.5	-6.4	-4.1	-3.8	-4.0
Gross official reserves in months of imports/8	1.0	0.9	2.2	1.3	1.1	1.3	1.5	1.7
Official debt service in percent of exports/9	15.9	13.5	11.4	15.0	20.8	6.8	4.3	5.4
Net present value of debt, percent of exports	213	211	212	192	164	132	117	115

Data Sources: Bank of Zambia (BoZ); and Fund and Bank staff.

a/ This indicative scenario is based on GRZ's MTEF and the IMF's PRGF projections.

1/ Excluding grants and debt relief on interest.

2/ Indicates debt relief that would have been available under the traditional mechanism, relative to 1999 Paris Club rescheduling, comparable treatment from non-Paris Club bilaterals and the 1997 restructuring of Camdex claim on

3/ It is assumed that Zambia will reach the HIPC completion point by end-2005.

5/ Reconciliation of scheduled debt service after scheduled debt relief with actual cash payments. Item includes overpayments, refunds, debt service carryover, currency revaluations and additional debt relief.

6/ Additional debt relief is expected from Paris Club creditors once Zambia reaches the HIPC completion point.

7/ Includes project and program grants, as well as debt relief on interest payments. Also includes grants assumed to

8/ Reserves at current exchange rates. Includes balances in the special Bank for International Settlements.

9/ Includes debt service on new PRGF disbursements as well as loans assumed to help close the financing gap. Also assumes debt relief beyind HIPC from 2005.

Annex 2.1: Status of CAS Lending Triggers

Justification for Moving Zambia to a Base Case Lending Scenario

Results for a CAS Base Case lending scenario requires achieving milestones in five areas:

1. Maintenance of good portfolio performance as measured by a disbursement ratio of 20 percent per annum or higher and a portfolio rating of less that 20 percent unsatisfactory.
2. Satisfactory implementation of the PRSP;
3. Maintenance of sound macroeconomic framework;
4. Continued progress in improving economic governance;
5. Satisfactory performance in the Education and Health sectors.

The country is in essence in compliance with all triggers as follows:

- **The World Bank group portfolio is in line with the benchmarks required.** At present, the disbursement ratio is around 31 percent and the portfolio contains only one project rated unsatisfactory out of 15 resulting in a rating clearly less than 20 percent.
- The Joint Staff Assessment (JSA) for the period January 2002-June 2003 discussed with the Board on June 15 stated that satisfactory progress in PRSP implementation and monitoring still needed to be established. Current developments indicate that a positive review over the period July 2003-June 2004 is possible and **a new PRSP- progress report has been drafted which indicates that satisfactory progress is being made**. A formal JSAN is being prepared and will accompany Zambia's HIPC Completion documentation.
- **The country has maintained a sound macroeconomic framework** since GRZ agreed on an extended IMF Staff Monitoring Program in November 2003, which was followed up with a three-year PRGF arrangement that was approved by the IMF Executive Board in June of 2004. To remain in the base case consecutive positive reviews of the PRGF will be needed.
- **Economic governance is steadily improving** as can be witnessed by a continuous effort to improve public expenditure management and civil service processes and progress in improving the performance of the energy utility, ZESCO, and finding a solution to the stalled privatization of Zanaco.
    - In the area of public sector management reform, **the MTEF has been further enhanced** through strengthening the bottom up part of the budget preparation process by involving the originally PRSP related sector advisory groups in evaluating sectoral needs, the involvement of Cabinet as an entity in the setting of the sectoral expenditure ceilings, and widening of stakeholder consultations;
    - Even though IFMIS has not yet been implemented in three pilot ministries, the commitment to put IFMIS into operation is no less as can be witnessed by the agreement reached with the contractor and **the expected signing of the IFMIS 'turn key' contract in November**[10], which not only commits the Government to its implementation but also commits the Government financially;
    - The ZESCO commercialization process is to pass the interim point as agreed in the commercialization roadmap this December and as such will enter the final stage of commercialization this month;
    - ZANACO: Government is parallel negotiating with the two preferred bidders. Progress is being made, but at a slow pace.
- **In the area of human development satisfactory progress has been made** in the areas of education and health as measured by the fact that student retention rates increased for grades 1-7 from 96.5 percent in 2002 to 97.6 percent in 2003 and that cash releases to health and education in 2003 were as provided in the budget.

[10] Note that the Bank has given a no-objection to the 'Turn Key' contract and the contract is to be signed momentarily.

Annex 2.2: Status of Bank Group Operations and Status of IFC Operations

Operations Portfolio (IBRD/IDA and Grants)
As Of Date 11/08/2004

Closed Projects	**68**
IBRD/IDA *	
Total Disbursed (Active)	378.0
of which has been repaid	0.0
Total Disbursed (Closed)	2,606.0
of which has been repaid	839.3
al Disbursed (Active + Closed)	2,983,941,316.5
of which has been repaid	839,326,236.7
Total Undisbursed (Active)	275.2
Total Undisbursed (Closed)	0.0
Undisbursed (Active + Closed)	275,205,148.9

Active Projects

Project ID	Project Name	Last PSR Supervision Rating: Development Objectives	Last PSR Supervision Rating: Implementation Progress	Original Amount in US$ Millions: Fiscal Year	IBRD	IDA	Undisb.	Difference Between Expected and Actual Disbursements [a]: Orig.	Frm Rev'd
P003249	Basic Ed. Subsect. Inv. Pgr	S	S	1999		40.0	12.9	13.5	6.6
P070962	Copperbelt Environment	S	S	2003		40.0	40.6	3.4	
P040642	ERIPTA	S	S	1996		40.5	9.6	-8.1	-8.1
P003248	HIV/AIDS (ZANARA)	S	S	2003		42.0	43.0	-6.6	-4.5
P064064	MINE TOWNSHIP SERVICES PROJECT	S	S	2000		37.7	15.8	13.7	1.5
P050400	PUB SVC CAP (PSCAP)	S	S	2000		28.0	1.9	1.5	
P070122	Regional Trade Fac. Proj. - Zambia	S	S	2001		15.0	11.8	9.4	
P063584	Social Investment Fund (ZAMSIF)	S	S	2000		64.7	16.4	4.6	
P080612	ZA:Emergency Drought Recovery Project	S	S	2003		50.0	14.9	25.7	-0.3
P003227	ZAMBIA RAILWAYS RESTRUCTURING PR(	S	S	2001		27.0	1.1	0.1	
P003236	ZM NATIONAL ROAD	S	S	1998		70.0	1.5	1.7	-0.7
P035076	ZM POWER REHABILITATION	S	S	1998		75.0	9.8	9.8	8.2
P071985	ZM-Road Rehab Maintenance Prj (FY04)	S	S	2004		50.0	46.5	0.5	
P071407	ZM-SEED SIL (FY05)	#	#	2005		28.2	28.0		
P057167	ZM-TEVET SIM (FY01)	U	U	2001		25.0	21.5	-0.4	
Overall Result						633	275.2	68.8	2.8

Statement of IFC's
Held and Disbursed Portfolio
As of 9/30/2004
(In US Dollars Millions)

FY Approvε	Company	Held: Loan	Equity	Quasi	Partic	Disbursed: Loan	Equity	Quasi	Partic
1998	AEF Amaka Cotton	1.3	0.0	0.0	0.0	1.3	0.0	0.0	0.0
2001	AEF Chingola Htl	0.7	0.0	0.0	0.0	0.7	0.0	0.0	0.0
1998	AEF Drilltech	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
1999	AEF Esquire	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
1997	AEF JY Estates	0.9	0.0	0.0	0.0	0.9	0.0	0.0	0.0
2001	AEF Michelangelo	0.2	0.0	0.0	0.0	0.2	0.0	0.0	0.0
2000	APC Ltd.	0.8	0.0	0.0	0.0	0.8	0.0	0.0	0.0
2000	Marasa Holdings	3.6	0.0	0.0	0.0	3.6	0.0	0.0	0.0
1998	NICOZAM	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0
1999/00/04	Zamcell	0.0	0.3	0.0	0.0	0.0	0.3	0.0	0.0
Total Portfolio:		7.7	0.4	0.0	0.0	7.7	0.4	0.0	0.0

Annex 3: Timetable of Key Processing Events

1. Time taken to prepare:	14 months[11]
2. Prepared by:	Government of the Republic of Zambia with the assistance of IDA staff and consultants.
3. Preparation Mission	November 2003
4. Pre-Appraisal/Appraisal mission:	July 2004
5. Negotiations	September/October 2004
6. Planned Board Presentation	December 2004
7. Planned date of Effectiveness	December 2004

[11] A follow-up credit with regard to the Fiscal Sustainability was originally planned for 2001. However, that credit did not materialize at that time.

Annex 4: Letter of Development Policy

Republic of Zambia

Letter of Development Policy

November 10, 2004

Mr. James D. Wolfensohn
President
International Development Association
1818 H St. NW
Washington, D.C.

Dear Mr. Wolfensohn:

Subject: Proposed Economic Management and Growth Credit
Letter of Development Policy

1. I am writing to request on behalf of the Government of the Republic of Zambia (GRZ), a Credit of US$40 million equivalent from the International Development Association (IDA) in support of our reform efforts. This Credit, the Economic Management and Growth Credit (EMGC) aims at helping my country to sustain the economic gains it has achieved over the last few years and to further enhance our capabilities to reduce poverty. The GRZ believes that the policies set forth in this Letter of Development Policy are needed to achieve and sustain the objectives described in our Poverty Reduction and Strategy Paper (PRSP) as well as in our Transitional National Development Plan (TNDP).

2. Zambia adopted a multi party democratic system in 1991 and initiated a transition from a state led economic system to one with private ownership where market forces determine decisions with regard to resource allocation. During this transition, the country has experienced profound challenges. The reform programs did not produce quick positive results. Although growth has resumed and it is now in its fifth consecutive year, it has not been in the high range of 6-8 percent, which is what is required for a significant impact on the livelihood of our citizens. Similarly, export diversification is occurring and

non-copper exports now contribute about 35 percent of total export earnings. However, both economic growth and export diversification are fragile and need to be consolidated.

3. In July 2002, GRZ launched its first PRSP for the period 2002-2004. The PRSP highlights as barriers to poverty reduction, lack of sustainable economic growth, high inequality, excessive dependence on foreign aid, poor prioritization of public resources, inadequate safety nets, and HIV/AIDS. It 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 infrastructure, governance, HIV/AIDS, gender, and the environment. In addition to the PRSP, the GRZ prepared the TNDP covering the period 2002-2005. The TNDP, which was launched in December 2002, extends the PRSP by bringing in additional sectors of the economy that were not included in the PRSP.

4. Macroeconomic stability, although within reach, is not yet fully attained in Zambia. The current economic environment of positive growth undoubtedly provides opportunities to make the tough choices needed to reach and sustain macroeconomic stability. Further fiscal consolidation through clearance of government arrears, improving debt management and budget processes, and stronger efforts at implementing the broader public sector reforms remain the principal ways through which the GRZ intends to restore macroeconomic stability (single digit inflation, lower real interest rates and a stable Kwacha) and improve the efficiency and effectiveness of the public sector. Improved macroeconomic stability and public sector effectiveness are in turn essential for improved private sector investment and growth. In this regard, the GRZ welcomes the World Bank support, through the proposed EMGC because it will assist the country consolidate the recent macroeconomic gains and also help support the PRSP implementation.

5. In the medium term growth will also depend on improved business environment for private sector led growth, the containment of the HIV/AIDS pandemic and investment in infrastructure. Investment in infrastructure is particularly key to facilitating growth in agriculture and tourism, and to scaling up poverty reduction in rural areas. In the current circumstances of Zambia, the reform program should focus on consolidating the macroeconomic environment for growth, improving the functioning and effectiveness of public sector, and laying the foundation for improved business environment through better dialogue, improved regulatory framework, and public-private partnership. We request that this reform program be supported by the World Bank through the proposed EMGC, to be released in two tranches. We fully understand that World Bank's support will depend on making adequate progress in the proposed reform areas, which are further articulated below.

A. Returning to a macroeconomic framework conducive to robust growth

6. The GRZ aims, in the context of its program with IMF PRGF, to reduce inflation to around 10% in 2006 and single digits thereafter and to increase gross international reserves of the Bank of Zambia (BoZ) to about 2 months of import cover by 2007. In addition, the GRZ aims to halt the unsustainable cycle of rising domestic debt and interest payments and reduce fiscal deficit to below 2.5% of GDP by 2006 in order to make room

for increased spending on poverty-reducing programs. Spending on priority poverty reducing programs is expected to increase from an estimated 1% of GDP in 2003 to 2% in 2006. The crux of the needed fiscal adjustment will come from the expenditure side. The wage bill and recurrent departmental charges will be reduced each by 0.5% of GDP and the foreign financed capital expenditures are expected to fall by a full percentage point of GDP in 2004. These developments together with the reduction of the fiscal deficit and an improved composition of public expenditure should contribute to a reduction in real interest rates, thereby improving Zambia's investment climate and investment opportunities. Economic growth is expected to be at least 4.5% in 2004, 4.5% in 2005, and 5% in 2006 and 2007.

7. The GRZ also intends to eliminate the build up of budgetary arrears and arrears by parastatals with utilities as this threatens not only the financial viability of the utilities themselves and their ability to operate, but often will require budgetary transfers in the end to settle them. In addition, the failure to pay utility bills by the GRZ has also affected the ability of the utilities to settle the bills among themselves on time. The GRZ has recognized this problem and has taken measures aimed at ensuring that the line ministries pay their utility bills and insurance premiums on time. With regard to the arrears, the GRZ is committed to work out a time bound restructuring plan of the arrears with the utility companies. It is therefore our expectation that when these arrears are being cleared, the utilities will also be clearing their own arrears too. The GRZ nevertheless believes that the long-term solution to the problem of arrears, either between itself and the utilities or among the utilities themselves, is to empower the utilities to operate strictly on commercial lines of business. This is one of the measures that the GRZ is putting in place to address the problem of arrears.

8. Prior to Board Presentation of the proposed credit, the key results we expect to achieve in this area include:

- Cabinet has issued a decision to empower utilities and insurance companies to treat government institutions as any other client including that the utilities and insurance companies would be expected to discontinue their services to Government institutions in similar fashion as any other customer;
- The Accountant General has instructed accounting officers to pay their utility and insurance bills on time;
- The Secretary of the Treasury has issued a letter to the utilities and insurance companies reiterating the decision made by Cabinet.

9. Prior to the release of the second tranche of the credit, we will have achieved the following:

- The MoFNP has adopted a time bound restructuring plan for payment of the Government's arrears to utility and insurance companies. The MoFNP has developed an action plan in case of no significant improvement in payment patterns or signs of independent commercial actions taken by utilities on public institutions not paying their bills on time;
- MoFNP, if necessary, has adopted a time bound restructuring plan for payment of (i) the Government's arrears to utility companies and (ii) inter utility arrears.

10. The GRZ would like to undertake pension reforms to create a financially viable and sustainable pensions system in the country. In Zambia, four major institutions provide pensions to retirees. Civil service members hired before February 1, 2000 belong to either the Public Service Pensions Fund (PSPF) or the Local Authorities Superannuation Fund (LASF). The President's office and the Minister of Local Government and Housing, respectively, supervise the funds and the GRZ is the financial guarantor of both. In February 2000, the National Pension Scheme (NAPSA), which was created by a 1996 Act, was implemented. Civil servants hired after February 2000 are enrolled in NAPSA except for the teaching service and defence personnel. Public service schemes, together have 130,000 active members, about a quarter of the formal workforce, and pay pensions to more than 50,000 retirees. NAPSA, which is supervised by the Ministry of Labor, covers about 350,000 workers.

11. The financial status of the pension schemes is mixed. The two public sector schemes, PSPF and LASF, are insolvent, although both hold some assets and are owed considerable amounts in contribution arrears. Benefits are simply too high relative to current contribution rates and would remain too high even if contribution rates were doubled. The actuarial deficits of the two public service funds is almost 3 trillion kwacha, an amount greater than 1/3rd of external debt, and since benefit levels in these schemes are protected in the Constitution, reform has proved difficult without the constitutional amendment. The GRZ has accepted the need to reform the PSPF and LASF and has recognized that a constitutional amendment is necessary to put the PSPF and LASF on a sound financial footing. Therefore, Cabinet will have approved before the release of the second tranche (i) a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reforms to be applicable to existing participants in PSPF and (ii) a reform program that ensures the financial sustainability of the fund.

12. The issues facing NAPSA are largely operational rather than financial. The most urgent need is for procedural reform, tooling up, and capacity building in asset management. Currently NAPSA's investment guidelines do not adequately protect the principle of its assets or promote diversification, nor support effective development of Zambia's capital markets. In addition, NAPSA could benefit from reducing its high administrative cost by allowing Zambia Revenue Authority (ZRA) to collect NAPSA contributions.

13. Prior to Board Presentation of the proposed credit, the key results we expect to achieve in this area include:

- PSPF Board has approved amendments to reform pensions including the benefit formula, commutation factors, and contribution rates for new PSPF members since the year 2005 and PSPF has completed a draft three year implementation plan to reduce administrative expenses to 12 percent of 2003 annual accrued contributions as approved by its board;
- PSPF has introduced computer-based capability to produce monthly reports on benefits and full range of beneficiary characteristics to improve PSPF policy development and projections of cash needs;

- LASF has shown progress towards completion of actuarial valuation of LASF and completion collection of data for PROST analysis of various policy reform options;
- MoFNP has proposed a draft law to set up PIA as an autonomous institution in line with the FSDP recommendations and submits the draft law to Cabinet for approval.

14. Prior to the release of the second tranche of the credit, we will have achieved the following:

- Cabinet has approved (i) a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reforms to be applicable to existing participants in PSPF and (ii) a reform program that ensures the financial sustainability of the fund;
- LASF has submitted a reform proposal for Cabinet approval based on actuarial valuation and if necessary PROST analysis;
- The National Pension Scheme Authority (NAPSA) has (i) adopted a revised investment policy, appointed a global custodian, and selected a pension fund manager; (ii) drafted an operations manual on corporate governance; and (iii) developed a program for training trustees;
- Cabinet has submitted amendment to the ZRA Act to Parliament to allow ZRA to collect NAPSA contributions;
- PIA has prepared an overall vision paper backed by operating action plans, budgetary and HR needs.

B. Strengthening the role of the financial sector

15. Zambia's financial sector is characterized by several weaknesses, which continue to limit its role in private sector development and growth: Low financial intermediation; high interest margins and ratio of fee income to average assets; limited capacity with regard to financial sector supervision; multiple and conflicting roles by the GRZ in the financial sector; and a poor credit culture.[12]

16. In view of these weaknesses, the GRZ in consultation with other stakeholders has prepared a Financial Sector Development Plan (FSDP), which provides for a systematic and coherent action plan that would lead to the realization of a well functioning financial sector in Zambia. The Cabinet has formally adopted the FSDP and as such agreed to strengthen the supervisory powers of the BoZ through harmonization of legislations (e.g. inclusion of state-owned non-bank financial institutions (NBFIs) under the Company's Act) and strengthening of the Bank of Zambia's supervisory powers over NBFIs.

In addition, the GRZ intends to strengthen the operational governance arrangements of the BoZ. The Government plans to change the procedures by which the board members of the BoZ are appointed to ensure maximum autonomy in the conduct of monetary policy.

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[12] These weaknesses were identified by the Financial Sector Assessment Program (FSAP) report of 2002 carried out jointly by the IMF and the World Bank, as well as by self-assessments undertaken by the Bank of Zambia, including assessment of the Basle Core Principles for effective Banking Supervision and the Monetary and Financial Policies Transparency Codes.

17. The BoZ will undertake a comprehensive evaluation of the business model options available for a credit bureau, before a credit bureau is set up. The establishment of a credit bureau is essential to improve Zambia's credit culture, which so far has been characterized by non-timely servicing of financial obligations by debtors.

18. Prior to Board Presentation of the credit, we expect to achieve the following:

- Cabinet has approved the Financial Sector Development Plan (FSDP), which stipulates the repeal of those sections of the Building Societies Act, the National Savings and Credit Bank (NSCB) Act, and the Development Bank of Zambia (DBZ), such that (i) these institutions can be incorporated under the Company's Act, (ii) inconsistencies with the BFSA are removed; and (iii) supervisory powers over NBFIs by the Bank of Zambia are strengthened;
- The Bank of Zambia, MoFNP, and the Development Bank of Zambia have signed a Memorandum of Understanding, which specifies the supervisory role of the Bank of Zambia and the MoFNP with regard to the Development Bank of Zambia until DBZ falls under the BFS Act;
- A ceiling on lending by DBZ of US$10 million would be adhered to pending the repeal of the DBZ act, bringing DBZ under the Companies Act and under the provisions of the BFS Act, including the provision regarding the limit of single shareholding.

19. Prior to the release of the second tranche of the credit, the GRZ will have achieved the following:

- The GRZ has made progress in the process of adopting the necessary legal changes to the Building Societies Act, the National Savings and Credit Bank Act, and the Development Bank of Zambia Act;
- The GRZ has commenced implementing our FSDP pertaining to the reform of state-owned NBFIs including NSCB, ZNBS, and DBZ,
- DBZ shall not (i) accept deposits and (ii) raise any loan requiring Government guarantee;
- In addition, GRZ has commenced implementing the recommendations of our FSDP pertaining to the provisions of the Government's credit facility at the Bank of Zambia;
- The independence of the BoZ is strengthened by changing the procedures by which the Governor is appointed as well as its board of directors;
- BoZ has undertaken a comprehensive evaluation of available options with regard to which business model of a credit bureau before setting up a credit bureau.

C. Strengthening the credibility and institutional capacity of the Public Sector

20. The GRZ embarked on its Public Sector Reform Program (PSRP) in 1993 with the overall goal of improving the quality, delivery, efficiency, and cost effectiveness of public services. It was recognized that this would require significant institutional changes and capacity building over a medium term. With assistance from the World Bank, the GRZ designed and started implementing its Public Service Capacity Building Project (PSCAP) in 2001. Much of the support under PSCAP is focused on improving public

expenditure management and accountability, and service delivery in the public sector. In 2003, the GRZ prepared its first Medium Term Expenditure Framework (MTEF), based upon the priorities laid out in the TNDP and the PRSP, introduced a programmatic classification of the budget (known as an Activity Based Budgeting system). In addition, to improve effectiveness of the public sector and service delivery, the Government also implemented a pay reform strategy in 2003, which included the decompression of salary scales and consolidation of allowances. Further, an integrated personnel and payroll system is being implemented to improve management and control of the Government payroll

21. The Government with assistance of the collaborating partners has prepared and adopted an updated and revised Public Sector Reform Program, which includes a time bound and phased implementation plan for three priority areas: (i) public expenditure management and financial accountability; (ii) right sizing and pay reform; and (iii) decentralization and strengthening of Local Government. In the context of these three broad areas of priorities, the main areas where Government seeks support are in upgrading Government's debt management capacity, improving public expenditure management and financial accountability practices, and streamlining of ministerial structures and improving incentives for service delivery.

22. *Upgrading Government's debt management capacity.* Under the current institutional arrangement for debt management, responsibilities are split between MoFNP and BoZ, where BoZ is de facto responsible for the management of domestic debt on securities. This not only makes it difficult to formulate a consolidated strategy as well as monitor and evaluate effectively Government debt, but also poses the risk that monetary policy and debt management are not efficiently separated. To address this problem, the MoFNP has taken two important initial steps, one of which is strengthening the role of the MoFNP in the process of debt issuance. The other steps are the formulation of a debt management strategy for the post-HIPC completion period, including the; and the other lead to an up to date database of Government debt that can be used for monitoring and evaluation.

23. Prior to Board Presentation of the credit, we expect to achieve the following:

- MoFNP (i) has prepared a detailed Terms of References and has established a Task Force with the objective of reconciling the debt database covering domestic and foreign direct debt, as well as on-lending, (ii) is reporting on progress to the Secretary to the Treasury on a regular basis.

24. Prior to the release of the second tranche of the credit, we will have achieved the following:

- MoFNP (i) has established procedures for updating and maintaining the debt database; and (ii) has started producing regular reports on outstanding debt for internal, MoFNP and BoZ, use, and (iii) has initiated work on establishing clear procedures for updating and maintaining the debt database;
- MoFNP (i) has formulated in broad terms a strategy for debt management post-HIPC completion point with a particular focus on the distribution between foreign and domestic borrowing; (ii) has given and continuous to give inputs to the decision

making at the Tender Committee meetings; and (iii) has started preparing a framework within which the MoFNP can act as decision maker on issues regarding domestic debt with BoZ acting as agent.

25. *Improving public expenditure management and financial accountability practices.* Notwithstanding the progress made in 2003, significant shortcomings still exist in ensuring sound public expenditure management and financial accountability. The laws and institutions for public expenditure and accountability in Zambia are weak; the budget lacks credibility as actual spending differs considerably from the planned amounts; supplemental appropriations are large and parliamentary approval is usually granted after the spending has occurred; budget execution is weak due to lack of enforcement of expenditure controls, lack of proper recording of commitments, and weak procurement practices and regulations; and the weak oversight and scrutiny of the Executive's financial management by the Office of the Auditor General and the parliament has undermined transparency and accountability. Key steps will be taken to improve the legal basis for public expenditure management as well as strengthen the oversight functions of the Parliament and the Office of the Auditor General (OAG).

26. Prior to Board Presentation of the credit, we expect to achieve the following:

- Cabinet has adopted Zambia's revised Public Sector Reform Strategy;
- The MoFNP has submitted recommendations to the constitutional review committee that would (i) enable the budget to be approved by parliament before the start of the fiscal year; (ii) enhance accountability for public expenditure by restricting retroactive approval of supplementary appropriations; and (iii) the Office of the Auditor General has submitted its recommendations to the CRC on enhancing its autonomy and expanding its duties;
- Cabinet has approved for submission to Parliament a revised Finance Act that strengthens financial management and accountability, including provisions that: (i) Define the role and functions of The Treasury; (ii) Strengthen the role of internal audit through establishment of audit committees; (iii) Define the responsibilities of the Accountant General's Department; (iv) Enhance provisions for oversight of statutory corporations, and (v) prohibits expenditures from being incurred that exceed the appropriation;
- Cabinet has agreed that it will approve any supplemental to the budget, if any, prior to the spending occurring and that such supplemental would show not only where spending will increase, but also where it will be reduced as a result;
- MoFNP has submitted a Green Paper to Cabinet in the third quarter of 2004 with three-year indicative budget ceilings for each ministry, inclusive of ceilings for personal emoluments (PE's);
- New FMS software has been installed in all ministries that would permit reporting by ABB format;
- Accountant General's Department has generated a report from the FMS on actual expenditure by ministry for the first six months of 2004 under the ABB classification;
- Cabinet has approved the new structure for the OAG, which includes authority to fill vacant auditor positions.

27. Prior to the release of the second tranche of the credit, we will have achieved the following:

- MoFNP has tabled in our legislature the annual budget for 2005 including an annex, which compares the estimated expenditures for the year 2005 with the budget releases for the year 2004 and 2003. This would be presented in summary table aggregated by budget head, showing the PE and non-PE spending from GRZ resources.

28. *Streamlining of ministerial structures and improving incentives for service delivery.* Until recently the Government's payroll has been managed by the MoFNP's Data Center using an outdated system that was basically inaccessible to key decision-makers and lacked adequate controls on data quality. In addition, the payroll database has been completely separate from management of the establishment registry, i.e., cabinet office responsible for the management of the civil service was generally unaware if ministries had recruited people for unauthorized positions. Furthermore, as people have been separated from the public service, the cabinet office has had difficulty assuring that they are indeed removed from the payroll.

29. The proliferation of allowances has created distortions in the pay system, where job responsibility and qualification have less to do with ones total remuneration. The medium-term pay reform strategy adopted by the Cabinet in 2002 therefore included the elimination of cash allowances in favor of improvements in base salary. This was intended to improve transparency and equity in pay policy and enhance Government's ability to accurate cost adjustments to the salary system. However, in 2003, negotiations between the Government and the public services unions failed to follow-through on the policy of eliminating allowances, and resulted in significant increases in the wage bill. As a result, recent years have seen unsustainable growth in the wage bill from 5.3% percent of GDP in 2000 to 8.4% in 2003. The growth in wages and salaries has crowded out expenditures for recurrent departmental charges, which include expenditures for poverty reduction programs, harming the ability of Government to effectively implement its PRSP. Looking forward, the Government believes it is important to regain control over the wage bill, by reducing the number of positions on the establishment, consistent with the current budget levels for personnel emoluments as well as consolidate most allowances into base salary.

30. Prior to the release of the second tranche of the credit, we will have achieved the following:

- PSMD in the Cabinet office has consolidated most allowances into base salary and reduced the overall ratio of allowances to base salary ***subject*** to negotiations with Public Service Unions and the identification of their fiscal implications;
- MoFNP has (i) transferred the payroll to the PMEC system; (ii) trained users for all central ministries; (iii) based Personal Emoluments releases on PMEC; (iv) matched each public servant to a specific post on the establishment; and (v) ceased to pay public servants whose post is not on the establishment except those identified for retrenchment but not yet paid off;

- ➢ Personnel emoluments are adequately budgeted for so that there is no accumulation of new PE arrears by line ministries;
- ➢ Cabinet has approved the new structures for the four remaining ministries and any excess staffs are removed from the payroll;
- ➢ The new annual performance appraisal system (APAS) has been implemented for all management positions and PSMD has issued a circular after agreements with the Public Service Unions that annual salary increments are no longer automatic but instead will be based on employee performance.

D. Improving Zambia's business environment

31. We recognize that improving the environment for doing business in Zambia is imperative to accelerate our development. Good partnership between the public and the private sector is critical for this acceleration to materialize and therefore this partnership can potentially bring significant benefits to Zambia. In the past we have undertaken several initiatives to jump start private sector development and to streamline our interactions with the private sector. However, for a variety of reasons, those have not always had the impact on Zambia's development that we had expected.

32. One of the lessons learned was that we needed to develop our strategy more in partnership and through various consultations with the private sector and other stakeholders. In addition, the strategy for private sector development needs also to be not only designed jointly but also implemented in cooperation. To that effect we have held a Private Sector Development Forum in Livingstone in June of this year. This forum was attended by all relevant stakeholders and has led to a variety of implementable action plans. I will not dwell on all the action plans that we agreed upon, but would like to inform you that before Board presentation of the credit, we expect to achieve the following:

- ➢ Cabinet has reaffirmed its commitment to market-based policies for private sector development by adopting the PSD Reform Action Plan;
- ➢ Government has circulated to the private sector a paper outlining Zambia Development Agency proposal and received comments on the proposal;
- ➢ Revision of Investment Act has been finalized in consultation with the private sector and in that process the Draft Act has been circulated widely to the private sector for comments.

33. Prior to the release of the second tranche of the credit, we will have achieved the following:

- ➢ Government has established an implementation framework for the PSD Reform Action Plan and began implementing some of the actions;
- ➢ Commenced work on rationalizing and enhancing effectiveness of ZIC, EBZ, ZPA, ZEPZA i.e. created a single Zambia Development Agency (ZDA);
- ➢ The Government has completed a review of related legislation to ensure consistency with the Investment Act and the Government's policy on PSD and to amend legislation if necessary;

- Started work on simplifying and rationalizing the licensing framework for the tourism sector;
- Government has identified priority infrastructure sectors, which lend themselves to a PPI in Zambia and started establishing an appropriate regulatory framework;
- Government has amended Statutory Instruments #s 2 and 3 of 2002 to deal with these retrenchment and expatriate permit issues;
- The Government has reviewed and updated the EPZ strategy and business plan and prepared revisions of EPZ legislation.

34. We are well aware that policy stability and regulatory commitment are important prerequisite for sustained large-scale private, especially foreign, investment. Of particular importance is the country's institutional capacity to restrain arbitrary administrative action and credibly commit to a stable regulatory and overall policy process. This is especially relevant for our infrastructural sectors, where the establishment of production systems, transportation and distribution networks require large investments that are mostly sunk. To succeed in this task we need to establish an effective, market based, well-focused, and flexible governance structure that serves the public interest. Therefore, we will need to follow up the above actions with some sectoral measures in the energy and telecommunications sectors, which are presented below. Our overall objective in the energy sector is to establish a stable and credible policy and regulatory framework and a market structure that is consistent with regional initiatives and above all promotes competition and private sector involvement. This framework and structure should continue to ensure a smooth transition to a liberalized electricity supply industry consistent with the changing technological characteristics of the industry and its demand constraints.

35. As you are aware we have initiated a commercialization program for ZESCO. The implementation of this road map is well on its way and all the Interim Point actions for ZESCO's commercialization have been met; and the achievements on the Entry Point actions have indeed been sustained. The main challenges that lie ahead of us are related to the articulation of a consistent and forward looking energy policy, that defines the sector's market structure and as a consequence the sector's legal and regulatory frameworks. To that end we expect that prior to the release of the second tranche of the credit, we will have achieved the following:

- Cabinet has adopted a comprehensive Policy Statement for the Energy that clearly articulates the Government's vision for the development of the sector over the medium to long-term;
- Amendments to Electricity and ERB Acts have been made as stipulated in the adopted energy policy;
- Satisfactory progress in ERB capacity building, and in implementation of ZESCO Commercialization.

36. We face very similar issues in the telecommunications sector, where technological change and its impact on market structure of the sector, requires a flexible and market-based approach to policymaking. The absence of a comprehensive policy document for

the telecommunications sector that clearly articulates our vision for the development of that sector over the medium to long-term and guides the changes need to the legal and regulatory frameworks therefore needs to be corrected. Therefore, we expect that prior to the release of the second tranche of the credit, we will have achieved the following:

- Cabinet has adopted a comprehensive Policy Statement for the telecommunications sector that clearly articulates our vision for the development of the sector over the medium to long-term;
- Development of new telecommunication law has started which is to ensure autonomy of regulator and separation of policy and regulatory functions;
- We have embarked on the commercialization of ZAMTEL, which include a framework to ensure effective management and regulation of ZAMTEL operations to prevent anti-competitive behavior by ZAMTEL.

Yours sincerely,

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

ANNEX 5: POLICY REFORMS PROGRAM MATRIX: GOVERNMENT'S POLICY OBJECTIVES, ACTIONS, AND OUTCOMES

MILESTONES[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
A. RETURNING TO A MACROECONOMIC FRAMEWORK CONDUCIVE TO ROBUST GROWTH			
Longer Term Country Outcome to which component contributes: *A GROWTH CONDUCIVE MACROECONOMIC ENVIRONMENT*			
A.1. OBJECTIVE: CORRECTING MACRO ECONOMIC IMBALANCES			
Issue: Macro economic stability has been illusive. Serious imbalances exist negatively impacting Zambia's investment climate and growth opportunities.	***Maintenance of an appropriate macroeconomic framework.***	***Maintenance of an appropriate macroeconomic framework.***	▪ Reduced domestic borrowing requirements from an estimated 3% of GDP in 2003 to less than 1% of GDP annually by 2006. ▪ Reduced arrears of Government (including parastatals) from an estimated 2% of GDP in 2003 to zero by 2007.
Issue: Need to eliminate the build up of budgetary arrears and arrears by parastatals with utilities as this threatens the financial viability of the utilities	***Cabinet has issued a decision to empower utilities and insurance companies to treat government institutions as any other client including that the utilities and insurance companies would be expected to discontinue their services to Government institutions in similar fashion as any other customer;*** ***The Accountant General has instructed accounting officers to pay their utility and insurance bills on time;*** ***The Secretary of the Treasury has issued a letter to the utilities and insurance companies reiterating the decision made by Cabinet.***	***The MoFNP has adopted a time bound restructuring plan for payment of the Government's arrears to utility and insurance companies.*** The MoFNP has developed an action plan in case of no significant improvement in payment patterns or signs of independent commercial actions taken by utilities on public institutions not paying their bills on time.	

[1] Milestones in ***bold and italic*** are credit conditions that are included in the credit agreement.

	MILESTONES[1]		
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
A.2. OBJECTIVE: WORKING TOWARDS A FINANCIAL SUSTAINABLE PENSION SYSTEM			
Issue: Public service pension schemes are not in financial balance and will create rapidly increasing fiscal drains compromising financial sustainability of the overall pension system and threatening macro economic stability.	***PSPF Board has approved amendments to reform pensions including the benefit formula, commutation factors, and contribution rates for new PSPF members since the year 2005 and PSPF has completed a draft three year implementation plan to reduce administrative expenses to 12 percent of 2003 annual accrued contributions as approved by its board.*** PSPF has introduced computer-based capability to produce monthly reports on benefits and full range of beneficiary characteristics to improve PSPF policy development and projections of cash needs.	***Cabinet has approved (i) a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reforms to be applicable to existing participants in PSPF and (ii) a reform program that ensures the financial sustainability of the fund.*** .	▪ Reduced domestic borrowing requirements from an estimated 3% of GDP in 2003 to less than 1% of GDP annually by 2006. ▪ Reduced arrears of Government (including parastatals) from an estimated 2% of GDP in 2003 to zero by 2007. *Even though Pensions were not explicitly mentioned in the CAS, addressing the pension issues is necessary to achieve the CAS outcomes as well as to contribute to a growth conductive macroeconomic environment.*
	LASF has shown progress towards completion of actuarial valuation of LASF and completion collection of data for PROST analysis of various policy reform options.	LASF has submitted a reform proposal for Cabinet approval based on actuarial valuation and if necessary PROST analysis.	
Issue: NAPSA's Investment Guidelines do not adequately protect the principal of its assets or promote diversification, or supports Zambian capital market development without unreasonable risk.		***The National Pension Scheme Authority (NAPSA) has (i) adopted a revised investment policy, appointed a global custodian, and selected a pension fund manager; (ii) drafted an operations manual on corporate governance; and (iii) developed a program for training trustees.***	

[1] Milestones in ***bold and italic*** are credit conditions that are included in the credit agreement.

MILESTONES[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
Issue: Need to reduce high administrative costs.		Cabinet has submitted amendment to ZRA Act to Parliament to allow ZRA to collect NAPSA contributions.	
Issue: There is a need to upgrade and reform Zambia's Pensions and Insurance Authority as it is seriously understaffed.	MoFNP has proposed a draft law to set up PIA as an autonomous institution in line with the FSDP recommendations and submits the draft law to Cabinet for approval.	PIA has prepared an overall vision paper backed by operating action plans, budgetary and HR needs.	
B. STRENGTHENING THE ROLE OF THE FINANCIAL SECTOR			
LONGER TERM COUNTRY OUTCOME TO WHICH COMPONENT CONTRIBUTES: ***A Growth Conducive Macroeconomic Environment and A diversified and Export Oriented Economy***			
B.1. RESOLUTION OF STATE-OWNED NON-BANK FINANCIAL INSTITUTIONS			
Issue: Zambia's State owned Non Bank Financial Institutions compromise the functioning of the financial sector	***Cabinet has approved the Financial Sector development plan, which stipulates the repeal of those sections of the Building Societies Act, the National Savings and Credit Bank (NSCB) Act, and the Development Bank of Zambia (DBZ), such that (i) these institutions can be incorporated under the Company's Act, (ii) inconsistencies with the BFSA are removed; and (iii) supervisory powers over NBFIs by the Bank of Zambia are strengthened.*** ***The Bank of Zambia, MoFNP, and the Development Bank of Zambia have signed a Memorandum of Understanding, which specifies the supervisory role of the Bank of***	***The Borrower has made progress in the process of adopting the necessary legal changes to the Building Societies Act, the National Savings and Credit Bank Act, and the Development Bank of Zambia Act*** ***The Borrower has commenced implementing its Financial Sector Development Plan pertaining to the reform of state-owned NBFIs including NSCB, ZNBS, and DBZ, to ensure that no public funds will be used without a business plan acceptable to IDA.*** ***DBZ shall not (i) accept deposits and (ii) raise any loan requiring Government guarantee.***	▪ Resolution of state owned financial institutions.

[1] Milestones in ***bold and italic*** are credit conditions that are included in the credit agreement.

MILESTONES[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
	Zambia and the MoFNP with regard to the Development Bank of Zambia until DBZ falls under the BFS Act. A ceiling on lending by DBZ of US$10 million would be adhered to pending the repeal of the DBZ act, bringing DBZ under the Companies Act and under the provisions of the BFS Act, including the provision regarding the limit of single shareholding.		
B.2. BUILDING A BETTER GOVERNANCE STRUCTURE FOR THE BANK OF ZAMBIA			
Issue: The Governance arrangement of the BoZ does not guarantee its independence or independent execution of monetary policy.		GRZ has commenced implementing the recommendations of the FSDP pertaining to the provisions of the Government's credit facility at the Bank of Zambia. The independence of the Bank of Zambia is strengthened by changing the procedures by which the Governor is appointed as well as its board of directors.	*Necessary to achieve the CAS outcomes in Strategic Priority 1 as well as to contribute to a growth conductive macroeconomic environment.*
B.3. PROMOTING A BETTER CREDIT CULTURE			
Issue: One of the major problems of Zambia's financial sector is the lack of credit culture, which undermines timely servicing of financial obligations.		BoZ has undertaken a comprehensive evaluation of available options with regard to which business model of a credit bureau before setting up a credit bureau.	*This is a precursor to future work on building a credit culture to contribute to a better functioning of the financial system.*

[1] Milestones in ***bold and italic*** are credit conditions that are included in the credit agreement.

MILESTONES[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
C. STRENGTHENING THE CREDIBILITY AND INSTITUTIONAL CAPACITY OF THE PUBLIC SECTOR			
LONGER TERM Country Outcome to which component contributes: *Increased Accountability And Transparency Of Government*			
C.1. OBJECTIVE: UPGRADING GOVERNMENT'S DEBT MANAGEMENT CAPACITY TO SUPPORT FISCAL SUSTAINABILITY			
Issue: Current arrangements, institutional as well as for monitoring and evaluation of Government Debt, make it difficult to formulate a consolidated strategy as responsibilities are split between MoFNP and BoZ. The latter is responsible for domestic debt and implies risk that monetary policy and debt management cannot be efficiently separated.	MoFNP (i) has prepared a detailed Terms of References and has established a Task Force with the objective of reconciling the debt database covering domestic and foreign direct debt, as well as on-lending, (ii) is reporting on progress to the Secretary to the Treasury on a regular basis.	MoFNP (i) has established procedures for updating and maintaining the debt database; and (ii) has started producing regular reports on outstanding debt for internal, MoFNP and BoZ, use, and (iii) has initiated work on establishing clear procedures for updating and maintaining the debt database. MoFNP (i) has formulated in broad terms a strategy for debt management post-HIPC completion point with a particular focus on the distribution between foreign and domestic borrowing; (ii) has given and continuous to give inputs to the decision making at the Tender Committee meetings; and (iii) has started preparing a framework within which the MoFNP can act as decision maker on issues regarding domestic debt with BoZ acting as agent.	This debt management capacity building contributes to a growth conducive macroeconomic environment, in conjunction with the proposed PSM project (FY05).

[1] Milestones in ***bold and italic*** are credit conditions that are included in the credit agreement.

	MILESTONES[1]		
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
C.2. OBJECTIVE: IMPROVING PUBLIC EXPENDITURE MANAGEMENT AND FINANCIAL ACCOUNTABILITY PRACTICES			
Issue: processes related to budget preparation and execution lacks a critical degree of credibility.	Cabinet has adopted Zambia's revised Public Sector Reform Strategy. ***The MoFNP has submitted recommendations to the constitutional review committee that would (i) enable the budget to be approved by parliament before the start of the fiscal year; (ii) enhance accountability for public expenditure by restricting retroactive approval of supplementary appropriations; and (iii) the Office of the Auditor General has submitted its recommendations to the CRC on enhancing its autonomy and expanding its duties.*** ***Cabinet has approved for submission to Parliament a revised Finance Act that strengthens financial management and accountability, including provisions that:·(i) Define the role and functions of The Treasury; (ii) Strengthen the role of internal audit through establishment of audit committees; (iii) Define the responsibilities of the Accountant General's Department; (iv) Enhance provisions for oversight of statutory corporations, and (v) prohibits expenditures from being incurred that exceed the appropriation.***	***MoFNP has tabled in the Borrower's legislature the annual budget for 2005 including an annex, which compares the estimated expenditures for the year 2005 with the budget releases for the years 2004 and2003. This would be presented in summary table aggregated by budget head, showing the PE and non-PE spending from GRZ resources.***	The operation will in conjunction with the ongoing PSCAP project and the proposed PSM project (FY05) contribute to the following CAS Outcome indicators: ▪ Variation between planned budget and actual expenditure at sector level no greater than 10%· ▪ Budget presentation reflects summary of proposed budget alongside with actual expenditures in previous years (Y/N)· ▪ Expenditures stay within the appropriations which are validated through tracked/audited reports (Y/N)· ▪ Supplemental appropriations approved by Parliament ex-ante (Y/N)· ▪ Greater share of budget resources allocated to service delivery functions as measured by total social expenditures, currently at 38% of total

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Milestones[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
	Cabinet has agreed that it will approve any supplemental to the budget, if any, prior to the spending occurring and that such supplemental would show not only where spending will increase, but also where it will be reduced as a result.		(Y/N)·
	MoFNP has submitted a Green Paper to Cabinet in the third quarter of 2004 with three-year indicative budget ceilings for each ministry, inclusive of ceilings for personal emoluments (PE's).		
	New FMS software has been installed in all ministries that would permit reporting by ABB format.		
	Accountant General's Department has generated a report from the FMS on actual expenditure by ministry for the first six months of 2004 under the ABB classification.		
	Cabinet has approved the new structure for the OAG, which includes authority to fill vacant auditor positions.		

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MILESTONES[1]			
Issue	Board: December 2004	Second tranche (targeted for June 2005)	CAS outcome(s) to which the policy action/milestone contributes
C.3. OBJECTIVE: STREAMLINING MINISTERIAL STRUCTURES AND IMPROVING INCENTIVES FOR SERVICE DELIVERY			
Issue: The number of civil servants has been stagnant over the last decade while payroll has been rising significantly, which has deviated funds available for maintenance and investments.		***PSMD in the Cabinet office has consolidated most allowances into base salary and reduced the overall ratio of allowances to base salary subject to negotiations with Public Service Unions and the identification of their fiscal implications.***	The operation will in conjunction with the ongoing PSCAP project and the proposed PSM project (FY05) contribute to the following CAS Outcome indicators: ▪ Allowances are consolidated into base salary ▪ Increasing percentage of management staff are eligible for performance pay ▪ Composition of staffing shifts toward support of service delivery functions
		MoFNP has (i) transferred the payroll to the PMEC system; (ii) trained users for all central ministries; (iii) based Personal Emoluments releases on PMEC; (iv) matched each public servant to a specific post on the establishment; and (v) ceased to pay public servants whose post is not on the establishment except those identified for retrenchment but not yet paid off.	
		Personnel emoluments are adequately budgeted for so that there is no accumulation of new PE arrears by line ministries.	
		Cabinet has approved the new structures for the four remaining ministries and any excess staffs are removed from the payroll.	
		The new annual performance appraisal system (APAS) is implemented for all management	

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MILESTONES[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
		positions and PSMD has issued a circular that annual salary increments are no longer automatic but instead will be based on employee performance.	
D. IMPROVING ZAMBIA'S BUSINESS ENVIRONMENT			
Long Term Country Outcome to which component contributes: A *Diversified and Export-Oriented Economy*			
D.1. ENHANCING PRIVATE SECTOR DEVELOPMENT			
Private sector development issues: Inconsistent Government policies towards the private sector. Weakness of public agencies serving the private sector Contradictions between Investment Act and related legislation Restrictive labor laws related to retirement, retrenchment and expatriate work permits. Multiplicity of licenses required to establish a business	Cabinet has reaffirmed its commitment to market-based policies for private sector development by adopting the PSD Reform Action Plan; Government has circulated to the private sector a paper outlining Zambia Development Agency proposal and received comments on the proposal; A revised draft Investment Act has been finalized and has been circulated to the private sector for comments;	Government has established an implementation framework for the PSD Reform Action Plan and began implementing some of the actions. Work has started on rationalizing and enhancing effectiveness of ZIC, EBZ, ZPA, ZEPZA (creation of a single Zambia Development Agency (ZDA)) Investment Bill has been submitted to Parliament and amendments to related legislation prepared. Government has amended Statutory Instruments #s 2 and 3 of 2002 to deal with these labor issues Tourism and hospitality bill has been submitted to Parliament	The operation will in conjunction with the ongoing ERIPTA, Regional Trade Facilitation, ·Zambia Power Rehabilitation and SEED projects contribute the following CAS Outcome indicators ▪ Pay refund for duty drawback are of an acceptable speed for the private sector ▪ Exporters are informed of the opportunities available under AGOA and EBA so that they can take advantage of these opportunities

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MILESTONES[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
in the tourism sector			
Inadequate regulatory environment to support Government's decision to encourage private participation in infrastructure provision.		Government has identified priority infrastructure sectors, which lend themselves to a PPI in Zambia and started establishing an appropriate regulatory framework.	
Inadequate strategic and regulatory framework for Export Processing Zones		Review and update of EPZ strategy and business plan completed and amendments to EPZ legislation prepared.	
D.2. IMPROVING THE LEGAL AND REGULATORY ENVIRONMENT FOR NETWORK UTILITIES			
Issue in the Energy Sector: The absence of a comprehensive document of Policy Statement for the Energy sector that clearly articulates the Government's vision for the development of sector over the medium to long-term and guides the changes need to the legal and regulatory frameworks.	Interim Point actions for ZESCO Commercialization met; and achievements on Entry Point actions sustained.	Cabinet has adopted a comprehensive Policy Statement for the Energy that clearly articulates the Government's vision for the development of the sector over the medium to long-term. Amendments to Electricity and ERB Acts are prepared Satisfactory progress in ERB capacity building, and in implementation of ZESCO Commercialization. (CAS progress indicator)	▪ All three stages of the commercialization roadmap of ZESCO are completed, meeting all of the agreed milestones.
Issue in the telecommunications sector. The absence of a comprehensive document of Policy Statement for the Telecommunications sector		Cabinet has adopted a comprehensive Policy Statement for the telecommunications sector that clearly articulates the Government's vision for the development of the sector over the medium to long-term	

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Milestones[1]			
Issue	**Board: December 2004**	**Second tranche (targeted for June 2005)**	**CAS outcome(s) to which the policy action/milestone contributes**
that clearly articulates the Government's vision for the development of sector over the medium to long-term and guides the changes need to the legal and regulatory frameworks		(CAS progress indicator) Development of new telecommunication law has started which ensures autonomy of regulator and separation of policy and regulatory functions, The Government has embarked on the Commercialization of ZAMTEL, which includes a framework to ensure effective management and regulation of ZAMTEL operations to prevent anti-competitive behavior by ZAMTEL.	

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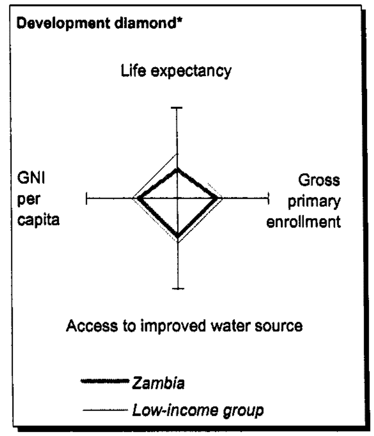
[1] Milestones in ***bold and italic*** are credit conditions that are included in the credit agreement.

Annex 6: Zambia At a Glance

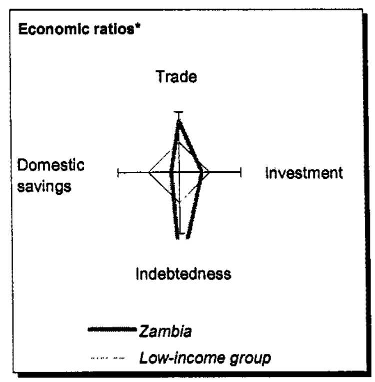
Zambia at a glance

9/15/04

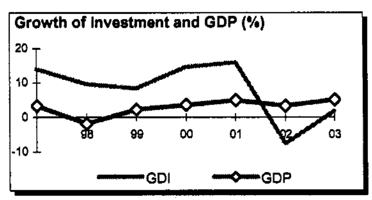
POVERTY and SOCIAL	Zambia	Sub-Saharan Africa	Low-income
2003			
Population, mid-year *(millions)*	10.4	703	2,310
GNI per capita *(Atlas method, US$)*	380	490	450
GNI *(Atlas method, US$ billions)*	4.0	347	1,038
Average annual growth, 1997-03			
Population *(%)*	1.9	2.3	1.9
Labor force *(%)*	2.4	2.4	2.3
Most recent estimate (latest year available, 1997-03)			
Poverty *(% of population below national poverty line)*	73	..	..
Urban population *(% of total population)*	36	36	30
Life expectancy at birth *(years)*	37	46	58
Infant mortality *(per 1,000 live births)*	102	103	82
Child malnutrition *(% of children under 5)*	28	..	44
Access to an improved water source *(% of population)*	64	58	75
Illiteracy *(% of population age 15+)*	20	35	39
Gross primary enrollment *(% of school-age population)*	79	87	92
Male	81	94	99
Female	76	80	85

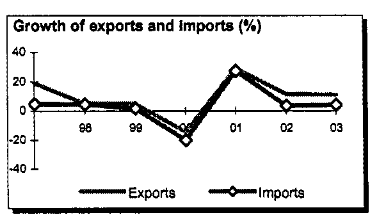


KEY ECONOMIC RATIOS and LONG-TERM TRENDS		1983	1993	2002	2003
GDP *(US$ billions)*		3.3	3.3	3.7	4.3
Gross domestic investment/GDP		13.8	15.0	17.4	16.0
Exports of goods and services/GDP		32.9	33.6	28.6	30.6
Gross domestic savings/GDP		15.2	8.2	4.1	4.9
Gross national savings/GDP		7.3	-0.2	0.1	0.8
Current account balance/GDP		-5.9	-14.3	-17.6	-14.6
Interest payments/GDP		2.2	2.8	2.8	..
Total debt/GDP		113.1	198.1	161.5	..
Total debt service/exports		27.1	33.0	27.8	..
Present value of debt/GDP		..	..	115.9	..
Present value of debt/exports		..	..	386.5	..
	1983-93	**1993-03**	**2002**	**2003**	**2003-07**
(average annual growth)					
GDP	1.3	2.0	3.3	5.1	3.7
GDP per capita	-1.6	-0.1	1.6	3.5	1.8
Exports of goods and services	-2.1	5.5	11.4	11.1	12.3



STRUCTURE of the ECONOMY	1983	1993	2002	2003
(% of GDP)				
Agriculture	16.7	34.1	22.2	19.3
Industry	47.2	41.9	26.1	29.7
Manufacturing	23.4	27.9	11.6	11.3
Services	36.1	24.0	51.7	51.1
Private consumption	60.7	73.4	84.3	83.8
General government consumption	24.1	18.4	11.6	11.3
Imports of goods and services	31.5	40.4	42.0	41.8
	1983-93	**1993-03**	**2002**	**2003**
(average annual growth)				
Agriculture	1.6	2.2	-1.7	6.0
Industry	2.1	-0.9	9.7	4.3
Manufacturing	5.9	3.0	5.7	4.0
Services	0.8	4.4	3.9	4.6
Private consumption	1.9	0.3	4.8	2.2
General government consumption	-0.1	-2.8	-11.9	1.3
Gross domestic investment	-1.8	7.7	-7.6	1.8
Imports of goods and services	-2.3	2.8	3.5	4.1





Note: 2003 data are preliminary estimates.

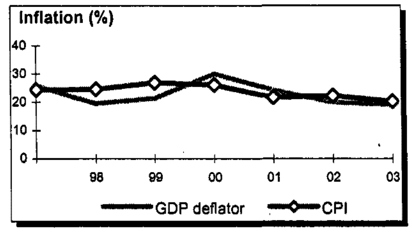
This table was produced from the Development Economics central database.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Zambia

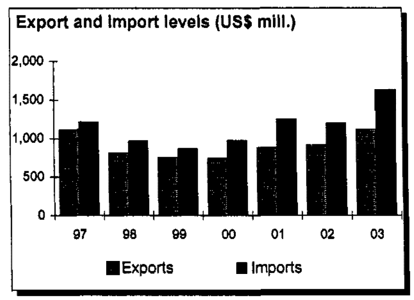
PRICES and GOVERNMENT FINANCE

	1983	1993	2002	2003
Domestic prices				
(% change)				
Consumer prices	..	188.1	22.2	20.2
Implicit GDP deflator	18.6	143.7	19.9	19.0
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	15.9	17.9	18.3
Current budget balance	..	-10.4	-1.5	-1.5
Overall surplus/deficit	..	-13.6	-13.9	-13.0



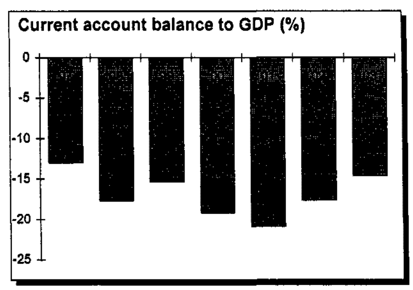
TRADE

	1983	1993	2002	2003
(US$ millions)				
Total exports (fob)	992	994	916	1,117
Copper	864	734	520	599
Cobalt	..	108	39	66
Manufactures	102	103	213	312
Total imports (cif)	716	1,019	1,204	1,633
Food	..	50	11	15
Fuel and energy	..	47	247	230
Capital goods	..	328	325	579
Export price index *(1995=100)*	..	70	62	67
Import price index *(1995=100)*	64	..	88	81
Terms of trade *(1995=100)*	..	..	70	83



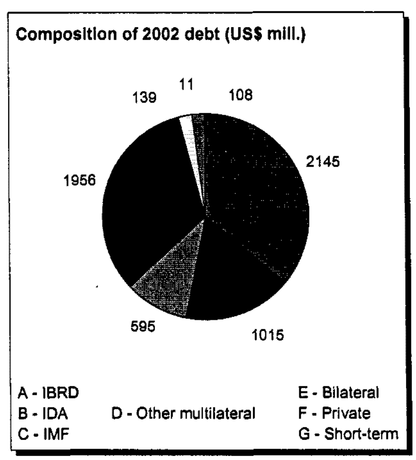
BALANCE of PAYMENTS

	1983	1993	2002	2003
(US$ millions)				
Exports of goods and services	1,101	1,091	1,081	1,314
Imports of goods and services	951	1,313	1,585	1,791
Resource balance	150	-222	-504	-477
Net income	-337	-226	-155	-148
Net current transfers	-10	-19	7	-2
Current account balance	-197	-467	-652	-628
Financing items (net)	128	484	881	702
Changes in net reserves	69	-17	-229	-74
Memo:				
Reserves including gold *(US$ millions)*	..	..	306	245
Conversion rate *(DEC, local/US$)*	1.3	452.8	4,398.6	4,733.3



EXTERNAL DEBT and RESOURCE FLOWS

	1983	1993	2002	2003
(US$ millions)				
Total debt outstanding and disbursed	3,755	6,485	5,969	..
IBRD	345	240	11	..
IDA	21	817	2,145	..
Total debt service	299	364	309	..
IBRD	48	72	8	..
IDA	0	6	5	..
Composition of net resource flows				
Official grants	76	478	348	..
Official creditors	96	139	44	..
Private creditors	32	-40	-12	..
Foreign direct investment	26	314	197	..
Portfolio equity	0	0	0	..
World Bank program				
Commitments	20	189	44	..
Disbursements	28	174	141	..
Principal repayments	22	52	7	..
Net flows	7	122	134	..
Interest payments	26	26	7	..
Net transfers	-19	96	128	..



Note: This table was produced from the Development Economics central database. 9/15/04

Annex 7: Fund Relations Note

DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

BUFF/04/106

June 16, 2004

The Acting Chair's Summing Up
Zambia—Three-Year Arrangement Under the Poverty Reduction and Growth Facility, First Poverty Reduction Strategy Paper Implementation Progress, and Joint Staff Assessment
Executive Board Meeting 04/57
June 14, 2004

Executive Directors welcomed the recent improvement in Zambia's economic performance, with growth in 2003 attaining the highest rate in two decades with falling inflation. However, Directors observed that the easing of drought conditions and higher copper prices were largely responsible for the positive outcome. They also noted with concern that sharp overruns in expenditure stemming from wage increases and unbudgeted expenditures had taken place, and that domestic debt and related interest payments had increased sharply.

Directors observed that Zambia's economy remained fragile and significant progress toward the Millennium Development Goals (MDGs) will only be possible with faster growth and better targeted public spending. They noted that more rapid and sustained economic growth will require prudent macroeconomic management and a deepening of structural reforms to engender higher donor inflows and private sector investment. Against this background, Directors welcomed the recent actions taken by the authorities to achieve macroeconomic stability. In particular, they welcomed the government's efforts to contain the public sector wage bill, noting that this would provide room for increasing spending on other priority poverty-reducing programs.

Directors noted that policy implementation and macroeconomic performance has improved under the extended Staff-Monitored Program (SMP). Directors, therefore, supported moving ahead with a new arrangement under the PRGF and urged the authorities to persevere in implementing reforms. Some Directors, however, indicated that they would have preferred a somewhat longer track record of sound performance under the SMP.

Directors considered that the envisaged fiscal adjustment and re-orientation of expenditure would unlock resources for pro-poor spending, reduce public borrowing, and free up resources for private sector growth. Given these important benefits, Directors urged the authorities to resist pressures for higher expenditures in areas not related to poverty reduction, including for wage payments. They underscored the importance of expediting the preparations of plans for right-sizing and pay reform of the public sector, with assistance from the World Bank and other donors. Progress in this area will be crucial to ensure the effective delivery of public services by a better paid, but affordable, government workforce.

Directors expressed concern over the recent monetary expansion and urged the authorities to monitor monetary developments closely—including the effects of negative real interest rates on placements of Treasury bills—and be ready to absorb excess liquidity in the banking system that could jeopardize Zambia's inflation and external sector objectives. Directors supported the maintenance of a flexible exchange rate system to allow prompt adjustment to changes in Zambia's external circumstances.

Directors welcomed the development of the Public Expenditure Management and Financial Accountability program in collaboration with key donors. They noted that successful implementation of the program would facilitate increased budgetary assistance critical for making progress toward the MDGs.

Directors considered the recent completion of the Financial Sector Development Plan an important step toward addressing the issues identified in the Financial Sector Assessment Program. They encouraged the authorities to ensure that urgent issues, such as the insolvency of the non-bank financial institutions, are addressed in 2004. They welcomed further progress toward the sale of the Zambia National Commercial Bank. Directors encouraged the authorities to revise the anti-money laundering legislation to comply with international best practice.

Directors underscored the importance of improving the environment for private sector development and foreign investment in order to accelerate economic growth. They considered the elaboration of a strategy and action plan to remove obstacles to investments to be crucial, and were encouraged by the process of consultation now under way under the Private Sector Development Initiative. In this context, they stressed the importance of defining a consistent policy for tax exemptions that achieves a prudent balance between the desire to encourage investment and the risk that exemptions could rapidly undermine Zambia's resilient revenue base. Directors welcomed the government's efforts to improve governance through the anti-corruption drive and the enhancement of transparency and accountability of government operations.

Directors generally concurred with the conclusions of the Joint Staff Assessment on Zambia's first Poverty Reduction Strategy Paper (PRSP) Progress Report. They agreed that in light of the authorities' recent renewed commitment to reforms and policy implementation, the strategy proposed in the PRSP continues to provide a credible framework for Fund concessional assistance.

Directors urged the authorities to make additional efforts to strengthen ownership of the PRSP and continue to make progress toward implementing the few remaining HIPC completion point triggers. Several Directors felt that the completion point could be reached in December 2004. However, the majority of the Executive Board looked forward to Zambia's sound policy implementation under the PRGF program as the basis for consideration of the completion point in early 2005.

Appendix 1:Zambia Pensions: Current and Emerging Issues

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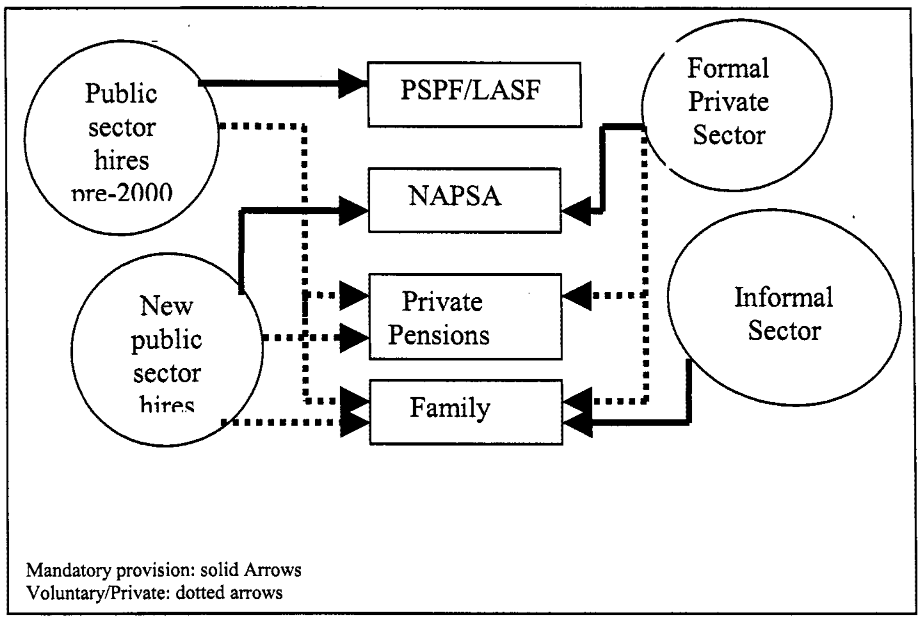
1. Major Pension Schemes and Current Coverage

Institutional Framework. In Zambia, four major institutions provide pensions to retirees. Civil service members hired before February 1, 2000 belong to either the federal-level public sector pensions fund (PSPF) or the Local Authorities Superannuation Fund (LASF). The President's office and the Minister of Local Government and Housing respectively supervise the funds. The Government of the Republic of Zambia (GRZ) is the financial guarantor of both.

In February 2000, the National Pension Scheme (NAPSA) was implemented. At that time, members of the successor private sector scheme, the National Provident Fund, were transferred to NAPSA. New government hires are also required to join NAPSA. In addition to NAPSA, workers in the formal private sector may be covered under an employer-sponsored occupational pension scheme. In rare instances, workers purchase pension insurance privately through insurers.

Figure 1: Pensions in Zambia today



The Pension and Insurance Authority, which is housed within the Ministry of Finance, regulates employer-sponsored private sector schemes, insured schemes, and the two public sector schemes. However, lacking both staff and an appropriate legislative mandate, it is ineffective and lacks the capacity to enforce prudent regulations of pension funds. This has been recognized by the FSDP and a development plan is being prepared.

Coverage. Although the public service schemes are being slowly phased out, they still cover the vast majority of the public service. Together the two schemes have 130,000 active members, about a quarter of the formal workforce, and pay pensions to about 50,000 retirees.

NAPSA, which is supervised by the Ministry of Labor, covers about 400,000 workers in the private sector. It has no pensioners yet. In 2005 disability and survivors pensions will become available, and in 2007 NAPSA will begin paying old age pensions most of which will be in the form of lump-sums or contribution returns with interest.

There are between 150 and 200 employer-sponsored private pension schemes spread across various sectors in Zambia although most of them are based in the metropolitan areas of Lusaka and the copper belt. These schemes cover about 100,000 workers in the formal private sector. About half the workers covered belong to defined benefit plans and half to defined contribution plans. With some exceptions, the largest schemes are defined benefit although in line with international trends, most new plans are of the defined contribution type.

Table 1: Some pension schemes in Zambia

Type and Institution	Members	Assets (K' Billion)
Statutory Pension Schemes		
NAPSA	330,000	500
LASF	22,907	31
Public Service Pensions Fund	130,012	70
Occupational Pension Schemes		
Bank of Zambia	692	46
Mukuba	14,798	64
African Life Financial Services	16,991	106
Professional Insurance Corporation Zambia	3,798	29
Madison Insurance Company Zambia	4,001	18
Zambia State Insurance Corporation	Over 3,000	98

Source: *Pensions and Insurance Authority*

There is little to no pension coverage in the informal sector where more than 90 percent of Zambia's 5 million workers estimated labor force is part. Thus, for the vast majority the family continues to bear the burden of providing old age income security. For the most part, pensions are not indexed and most workers receive the bulk of their pension as a lump sum at retirement. High inflation rates quickly erode the remaining low monthly benefit. In the private sector in about 12-15 years NAPSA will begin paying old age pension annuities. The benefits, though modest, will be indexed to average wage growth, which generally has been below the inflation rate.

Financial sustainability. The two public sector schemes, PSPF and LASF, are not financially sound. Although both hold some assets and are owed considerable amounts in back contributions, collecting all arrears would not substantially strengthen their financial position. As verified by latest actuarial evaluations and World Bank reports, benefits are simply too high relative to current contribution rates and would remain too high even e.g. if contribution rates were doubled.

NAPSA holds assets of over 500b Kwacha (about $110 billion US), and because it now pays few monthly pensions, its assets will continue to grow for another 10 to 15 years. Thereafter, assets will begin to decline, and the current 10 percent contribution rate will need to increase slowly or benefits will need to be decreased. One of the greatest challenges confronting NAPSA is to prudentially manage this large pool of long-term capital to the best interests of its members.

Private sector schemes have been growing rapidly in recent years and hold nearly 500b Kwacha in assets. However, many of the largest defined benefit schemes are seriously under funded and may be forced to partially default on benefits, especially those pension funds operating in the copper sector. In addition, some private sector schemes have had to close down on account of being squeezed out by NAPSA.

Problem Areas. The Zambian pension system has major difficulties. Financial soundness and the lack of coverage have already been mentioned. In addition, there is no coherent vision for unifying the fragmented systems or any plan for resolving chronic and mounting financial liabilities. The hidden pension liabilities of the two public service funds alone are almost K 3 trillion. Since benefit levels of public officers are protected in the Constitution, reform is all but impossible without constitutional amendment. Even without constitutional amendment it is urged that all new entrants to the public service contribute and receive benefits as per the specifications of NAPSA since this is the only way to slow down the exploding pension liabilities. In addition, if new entrants were kept at either the PSPF or LASF, it would allow both these institutions some fiscal breathing room to pay current pensioners.

The lack of coherent legislation and regulation weakens private sector pension schemes where defaults in defined benefits schemes could develop if economic conditions worsen or there are sectoral changes in the patterns of employment. The provisions of the minimum wages act and other employment related legislation needs to be carefully reviewed since these often tend to prescribe separation benefits from work in cases where no pensions exist. This provision in the minimum wages act has been a source of great concern to many stakeholders in Zambia – employers and employees alike.

Investing pension funds, both public and private, presents a major challenge. Long-run opportunities are limited, and there are questions of whether the domestic economy can absorb the rapidly growing assets of NAPSA and the growing number of private sector defined contribution schemes. These challenges occur against much needed improvements in investment management, corporate governance, collection procedures, and enforcement of collections of contributions while at the same time there are domestic pressures to use some of these funds for socially targeted activities solicited by unions and the Government.

2. Public Service Pension Fund

PSPF is not financially sound. In 2003 contributions from approximately 87,000 active members were about 110.0 b Kwacha -barely sufficient to cover payments to about 45,000 beneficiaries. In 2004 and subsequent years payouts will exceed contributions at current rates by increasing margins.

Table 2: Some PSPF data

Coverage	Pre-2000 public sector employees plus new ones exempt from NAPSA (e.g. military and teachers)
Financing	14.5% payroll tax split evenly between GRZ and employees.
Benefits	Final salary defined benefit scheme with 2/3 lump-sum commutation at retirement
Number of Active Workers	87,000
Number of Beneficiaries	45,000
Income	K110.0b
Expenditures	K115.0b
Pensions	K104.0b
Administrative Costs	K11.0b
Assets, Minus Loans and Arrears	K300b
Loans to GRZ and Contribution Arrears	K273b
Implicit Pension Liabilities	K3.0tr

Source: PSPF data files. Data are for the year 2003.

The consequences of inaction are growing and will create a fiscal burden for GRZ if no action is undertaken. Old aged pensioners are almost certain to receive less than the full value of their pension, and growing budget allocations to pay at least part of the benefits will crowd out other public expenditures, as the Government is required to fund the operational deficit of PSPF from budgetary resources.

To eliminate the financing gap would require raising contribution rates to nearly 50 percent of wages or reducing benefits to one-third of their current levels. The first option is neither economically nor politically viable while the second will face judicial challenges because the Constitution guarantees current benefit levels and places the ultimate burden for paying benefits on the treasury. Since the standard options are not feasible and the current contribution/benefit mix is not actuarially fair, it is recommended that the constitution be amended to allow the GRZ and the PSPF to manage the exploding pension liabilities by aligning benefits to contributions either within the current structure or in a new one. An option would be to move towards NAPSA contribution and benefit parameters thereby achieving harmonization while at the same time moving towards a system with balanced incentives.

Recognizing its current plight, the PSPF has begun implementing a strategic action plan that includes efforts to strengthen corporate governance and ease administrative bottlenecks as well as move toward financially viable benefits. Some of the elements of the program include:

- Addressing the financial sustainability through constitutional reform followed by reforms to correct the imbalance between contribution and benefit accrual rates.
- Improving investment policy for small amount of assets PSPF has and whatever it can collect through repayment of government arrears.
- Reducing the GRZ debt to the PSPF through debt/equity swaps.
- Working more closely with government to negotiate payment of current contributions and grants for pensions due to retrenchment.
- Coordinating accounting procedures with GRZ to clarify classification of GRZ current contributions, contributions to pay arrears, and grants to finance early retirements due to retrenchment.
- Reducing administrative costs and improving benefit delivery through implementing administrative reforms, adopting automated record keeping, and increasing training.

3. Local Authorities Superannuation Fund (LASF)

As with PSPF, financial sustainability is the overriding issue for LASF. At the time of the last actuarial valuation in 1997, the unfunded liability stood at 45b Kwacha, and it was estimated that a contribution rate of over 50 percent of wages would be required to bring the scheme into financial balance. The present contribution rate is 23 percent. The scheme is not financially sustainable without substantial modification or an infusion of $10-15m US or more—a large sum for a scheme that covers fewer than 23,000 workers and retirees.

Table 3: Some LASF data

Coverage	Pre-2000 local government employees
Financing	23% payroll tax, employees share equal 10%
Benefits	Final Salary DB with 2/3 lump-sum commutation
Number of Active Workers	14,500
Number of Beneficiaries	7706
Income	39.2b
Administrative Costs	4.0b
Assets, Minus Arrears	K28.4b
Contributions Arrears	About K44.7b
Implicit Pension Liabilities	Not estimated since 1997

Source: LASF for the year 2003.

Capacity building is needed in particular in the area of financial analysis to maintain LASF as a separate independent administrative unit. A prior decision, however, is whether to fold LASF into one of the other pension organizations since it is small and will loose contributors rather rapidly over the next several years as current members retire and newly hired local workers are diverted to NAPSA.

LASF has been proactive in attempting to improve its situation.

- In 2003, it reduced both contribution and benefits arrears. At the beginning of 2002, the fund had a 2-year backlog of unpaid benefits. In 2003, contributions were K37.6 billion, owing to a number of contributors paying a part of their arrears. In addition, LASF reduced the federal government's arrears by arranging a debt/equity swap. Some of the acquired equities in the swap have already yielded dividends. As a result of these actions, LASF is current in its payment of benefits.
- LASF also has commissioned a sorely needed actuarial valuation and hired an accounting firm to audit its accounts. The last independent audit was in 1998.
- Finally, LASF petitioned the Minister of Labor to exempt from NAPSA new employees of institutions formerly covered under LASF so that LASF could expand its membership. The Ministry of Labor rejected this request, which is appropriate in the absence of a comprehensive program for LASF financial rehabilitation.

4. National Pension Scheme (NAPSA)

The primary challenge facing NAPSA is the development of appropriate mechanisms for investing its pension assets. Because NAPSA has been in operation only 4 years, it currently pays few benefits and has a contribution rate that will exceed benefit payouts for the next 10 to 15 years. During that time NAPSA will accumulate a buffer fund that, at its peak, will be the largest pool of capital in Zambia. Thus it is important to ensure that these long-term savings are allocated and invested prudentially and efficiently.

Table 4: Some NAPSA data

Coverage	Private sector workers plus post-2000 public sector employees except for those exempt from NAPSA (e.g. military and teachers)
Financing	5.0% payroll tax split evenly between employer and employees.
Benefits	Defined benefit scheme with benefits based on average wage-indexed salary over 15 years
Number of Active Workers	435,900
Number of Beneficiaries	Under 5,000
Income	K219.2b
Expenditures	K39.0b
Pensions (contribution returns)	Under 2.5b
Administrative Costs	K37.4b
Assets	491.7Kb
Implicit pension liabilities	Fully funded over next 13 years with unfunded liabilities emerging thereafter

Source: NAPSA for 2003. Beneficiaries and returns of contributions estimated by EMGC team members.

Therefore, NAPSA's most urgent need is for procedural reform, tooling up, and capacity building in asset management. After 4 years of operation NAPSA holds nearly K500b in assets. Sixty percent of these are held in government bonds, and another 30% is in time deposits. There is no outside custodian as yet to hold a portion of assets abroad to diversity the portfolio. NAPSA has no asset management software, even though good packages exist and could be customized. There is no benchmarking of returns as of yet. NAPSA is aware of these issues and is in the process of implementing reforms although capacity remains a constraint while domestic pressures to invest the funds in socially targeted projects remains.

Internal investment procedures need improving and delay moving contributions promptly from the income stream into profitable investments. As a consequence, it appears that assets held for operations are too large. What is needed is a process for immediate distribution of assets via a formula into the operational working capital account of NAPSA and its investment account.

There is an urgent need for technical assistance and capacity building if one of the largest pools of assets in Zambia is to remain diversified.

NAPSA need to have a greater awareness and understanding of pensions in general and, more importantly, of modern principles for organizing and executing the duties of a major social pension program. For example, the Board should have an investment committee with expert advisors. The committee should be pro-active in assuring that management diversify the portfolio by taking advantages of domestic and external investment opportunities. Training of Board members in particular could improve the governance of NAPSA by ensuring that the Board properly focuses on its major responsibilities and decision-making in areas and ways appropriate for a pension trustees.

The review of the investment operation suggests that NAPSA must also effect improvements in internal controls and current procedures for separating the flow of finances and the flow of associated information. NAPSA's internal controls require further study to pinpoint additional improvements that can be made.

Other needs are to improve collections and lower NAPSA's administrative costs. NAPSA and the Zambian Revenue Authority (ZRA) should move quickly to implement the recommendations of a NAPSA/ZRA report completed a year ago that states that NAPSA could benefit from using ZRA as its collection agent. According to both organizations, a pilot project is to become operational in Lusaka as early as late December 2004. However, to start the pilot the law governing ZRA needs an amendment to this fact. Without this change, which will enable ZRA to collect monies that are not Treasury taxes, the project cannot move forward.

Record keeping for individual member contributions also requires additional work. Impressive strides have been made over the past year. However, the process of converting paper reports from employers into computerized data for individual member accounting remains cumbersome, error prone and costly. Modern technologies, such as scanning paper documents into the computer and using more computer friendly forms should be explored. Additional technical assistance and capacity building is needed to continue the modernization processes both technically and organizationally.

IT remains a challenge. NAPSA has an integrated member and employer database from which various departments receive and can request information. The software, which was designed in early 2000 before NAPSA implementation, does not adequately service current needs. Issues related to investment and the financial departments have already been mentioned. In addition, the research and actuarial department has difficulty extracting the information needed for management decision making, tracking participation trends and current financial status, and making financial projections.

Expanding coverage has long been a concern of NAPSA and following implementation of the ZRA collection arrangement would be an excellent time to focus on this. It is proposed that NAPSA and ZRA jointly undertake a number of field experiments to explore methods for expanding coverage into the informal sector. Designing these experiments would be challenging but would have the potential of high payoff for providing more widespread receipt of pension income in old age.

5. Pensions and Insurance Authority

Prior to the enactment of the Pension Schemes Regulation Act (PSRA) of 1996, pension schemes in Zambia were unregulated. They were only required to register with Zambia Revenue Authority (ZRA) for tax exemption purposes. The PSRA provides for the regulation of all pension schemes with the exception of the National Pension Scheme. In addition to the two public service schemes (PSPF and LASF), there are 130 to 150 occupational pension schemes. Most are defined contribution plans. In 2002, they covered about 150,000 contributors and paid benefits to 57,000 pensioners. Collectively, their assets are estimated to be about 500b Kwacha, roughly 5 percent of GDP.

Form its inception the precise role of the PIA and its interaction with other regulatory bodies has been ambiguous. The PSRA explicitly exempts the National Pension Scheme, but does not exempt the Local Authorities Superannuation Fund and the Public Service Pensions Fund, one of which is the Ministry of Local Government and Housing and the other within the Office of the President. The Income Tax Act, Cap 323 deals with tax exemptions for approved pension schemes, while the Pension Scheme Regulation Act requires that pension schemes be established under trust. The Deeds Registry under Ministry of Lands handles the process of establishing trusts. Additionally, the Pension Scheme Regulation Act provides for the regulation of fund managers. However, the Act does not define fund management, thus, creating an apparent overlap with other authorities including the S&EC, ZRA and to some extent the BoZ. The lack of harmony in the various pieces of regulation effecting pensions and ambiguities regarding the separation, or coordination, among regulators would undermine effective supervision and monitoring even if other conditions, such as adequate budgeting and staffing, were met.

Despite being operational since 1997, the PIA still remains under the Ministry of Finance and National Planning rather than being an independent corporate entity. Much of its budget is grant-financed and hence it has been unable to retain the required human resources to carry out its mandate effectively. The PIA currently has a single registrar for both pensions and insurance and only one additional staff person to carry out all regulatory responsibilities for pensions. Thus credibility in this organizations ability to function effectively is a valid concern and impacts the pension fund industry. Information and reporting requirements are not always adhered to making it difficult to assess the performance of the 8-10 fund managers that manage people's retirement savings. With the assets of occupational pension schemes exceeding 5 percent of GDP, this pool of savings represents an important source of long-term capital. It is critical to ensure that these pension funds are managed and administered with high standards of fiduciary prudence and transparency. The lack of independence of the regulator is an obstacle to meeting this challenge.

Regulation and supervision must be improved if current shortcomings of the occupational pension sector are to be properly monitored and, in time, corrected. Investment portfolios are weak with excessive real estate holdings still remaining in many funds. Administrative costs are also high. At present, the pension fund industry charges about 15 percent of contributions as administration costs or roughly 20 percent of benefits paid. These are unusually high by international standards and need to be reduced. High administration costs, coupled with relatively thin real estate and financial markets, limited supervision, and high inflation have resulted in negative real rates of return between 1996 and 2000.

Table 5: Investment trends in the private sector

Asset Class	1997	2000	2001
Fixed interest	12%	16%	19%
Equities	5%	8%	8%
Real Estate	34%	28%	28%
Cash Deposits	11%	10%	12%
Insurance Policies	1%	2%	0%
Other	37%	35%	33%

Source: Pension and Insurance Authority statistics, 2003.

6. Conclusion

To summarize, there are major weaknesses in the current system, especially in the pensions provided for government workers and the regulation of private sector occupational schemes. This is coupled with a lack of awareness of the costs, fiscal implications, and overall social consequences of inaction. Improving the financial viability of the two public sector schemes will require constitutional amendment, which is now under consideration

In the short run, it is recommended that the GRZ move to harmonize the major schemes accepting NAPSA as the basic pillar of social security. It should harmonize and resolve conflicts in existing labor legislations and other social security laws. New entrants to the public sector could contribute to the PSPF and LASF as additional supplementary schemes if they chose to. Alternatively, the PSPF and LASF could themselves administer public service pensions (with NAPSA parameters after a parametric reform). This has the added advantage that there will be an inflow of revenues to temporarily diffuse the liquidity problems facing the public service pension funds while plans are being made to tackle the stock of pension debt.

Pension reform in Zambia needs a coherent and holistic vision given the relatively fragmented nature of current arrangements. The reform agenda should focus on three critical areas that would result in a coherent social security framework for Zambia (a) fiscal solvency (b) regulation and governance and (c) capacity building. The reform effort for the pensions sector would need major coordination among a variety of stakeholders, substantial TA.

It is expected that in the near future the PSPF and the LASF would both submit requests/proposals to the cabinet for a) constitutional reform and b) strategic action plans to address insolvency and harmonization with the private sector.

For the public service pension funds, the appropriate strategy would be to implement parametric reforms after constitutional barriers are removed. The benefit rate and contribution rate of both schemes need to be adjusted to achieve financial balance going forward. An opportunity to harmonize all employment related defined benefit system across both public and private sectors can be utilized by shifting current public sector pension parameters to NAPSA parameters although the precise mechanisms of this transition would need further elaboration. Although constitutional reform is a necessary first step towards correcting untenable fiscal liabilities of the public sector pension schemes, both institutions needs substantial capacity building especially in the areas of financial management, actuarial analysis and corporate governance.

Table 6: Scattered supervisory arrangements

Institute	Responsible Ministry
PSPF	Ministry of Finance
LASF	Ministry of Local Government and Housing
NAPSA	Ministry of Labor
PIA	Ministry of Finance

For NAPSA – the major areas for improvement are in investment management, IT and collections. Plans are already underway to affect improvements but capacity is lacking especially in asset-liability modeling and strategic asset allocation. Collaboration with the income tax collection authority in Zambia needs to be carefully monitored to facilitate the transfer of collection responsibility to the tax authority. The internal networking process needs to be completed quickly to enable reliable data and information flows as well as facilitates transparent reporting procedures.

The PIA as the regulator of all pension funds (except NAPSA) needs considerable capacity building and should also submit to the Cabinet Office a strategic plan including a desired human resource structure. The institution is currently understaffed and does not have the capacity for this exercise. Within the context of Zambia where about 30 percent of the work force store their retirement savings in private plans, the importance of a sound regulatory framework can not be emphasized enough.

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