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Zambia
Economic Management and Growth Credit (Cr. No. 4009-ZA)
Release of the Second Tranche – Full Compliance

I. BACKGROUND

1. On December 14, 2004 the Board of Executive Directors of the International Development Association (IDA) approved the Economic Management and Growth Credit (EMGC), a structural adjustment credit, for the Republic of Zambia in the amount of SDR27.4 million (US$40 million equivalent). The Credit, a two tranche operation of SDR13.7 million each, was declared effective on December 21, 2004 and the first tranche released on December 26, 2004.

2. In view of the overall performance and progress with the implementation of the program supported by the Credit, and in compliance with the specific conditions of release referred in paragraph (d) of section 2.02 and listed in Schedule 2 of the Development Credit Agreement, the Second Tranche of SDR13.7 million, equivalent to US$19.8 million at current exchange rates, can be released to the Borrower.

3. The EMGC is the first development policy operation to support policy and institutional reforms as envisioned in the Country Assistance Strategy (CAS) for the period 2004-07 (Report No. 27654-ZA). The CAS envisaged that over the four-year period of CAS implementation, there could be at least two development policy lending operations. This credit assists Zambia to: (a) return to a macroeconomic framework conducive to robust growth; (b) strengthen the role of the financial sector; (c) strengthen the credibility and institutional capacity of the public sector; and (d) improve Zambia's business environment. IDA and the Government of the Republic of Zambia (GRZ) 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.

II. RECENT ECONOMIC PERFORMANCE

4. Performance under the IMF's Poverty Reduction and Growth Facility (PRGF) supported macroeconomic program has been positive. Economic growth has been robust and broad based. Strong performance of non-traditional exports combined with a resurgence of copper prices and production, have greatly improved Zambia's external accounts. In addition, reaching the HIPC Completion point in early 2005 has wiped out approximately US$4 billion of Zambia's external debt stock greatly reducing GRZ's external debt service and improving its external creditworthiness and solvability. The proposed Multilateral Debt Reduction Initiative (MDRI) will further reduce Zambia's

external debt to just about US$0.6 billion. At the same time fiscal policy has been put on a sustainable trajectory and has become more predictable through the introduction of a Medium Term Expenditure Framework (MTEF). Even though levels of inflation and interest rates remain fairly high, monetary policy has been relatively tight.

5. Zambia is experiencing a robust growth period with positive per capita GDP growth for seven consecutive years and with all sectors positively contributing. This contrasts sharply to the early period of reform of 1991-1998. As a consequence, the overall poverty headcount has declined from 73 percent in 1998 to 68 percent at the end of 2004. Even though this decline is less than needed to reach the poverty related Millennium Development Goal (MDG), which aims to reduce the proportion of Zambians whose income is less than one dollar a day by 50 percent between 1990 and 2015, the decline is a welcome outcome after decades of decreasing incomes and increasing poverty. Real GDP Growth is estimated to equal 4.3 percent for 2005 albeit the country experienced a drought for the 2004/05 farming season and witnessed serious fuel shortages in the fall of 2005 because of an unanticipated production failure at the local refinery.

6. These positive growth and poverty developments are supported and for a large part driven by favorable external developments. Zambia's terms of trade improved by 21.9 percent and an estimated 2.1 percent in 2004 and 2005 respectively. This has led to a decline in its current account deficit after grants from 7.5 percent of GDP in 2003 to 3.7 percent in 2004 and an estimated 4.6 percent for 2005. The main source of this improvement is the exceptional rise in copper prices by approximately 100 percent between 2003 and 2005. This combined with a recovery in copper production has allowed growth of export proceeds to outperform increases in imports. Imports rose sharply during this period as well triggered by rising fuel costs and imports of related investment goods for the mining sector in particular. In addition, non traditional exports have also grown rapidly amounting to an estimated US$540 million for 2005 up by 115 percent compared to its US$ level in 2000. As a result, overall export levels measured in US$ in 2005 are estimated to amount to US$2.1 billion, almost three times the level of exports in 2000.

7. These improvements in the external environment have resulted in a build up of international reserves which stand now at 1.4 months of imports, still a relatively low level, but up from less than 1 month of imports at the beginning of this millennium. The favorable external developments have impacted the Kwacha, which has been appreciating in real terms by approximately 8 percent annually in 2003 and 2004, and appreciated over 17 percent alone over the first 8 months of 2005. The impact of this appreciation, brought about by a fundamental improvement in Zambia's external environment, on its competitiveness can be curtailed if it is matched by increasing productivity and reducing the cost of doing business.

8. After years of weak fiscal policy implementation, the authorities have improved budget execution and reduced its domestic financing needs drastically. Domestic borrowing was reduced from 5.1 percent in 2003 to 0.8 percent in 2004, which

has crowded in credit resources available to the private sector and reduced yields on bonds and T Bills significantly. In 2005, the overall fiscal deficit is estimated to be around 2.7 percent of GDP, up slightly from a low 1.7 percent deficit in 2004. Under the recently issued Medium Term Expenditure Framework for the period 2006-08, domestic borrowing is expected to remain subdued allowing domestic resources to be increasingly channeled through the banking system to much needed private investment.

9. The reduction of the deficit from 6.6 percent in 2003 to an estimated 2.7 percent of GDP for 2005, has basically taken the fiscal angle out of inflation. Nevertheless, inflation remains relatively high and stood at 17.2 percent for November 2005, 1.1 percent lower, than the CPI inflation for November 2004. The smaller than anticipated reduction in inflation is mostly caused by the effect of the drought on food prices and the increase in oil prices on the world market. Monetary policy itself has become tighter with growth in broad money falling from 60 percent in 2000 to an estimated 18 percent in 2005.

10. The Government is in the process of preparing its next National Development Plan, which will cover the period 2006-10 and which is to focus on growth and its contribution to poverty reduction. It is recognized that through fiscal consolidation and public expenditure management reforms e.g. introduction of program budgeting and commitment control mechanisms in particular, the government is in a better position to provide not only a growth/investment conducive macro economic environment but also to better direct its expenditure programs to those in need and on those public investment programs and services that will allow the poor to be able to more fully participate in and benefit from the current economic growth momentum in Zambia.

III. PROGRESS AGAINST TRANCHE RELEASE CRITERIA

11. The Government has maintained a satisfactory macroeconomic framework. This has been confirmed by a positive second review under the PRGF arrangement, which was concluded on April 8, 2005. Zambia's current three-year arrangement in the amount of SDR220.1 million was approved by the IMF Board on June 16, 2004. Its Executive Board is tentatively scheduled to conduct the third review of the program on January 11, 2006. IMF staff has informed IDA that performance under the program has been broadly satisfactory. All quantitative performance criteria and benchmarks for the third review, which is based on program benchmarks for June 2005, were met, while all but one of the performance criteria for end-September was met. Under the structural program, all performance criteria have been met. Some benchmarks were, however, implemented with some delay.

12. The conditions of release referred in paragraph (d) of section 2.02 and listed in Schedule 2 of the Development Credit Agreement (DCA) between the Borrower and IDA dated December16, 2004, state that for the release of the second tranche the following milestones must be fulfilled:

Milestone 1: *The Borrower's Ministry of Finance and National Planning (MoFNP) has adopted a time-bound restructuring plan for payment of the Borrower's arrears to utility and insurance companies in accordance with paragraph 9 of the LDP.*

13. **This milestone has been met.** The Borrower has made separate arrangements with each of the relevant utility and insurance companies to dismantle the stock of arrears in a time bound manner. In addition, to strengthen oversight and control over the utility payments and insurance premiums, the MoFNP has decided to pay all utility bills and insurance premiums directly from the Treasury and debit the transfers it makes to the government agencies that are being billed by the utilities and the insurance companies.

Milestone 2: *The Borrower's Cabinet has approved a financial reform program for Public Sector Pension Fund (PSPF) including: (a) a proposal to the Constitutional Review Commission to change the provisions of article 124 of the Constitution; and (b) a reform program for PSPF that ensures the financial sustainability of the fund, all in accordance with paragraph 14 of the LDP.*

14. **This milestone has been met.** In November 2005, Cabinet approved PSPF's reform proposal including the constitutional amendments that will allow PSPF to undertake those reforms that will put the fund on a sound financial footing. Government has indicated that it will pursue parliamentary approval of the changes needed to the constitution. This will allow the reform program to be implemented within a shorter timeframe, greatly reducing the cost to the Zambian economy.

Milestone 3: *The National Pension Scheme Authority (NAPSA) has: (a) adopted a revised investment policy, appointed a global custodian and selected a pension fund manager; (b) adopted an operations manual on corporate governance; and (c) developed a program for training trustees, all in accordance with paragraph 14 of the LDP.*

15. **This milestone has been substantively met.** A revised investment policy that instructs NAPSA to invest in assets externally was adopted by NAPSA's Board in 2005. This requires the appointments of a global custodian and pension fund manager.

16. Although not yet final, the lengthy process of selecting a global custodian and NAPSA's first international asset manager is nearing completion. A request for proposals from global custodians is now pending before the Tender Board of the Government of Zambia. Simultaneously, NAPSA is developing a short list of asset managers from an expression of interest to which 16, mostly well-known, international asset managers responded. Drafting a request for proposals from prospective short-listed bidders is also underway. The draft proposal will be submitted to the NAPSA Board of Directors for review and comment in January. This review is essential since the Board is responsible for development and oversight of NAPSA investment guidelines. The request for proposals will be submitted to the tender board following approval of the Board. It should be acknowledged that institutional reforms of this type take time, require consensus building and therefore their exact pace cannot be determined with full

certainty at the outset. However, NAPSA's management has reiterated its commitment to without undue delay appoint the global custodian and fund manager in 2006.

17. With regard to sub milestone (b), an operational manual on corporate governance was prepared and adopted by NAPSA's board. The training program, sub milestone (c), as well as the training itself has taken place with participation not only of NAPSA's trustees but was also attended by officials of the Ministry of Labor, including the Minister, and members of the Board of PSPF.

Milestone 4: *The Borrower has made progress in the process of adopting the necessary revisions to the Building Societies Act, the National Savings and Credit Bank (NSCB) Act and the Development Bank of Zambia (DBZ) Act, all in accordance with paragraph 19 of the LDP.*

18. **This milestone has been met.** The necessary changes to the legal acts of the above mentioned state-owned non-bank financial institutions (NBFIs) with the objective to bring each of them under the Banking and Financial Services (BFS) Act such that all supervisory powers are with the Bank of Zambia (BoZ) has been adopted by Parliament. These amendments to the Building Societies Act, the National Savings and Credit Bank Act and the Development Bank of Zambia Act have been signed into Law by the President in October 2005.

Milestone 5: *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: (a) no public funds will be used with respect to NSCB, ZNBS or DBZ without a business plan; (b) operations restrictions on DBZ shall remain in effect until at least 75% of its equity is committed by a private entity; and (c) DBZ shall not: (i) accept deposits; and (ii) raise any loan requiring government guarantee, all in accordance with paragraph 19 of the LDP.*

19. **This milestone has been met.** The financial sector development plan, which was endorsed by Cabinet in July 2004, identified gaps in Zambia's financial sector in two particular crucial areas: (i) provision of investment finance and (ii) provision of financial services for Zambia's poor both in urban and rural areas. In order to fill these identified gaps, DBZ and NSCB are to be restructured to provide the Zambian population with these essential services. Government has put in place an implementation framework through a Memorandum of Understanding (MoU) for each of the three state-owned NBFIs. These MoUs were signed by the BoZ, MoFNP and management of each of the three state-owned NBFIs. The MoUs designate the BoZ as the implementing agency of the restructuring process. In addition, Cabinet also reviewed the proposed changes to the status of the state-owned NBFIs and agreed in principle to the proposed transformation of each of them.

20. In the case of DBZ the agreed restrictions as spelled out in the milestone have been fully adhered to and are an integral part of its MoU with the BoZ and the MoFNP. The MoU between BoZ, MoFNP and NSCB management provides adequate guarantees

that NSCB will not engage in activities that will negatively add to its financial situation. In addition, the International Fund for Agricultural Development (IFAD) is providing technical assistance to improve management of NSCB as well as project financing to assist the rural farming communities in Zambia. The operational restrictions on ZNBS as specified in the MoU have not led to a recovery of ZNBS's balance sheet

Milestone 6: *The Borrower's Ministry of Finance and National Planning has tabled in the Borrower's legislature the annual budget for the year 2005 including an annex which compares the estimated expenditures for the year 2005 with the budget releases for the years 2004 and 2003, in a summary table aggregated by budget head, showing the Personnel Emoluments (PE) and non-PE expenditures from the Borrower's resources all in accordance with paragraph 27 of the LDP.*

21. **This milestone has been met.** Due to confusion around the interpretation of those articles in Zambia's constitution that stipulate which documents need to be presented with the budget for next fiscal year to Parliament, the Ministry of Finance and National Planning issued the annex at the time the Medium Term Expenditure Framework for 2006-08 was presented to Parliament, which took place in November 2005. Note that however for the first time the 2005 budget document included a summary table that compares the estimated expenditures for 2005 with the budget releases for the year 2004 and the original budgeted expenditures for the year 2004 as well as the releases for 2003 per head but not disaggregated by PE and non-PE expenditures.

Milestone 7: *The Borrower's Public Sector Management Department in the Cabinet Office has consolidated routine and current 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 in accordance with paragraph 30 of the LDP.*

22. **This milestone has been met.** Zambia's civil service regulations identify over 50 allowances. In 2005, Government merged 14 general allowances into base pay for civil servants and froze the nominal amounts for those allowances independent of the recipient's base pay. This has indeed resulted in a decline of the overall ratio of allowances to base salary. It should be noted that the wage negotiations in 2005 were tense as wages had been frozen in nominal terms for almost two years and that therefore it was extremely difficult to ask for additional changes in conditions of service, which could have led to a further and more substantive decline in the ratio of allowances to base salary.

23. Government has also embarked on a comprehensive review of its pay structures as part of its overall reform program in the area of public sector management. This reform effort is supported by several donors including the Bank through a Sector Wide Approach (SWAp). IDA's proposed contribution to Zambia's public sector management reform program will be presented to our Board of Executive Directors for approval in

January, 2006 and includes support for the proposed pay reform which deals with the absorption of allowances into base pay.

Milestone 8: *The Borrower's Ministry of Finance and National Planning has (a) transferred the payroll to the Payroll Management and Establishment Control (PMEC) system; (b) trained users of the system in all of the Borrower's central ministries; (c) based Personal Emoluments releases on PMEC; (d) matched each public servant to a specific post on the establishment; and (e) ceased to pay public servants whose post is not on the establishment, except in relation to those identified for retrenchment but not yet paid off, all in accordance with paragraph 30 of the LDP.*

24. **This milestone has been met.** The transfer of the payroll to the new PMEC system was completed in October 2005 when the transfer of the staff of Ministry of Health was completed. The payment of salaries and benefits of November 2005 is based on the PMEC system. Government trained all users of the system in each central ministry before moving their specific payroll to the new PMEC system. In these cases were the transfer involved decentralized staff, the government agency responsible for the roll out also trained staff in the districts and provinces.

25. Each civil servant which has been transferred from the old payroll system to PEMC system has been matched to a specific post on the establishment. Approximately five thousand civil servants out of a total of 115 thousand could not be matched to a post on the establishment. Before deciding on retrenchment of those servants whose post is not on the establishment, the public service management division in the Cabinet Office is evaluating the qualifications of this group of civil servants to see if they can be allocated a post on the establishment that has remained vacant in another government agency. Once this process has come to an end the Government is committed to retrenching the remainder of this group of civil servants in 2006 and a budgetary allocation has been made for this exercise in the draft budget for 2006.

IV. CONCLUSION

26. In view of the overall performance and progress with the implementation of the program supported by the Credit and in compliance with the specific conditions of release as described in paragraphs (13-27) above the International Development Association has informed the Borrower of the availability of the second tranche in the amount of SDR13.7 million (US$19.8 million equivalent).