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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/117

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Executive Board Attendance

S. Sugisaki, Acting Chair

Executive Directors

K. Bischofberger

Ó. Ísleifsson

Y.V. Reddy

I. Usman

Alternate Executive Directors

A.A. Al-Nassar, Temporary
F. Vermaeten, Temporary

D.C. Guinigundo
S. Boitreaud
H.E. Phang, Temporary

J.W. Ralyea III, Temporary
S. Çakir, Temporary
L. Ocampos, Temporary
M. Daïri
S. Vtyurina, Temporary
N. Guetat, Temporary
P. Moreno, Temporary
H. Vittas
A. Maciá, Temporary

M.A. Brooke
N.H. Farhan, Temporary
P. Ngumbullu
Liu F., Temporary
N. Yeritsyan, Temporary
T. Komatsuzaki, Temporary
S. Vafaev, Temporary

A.S. Linde, Acting Secretary
J. Morco, Assistant

Also Present

IBRD: H. Dinh, Africa Regional Office. African Department: J. Fajgenbaum, Deputy Director; R. Chembe, S. Hossain, A. Krammer, K. Kostial, J. Mathisen, D. Rwegasira, R. Sharer. External Relations Department: L. Mboto Fouda. Fiscal Affairs Department: S. Fassina, P. Heller, G. Tsibouris. Legal Department: Y. Liu. Monetary and Exchange Affairs Department: S. Geadah, A. Morales, S. Sosa. Policy Development and Review Department: R. Kincaid. Secretary's Department: P. Ramlogan. Treasurer's Department: B. Christensen, Deputy Treasurer; H. Treichel. Office of the Managing Director: A. Tweedie. Advisors to Executive Directors: S.S. Farid, J. Milton, Y. Patel. Assistants to Executive Directors: D. Ayala, D. Baasankhuu, V. de los Santos, H. Fabig, R. Gauba, B. Gulbrandsen, J.K. Kwakye, B.T. Mamba, D. Merotto, B. Siegenthaler.

1. ZAMBIA—2002 ARTICLE IV CONSULTATION; POVERTY REDUCTION AND GROWTH FACILITY—REVIEW UNDER THREE-YEAR ARRANGEMENT; AND ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—ADDITIONAL INTERIM ASSISTANCE

Documents: Staff Report for the 2002 Article IV Consultation; Fifth Review Under the Poverty Reduction and Growth Facility, and Request for Additional Interim Assistance Under the Enhanced Initiative for Heavily Indebted Poor Countries (EBS/02/189, 11/14/02; and Sup. 1, 11/26/02); Statistical Appendix (SM/02/352, 11/14/02); and Financial System Stability Assessment (SM/02/339, 11/4/02)

Staff: Sharer, AFR; Kincaid, PDR

Length: 3 hours

The staff representative from the African Department (Mr. Sharer) submitted the following statement:

> The following information has become available since the issuance of the staff report for Zambia (EBS/02/189). The information does not change the staff's assessment of Zambia's economic performance and policies.
>
> Based on preliminary data provided by the authorities, all the quantitative performance criteria for end-September 2002 have been observed. As noted in the staff report, the authorities have also met the structural performance criteria through end-September 2002.
>
> CPI data through end-October 2002 indicate that the12-month inflation rate at 23.9 percent remain broadly unchanged from end-September, reflecting strong pressures from food prices. However, nonfood inflation, the indicator of core inflation, fell to 15.8 percent from 16.1 percent recorded in September, broadly in line with the program target.
>
> The kwacha has depreciated by about 2.5 percent vis-à-vis the U.S. dollar in October. Since end-December, the cumulative nominal depreciation has been about 22 percent and the real depreciation has been 8 percent. After experiencing a decline in September and October, world copper prices have risen by about 10 percent in recent weeks, with the spot price reaching about 71 cents per pound.
>
> In November, the government submitted the report on the investigation of the cobalt sales in 1998/99 to the Parliament. The report is now a public document, consistent with the commitment under the PRGF-supported program.

Mr. Usman submitted the following statement:

At the outset, I would like to convey the appreciation of my Zambian authorities for the constructive role that the staff continues to play in their numerous dialogues with the authorities. The staff's assessment of the economic developments in Zambia is, as usual, candid and their recommendations quite pragmatic. The papers for today's discussion clearly set out the progress that my authorities have made, in recent years, in implementing numerous macroeconomic consolidation and structural reform measures and the challenges that lie ahead, particularly for the immediate future. The report also emphasizes the economy's substantive vulnerabilities, especially to exogenous shocks.

The macroeconomic stabilization measures being implemented under the PRGF-supported program were essential to lay the grounds for a sustainable higher growth of the economy and reduction of widespread poverty. The pursuit of prudent fiscal and monetary policies, and significant steps taken towards the liberalization of trade and foreign exchange regime, divestiture of public enterprises, reform of the financial sector were undoubtedly critical for enhancing the overall performance and competitiveness of the Zambian economy. Notwithstanding the significant achievements of the recent years, Zambia's economic situation remains difficult, a challenge which my authorities intend to address through stepped-up reforms. In this regard, the acceptance, early this year, of the obligations under Article VIII, Sections 2, 3, and 4, was an important step aimed at providing a strong signal to both domestic and foreign investors of the authorities' commitment to achieving their external objectives through the continued implementation of sound economic policies.

My authorities are fully aware that these efforts need, however, to be complemented by determined efforts aimed at diversifying the productive and export bases of the economy. In this connection, the high-level workshop on diversification, held in July 2002, provided valuable lessons and identified a number of actions to be implemented in the short- and medium-term, including most importantly, to create the conditions for small businesses to thrive.

Policy Implementation under the Program

Following the generally good record of performance under the first two annual arrangements, preliminary data for 2002 indicate that all quantitative and structural performance criteria, as well as all the benchmarks, were met, with the exception of the benchmark on the reduction of domestic arrears, mainly due to penalty interest on late payments and the effect of the currency depreciation. Such performance is particularly remarkable considering the extremely difficult circumstances under which the authorities were implementing the program, which have somewhat clouded the outlook for this year. The sudden withdrawal of Anglo-American from the mining sector not only raised uncertainties in the economy, but also weakened business confidence. The economy continued to suffer the effects of further declines in copper prices, on which it relies substantially. The severe drought that affected the sub-region has further compounded the already difficult conditions confronting Zambia, affecting agricultural production as well as food distribution and prices, and placing large segments of the population under the spectrum of famine.

The increased resilience of the economy can, nevertheless, be assessed in light of these adverse conditions. Reflecting mainly the impact of the drought on agricultural production, GDP growth estimates were scaled down to 3.7 percent, still a strong growth, compared to 4.3 percent envisaged in the program. Significant rise in food prices due to the drought led the 12-month inflation rate to rise to 23.9 percent in September, against the 15 percent anticipated in the program.

During the first half of 2002, fiscal performance remained broadly in line with program projections despite a higher than expected wage bill. Owing mainly to the impact of the Kwacha depreciation on foreign currency deposits, monetary expansion largely exceeded the program target. Robust growth in copper production significantly contributed to the better than expected outcome in external sector position, that led to a further strengthening of the official international reserves position.

Regarding structural reforms, the authorities continued to build on the progress made in previous years. In particular, with regard to the sale of 51 percent of ZNCB shares, a team was appointed last September to negotiate the sale of the bank. Based on the proposal on modalities to review and streamline Bank of Zambia's (BoZ) mechanisms for financing government operations that has been prepared, the government has already delineated a strategy which is expected to be implemented by the end of 2002. Measures continue to be carried out to improve public expenditure management.

Policy Issues and Prospects

The numerous adversities confronting Zambia, while rendering the task of economic management quite difficult, have not diminished my authorities' resolve to face important challenges to continue building up the conditions for sustained and stronger growth and poverty reduction. The government's policies for the period ahead have been framed in the context of a medium-term program, which aims at attaining medium-term fiscal sustainability, while devoting substantial resources to priority social sectors and improving external sustainability. The program also targets the reduction of inflation to single digits, the strengthening of the international reserves position, the implementation of further efficiency-enhancing structural reforms, with special emphasis on raising the efficiency of the financial sector, and governance and accountability improvements.

Fiscal Policy

Consistent with the objectives outlined in the PRSP, fiscal policy will continue to focus increasingly on domestic policy measures needed to improve the public finances on a sustained basis, while taking into account the need to increase resources for programs aimed at growth promotion and poverty alleviation. This is viewed as important to gradually reduce the still heavy dependence on budgetary support from Zambia's development partners and thus reduce the uncertainties related to the donor financial flows. On the revenue side, the authorities intend to strengthen the already strong performance by expanding the tax base and reducing the scope of exemptions and rebates. The government is making every effort to contain the pressure on budgetary expenditure brought about by the larger than envisaged wage bill as a result of the wage increase granted by the previous administration to the defense and security forces, to teachers, and also the hiring of additional teachers in 2002. In this regard, measures have already been taken to not only contain the wage bill but also to offset the wage overruns. Accordingly, the payroll for the defense and security forces and for the National Assembly will henceforth be processed by the Ministry of Finance and National Planning (MoFNP) under the supervision of the Accountant General and the Centralized Computer Services Department; housing allowance, recently granted, has been cancelled; temporary suspension of overtime payments; freeze on all civil service hiring, with the exclusion of doctors, teachers, and nurses; and various cuts on non-priority social expenditures. As a result, the overall deficit in 2002 is expected to be contained to 6.1 percent of GDP and will largely be financed by external resources. The higher than anticipated recourse to domestic financing, by 0.9 percent of GDP, reflect the shortfall in foreign assistance and the need for additional financing for food imports because of the drought, and not any relaxation on fiscal policy.

Additional measures will be taken in the context of the 2003 budget, to contain the wage bill to 8 percent of GDP, particularly through efforts to reduce the size of public service and initiate the implementation of the medium-term pay reform strategy. The authorities view these actions as important steps towards reducing inflationary pressures. Moreover, to ensure that the program macroeconomic targets are met, the authorities stand ready to take any additional fiscal measures if needed. They are also fully committed to restore HIPC Initiative financed spending to the programmed level of 2.2 percent of GDP in 2003. In this regard, measures have been taken to improve the monitoring and tracking of HIPC Initiative resources to enhance management and control over the PRSP expenditures. Improvements being made in public expenditure management are expected to facilitate the authorities' efforts in dealing with the problem of the accumulation of domestic arrears.

Monetary Policy

Monetary policy remains geared to supporting growth, inflation, and foreign reserves objectives of the program. Broad money is expected to increase by 16 percent during 2002, only slightly above the initial rate of 15 percent. Monetary policy continued to be conducted through market-based instruments to ensure a fully flexible interest rate response. The authorities, however, remain concerned with the persistence of high level of commercial bank lending rates and their negative impact on growth performance and on prospects for diversification, notwithstanding their pursuit of prudent financial policies. Efforts will also continue to be made to enhance the soundness of the banking system and to strengthen the regulatory and prudential oversight. Exchange rate intervention will be limited to smoothing out short-term fluctuations and safeguarding the international reserves position.

Structural Reforms

The authorities are committed to accelerating their agenda of structural reforms in view of the salutary impact of these reforms on enhancing economic efficiency and improving the investment climate to facilitate the implementation of their poverty reduction strategy. They are hence, committed to consolidating the reforms in the financial and public sectors. Regarding the reform of the financial sector, the government will pursue its disengagement from the banking sector. In this regard, the sale of 51 percent of the shares of ZNCB is on schedule and expected to be concluded soon. The authorities broadly concur with the findings of the FSSA mission and intend to work with the assistance of the Fund and the World Bank, on a strategic plan on financial market development to tackle the problems of the financial sector, including the design of an appropriate institutional structure for providing rural service. The program to divest and/or liquidate public sector enterprises is also on schedule. In this regard, the liquidation of ZNOC and the liberalization of the retail prices of petroleum products would contribute to reducing the prevailing high energy costs. In addition, actions are being taken to expedite the concessioning of ZESCO, which is a trigger for reaching the completion point under the HIPC Initiative.

Technical Assistance

Zambia has large human capacity constraints and will continue to require substantial technical assistance in different areas to create the needed expertise to improve economic management and respond to the many demands of the reform process. The authorities are grateful for the technical assistance provided so far and hope that the Fund would acquiesce to their additional requests related with the implementation of the GDDS, which they consider to be a useful tool for statistical improvement and the phased introduction of an IFMIS to improve government financial control.

Conclusion

My Zambian authorities' strong commitment to the reform process has repeatedly been demonstrated by the fact that the adjustment program has been kept broadly on track, despite the extremely adverse environment. They intend to face the challenges ahead with equal determination and they hope to be able to count on the support of the international community in this effort. The completion of the fifth review under the PRGF and the extension of additional interim assistance under the HIPC Initiative would be an important step in this regard.

Mr. Shaalan and Ms. Farhan submitted the following statement:

We would first like to thank Mr. Usman for his assurances, in his informative statement, of the Zambian authorities' commitment to the reform process. We would also like to thank the staff for the well-written reports. The boxes on diversification, and structural reforms were particularly useful.

In contrast to the last two decades, Zambia's performance has improved in the past two years. Improvements in macroeconomic management and substantial progress in implementing structural reforms contributed to the strengthening of economic performance, although developments in the copper sector and the drought have curtailed this year's GDP growth. These issues bring to light the inherent vulnerabilities of the economy, associated with volatile copper markets, recurring droughts, and continued dependence on foreign aid. While these drawbacks will have an adverse impact on growth, good economic management, combined with significant structural reforms will be pivotal to initiate a virtuous circle of increased growth, a reduced debt burden, and effective poverty reduction.

We are in broad agreement with the staff appraisal and can support the completion of the fifth review and the decision to grant additional interim assistance under the enhanced HIPC Initiative. We would like to highlight a few issues that we hope will be high on the authorities' priority list.

On fiscal policy, while the fiscal outcome for the remainder of this year remains on track, like staff, we are concerned with the shift in the composition of expenditure reflected in the rise in the wage bill and lower social and capital expenditure. Zambia can ill afford any reductions in poverty related expenditure given the high incidence of poverty. At the same time, with clear pressures facing the budget, as explained in paragraph 25, combined with a narrow revenue base, persistent weaknesses in public expenditure management can threaten medium-term fiscal sustainability. Addressing this issue will be essential for improving the prospects for fiscal performance and hence macroeconomic stability and poverty reduction. Looking forward, we encourage the authorities to stand firm on their commitments to exercise expenditure control, most importantly by containing the wage bill, and re-orienting expenditures towards priority social sectors. Determined efforts in this area, together with the implementation of revenue measures to broaden the tax base, will be instrumental in generating enhanced donor support to cover the projected financing gap in 2003. In this context, we look forward to the endorsement of the Medium Term Expenditure Framework (MTEF) by the cabinet, which can help improve the quality of public expenditures. Better progress at implementing the public expenditure management (PEM) and poverty tracking of HIPC Initiative spending will also help improve budget formulation and execution. We encourage the authorities to make full use of the available technical assistance in this area.

The authorities' prudent monetary policy over the past two years has contributed to the decline in inflation from extremely high levels. Monetary conditions need to remain appropriately tight in the coming period, in order to achieve the program's inflation target. Only when inflation is brought firmly under control will it be possible to reduce interest rates, to more effectively promote private sector activity. Having said that, however, continued fiscal discipline is clearly a prerequisite for any eventual easing of monetary policy. We welcome the strategy set forth for streamlining the Bank of Zambia's mechanism of financing government operations, which will further improve the transparency of public accounts. As indicated in the FSSA, the financial system in Zambia remains relatively thin and financial intermediation is low. The major risk to the system appears to stem from the insolvency of the state owned ZNCB, which should be privatized as soon as feasible. Containing the losses of non-bank financial institutions should also be a priority. We therefore welcome the intention to develop a plan to address these issues, and more generally the various weaknesses of the financial sector with the assistance of the Fund and the World Bank.

On structural policies, maintaining the momentum on structural reforms is critical to accelerating growth and poverty reduction. Zambia still faces the challenge of diversifying its economy away from copper mining and developing the agricultural sector to increase food production. Here, we find the information provided in Box 2 of the staff report very useful. Such workshops can be helpful in highlighting the comparative advantages and possibilities available to improve trade capacity, and we therefore encourage the authorities to follow up on the actions identified in order to promote the development of other productive sectors and take advantage of favorable trading arrangements.

We also note that the privatization process is ongoing, albeit with some delays, and that supporting reforms in the areas of governance, regulatory and judicial reforms will also need to be pursued in order to improve the business environment and promote growth.

With these remarks, we wish the Zambian authorities success.

Mr. Reddy submitted the following statement:

The recent turnaround in Zambia's economic performance, following a prolonged period of high inflation, low growth, and decline in per capita income, inspires cautious optimism. Growth has picked up and inflation, though still high, has declined substantially. The need now is to consolidate this performance and build on these gains to achieve high growth and substantial poverty reduction. The authorities' success in adhering to all the program benchmarks and criteria, except one, despite adverse developments like severe drought, declining copper prices and the setback caused by the withdrawal of the Anglo-American, provides basis for confidence. We are broadly in agreement with the thrust of the well-written staff report and agree that Zambia deserves continued international assistance. We support the proposed completion of the fifth review under the PRGF and release of additional interim assistance under the HIPC Initiative.

That said, we wish to underscore that significant challenges remain. The authorities' commitment to continue structural and financial-sector reforms, improved public expenditure management and fiscal discipline, reiterated in Mr. Usman's cogent statement, is to be commended. Steadfast implementation of these policies would be required for improving the climate for investment and promoting growth. In this regard, we are encouraged by the measures already taken to contain and even compress the public sector wage bill and the proposals on the anvil to expand the revenue base and check leakages. Fiscal consolidation is essential also to address the problem of high interest rates which are inhibiting private investment and to support the prudent monetary policy for further subduing inflation. We welcome the steps proposed to be taken by the authorities, in the light of FSSA, to strengthen banking soundness and improve financial intermediation, particularly the provision of banking services in the rural areas.

Zambia continues to be vulnerable to external shocks and the uncertainty introduced by the withdrawal of Anglo-American is not yet resolved. The authorities are right to focus on strategies aimed at diversification of production and exports. We look forward to implementation of the short and medium term actions identified at the recent high-level workshop. We endorse the staff's observations emphasizing the need to increase social sector expenditure in line with the PRSP objectives. This is crucial, considering the deterioration of social indicators over the last decades and the high incidence of HIV/AIDS. We welcome the authorities' commitment to protect HIPC Initiative spending in 2003.

We wish the Zambian authorities success in their challenging endeavors.

Mr. Ondo Mañe submitted the following statement:

Zambia's economic prospects in 2002 have been clouded by a number of adverse shocks, stemming from a decline in world copper prices, a cutback of donors' assistance and a severe regional drought. The withdrawal of Anglo-American has severely affected the growth prospects and raised major uncertainties. Moreover, the impact of the HIV/AIDS pandemic is also a source of great concern. Despite these difficulties, the authorities have maintained the program on track and we are impressed by the efforts and progress made. All the quantitative and structural performance criteria under the program were observed and most benchmarks as well. They have also taken courageous corrective measures to address the slippages that occurred on the fiscal front to put the economic program back on track.

We share the thrust of the staff appraisal, and are reassured by Mr. Usman's statement on his authorities' determination to address the economic and financial challenges. We support the proposed decisions to complete the fifth review under the PRGF and grant additional interim assistance under the HIPC Initiative. However, we would like to highlight the following issues: fiscal policy, monetary and exchange rate policies, and structural reforms.

Fiscal policy

Despite the exogenous shocks, we are pleased to note that fiscal performance remains broadly in line with the program objective. However, we share the staff's concern on the overruns in the wage bill and the decline in social sector outlays. The authorities have responded well by taking decisive actions to halt the increase in the wage bill. To this end, the move of the defense and security forces to the public service payroll under the supervision of the Ministry of Finance and National Planning (MoFNP) and the freezing of hiring are steps in the right direction. In light of the shortfalls in spending that occurred on social programs in 2002, the authorities' commitment to protect HIPC Initiative spending will be key to restoring these spending to the programmed level compatible with their PRSP.

On the revenue side, we welcome the authorities' efforts in favor of the reduction of discretionary tax exemptions and the reduction of tax rebate. However, the authorities should also take further steps to broaden the tax base.

On Public Expenditure Management, we are encouraged by the recently introduced measures to enforce a more effective commitment control system, following recommendations by a technical assistance mission from the Fund's Fiscal Affairs Department. The creation of an Expenditure Monitoring Unit (EMU) in MoFNP that will monitor expenditure ceilings and the control system introduced in line ministries will also be helpful in strengthening the control of budget expenditures. Furthermore, we are pleased to note that the authorities are finalizing a comprehensive database to address the issue of domestic arrears. However, the debt burden will remain heavy since Zambia's debt will not be sustainable at the completion point under the HIPC Initiative, due to continuous falling copper prices.

Monetary and Exchange rates Policies

Monetary policy in 2002 was prudent and aimed at containing inflation and meeting official reserves target. We commend the efforts made by the monetary authorities to further use indirect monetary instruments to achieve monetary targets, notably the creation of an active treasury bonds and treasury bills markets. The implementation of these instruments will enable the government to manage its debt in a further transparent manner.

We also welcome the authorities' decision to maintain a market determined exchange rate regime, with intervention limited to meeting the international reserves goal and to smoothing short-term fluctuations. Their intention to increase the efficiency of the foreign exchange market, by introducing a unified inter-bank foreign exchange market during 2003 is also laudable. We support the authorities' request for additional technical assistance in this area.

Structural Reforms

Major challenges remain; mainly, diversifying the economy will be key to enhancing business confidence and strengthening competitiveness. However, it is worth mentioning that the authorities have made significant progress on the structural front. They have taken steps to expedite the sale of ZNCB, the most important state-owned bank. As regard the oil sector, the liberalization of retail prices of petroleum products and imports are also major achievements. On the privatization of the state electricity company, given the major difficulties to sell off national electricity companies as we have seen in several other cases, mainly due to major developments in the international energy sector, we wonder whether it is appropriate to make it an HIPC Initiative completion point trigger. Since the financial situation has not improved for the most players in the international electricity sector, we also question whether the Zambian authorities will be successful in their efforts to sell ZESCO. By making it a trigger point, are we not positioning the authorities at a disadvantage in their negotiations at the present time? The staff's clarification on this matter is welcome.

We would like to highlight the need to undertake a reform of the pension system, given the fact that currently, it is run on an unfunded basis. Given the importance of fiscal consolidation for the Zambian economy, we would like to know the impact of the reform on the 2003 budget and onward. Staff's clarification on this matter will also be welcome.

On the banking and the financial sectors, we are pleased to note that, with the exception of the state-owned ZNCB, the overall banking system was satisfactorily capitalized with moderate NPLs. However, there are still some weaknesses in the supervision of the banking system. The authorities have embraced the recommendations of the FSAP and we support their request for additional technical assistance to develop a medium-term strategic plan to address the weaknesses of the financial system, particularly the NBFIs. Additionally, the authorities should strengthen their supervision capacities.

With these remarks, we support the proposed decisions and we wish the Zambian authorities every success in the challenges ahead.

Mr. Ísleifsson and Mr. Gulbrandsen submitted the following statement:

Key points:

- The prime policy challenge for Zambia in the medium-term is to accelerate growth to reduce poverty, and to address the heavy social and economic effects of the HIV/AIDS pandemic.

- Measures to reduce the fiscal deficit and government domestic financing remain of vital importance. Furthermore, there is strong concern about the composition of expenditure in 2002. Effective management of public expenditure will be of crucial importance.

- The political commitment to implementation of key structural reforms is another major challenge, particularly measures to strengthen the business environment and improve business confidence, to address the financial sector weaknesses, and to privatize the ZNCB.

- The authorities' anticorruption effort is highly needed and most welcome. We urge the authorities to remain committed to implementing governance and transparency measures under the program.

Let us first thank the staff for a comprehensive set of papers and Mr. Usman for his informative statement. The Zambian authorities deserve to be complimented for their significant achievements over the past two years. After two decades of poor performance, the overall economic performance has strengthened since mid-2000. This reflects improved fiscal and monetary policies and progress on the structural front. The privatization of the copper mines in 2000 has contributed to improve Zambia's overall economic performance.

In spite of these gains, Zambia is facing very difficult economic circumstances. The severe drought during the first half of 2002 and the difficult food situation is a major concern. It is very unfortunate that donor assistance for this purpose may be significantly reduced because of the government's stance towards genetically modified (GM) maize. We urge the authorities to do their utmost to appropriately tackle this pressing problem. Furthermore, Zambia is among the African countries hit hardest by the HIV virus. The pandemic continues to exert a heavy social and economic burden on the country. The tremendous strain the disease currently imparts on all social and economic institutions in the Zambian society is clearly illustrated in Box 1.

The country's over-reliance on copper exports is highly worrying, and diversification of the economy away from the mining sector will be of crucial importance. This vulnerability has been highlighted by Anglo-American's (AA) announced withdrawal from the Konkola Copper Mines, which has raised major uncertainties and weakened business confidence. The authorities should, however, be commended for concluding the agreement with the AA in a satisfactory manner. We find it particularly important that the authorities have managed to find a solution that does not include a government takeover of the mines.

Fiscal policy

The authorities' commitment to achieving fiscal sustainability by maintaining a strong revenue effort and containing overall expenditures is encouraging. A further reorientation of outlays toward infrastructure and poverty-reduction will be important to achieve this goal.

There is, however, reason to be concerned about the remaining weaknesses in public expenditure management. It is highly regrettable that large overruns in the wage bill for defense and security forces has come on behalf of lower social and capital expenditure. We agree with Mr. Shaalan and Ms. Farhan that Zambia can not afford any reductions in poverty related expenditures given the high incidence of poverty. This will severely undermine the government's credibility in pursuing the poverty reduction goals of the PRSP. There is clearly a need to vigorously implement reforms that can ensure observance of budget limits and improve public expenditure management more generally. Staff's comments on the envisaged progress in this area would be welcome.

While a key objective of the fiscal policy is to reduce the budget deficit consistent with the inflation target, a tighter fiscal stance and increased growth will not be sufficient to achieve sustainable debt levels. We note that Zambia will face difficulties in achieving debt sustainability at the completion point under the HIPC Initiative, and that staff anticipate that Zambia will require significant debt relief beyond that provided under the HIPC Initiative. This underlines the necessity for the Zambian authorities to ensure that the program stays on track by steadfast implementation of the policy measures.

Structural policies and governance issues

While commendable progress has been made in implementing structural reforms, a lot remains to be done to improve the business climate. Improving the efficiency and accountability of state enterprises should be high on the agenda. Other important measures include further privatization to raise the performance of the industrial sector and financial sector reform. Mr. Usman's information on the progress in the sale of 51 percent of the shares of ZNCB is encouraging.

Improving governance is a major challenge for Zambia. The PRSP articulates a broad agenda of measures that is most welcome, including the efficient and transparent management of public services, the anticorruption drive initiated by the President, and the removal of corrupt officials. We encourage the authorities to accelerate this agenda.

Financial sector issues

We welcome Zambia's participation in the FSAP review. The authorities' intention to work with the World Bank and the Fund on a strategic plan to tackle the problems of the financial sector is encouraging. However, we note that Zambia is receiving extensive technical assistance from the Fund and other donors, while implementation of the recommendations sometimes has been slow. In light of the need for prioritization and further improvement in the effectiveness of technical assistance, we urge the authorities to follow up more vigorously on the recommendations of technical assistance missions.

Finally, we would like to encourage the authorities to publish these well-written and balanced reports. We can support the completion of the fifth review and the extension of additional interim assistance from the Fund for 2003 under the HIPC Initiative. We wish the authorities every success in their challenging policy endeavors.

Mr. Daïri submitted the following statement:

Key points:

- After a long period of low growth and high inflation, Zambia has turned its economy around and has relentlessly pursued its PRGF-supported program, in the face of crises in the copper and food sectors.

- The authorities realize that budget consolidation is central to achieving sustained macroeconomic stability and growth and are committed to implementing the requisite revenue and expenditure measures to that end.

- Greater coordination between the BoZ and the Treasury should improve the prospect for achieving monetary targets.

- We welcome the improved business environment, including the strong anti-corruption drive and other governance-related initiatives.

- Acceleration of structural reforms and a more aggressive economic diversification drive in line with the proposals of the July Workshop are critical to reduce vulnerability to exogenous shocks.

- The authorities have mapped out an appropriate strategy to combat the HIV/AIDS pandemic, which deserves maximum support from the international community.

- Following the decline in copper prices, Zambia will need significant additional debt relief to achieve debt sustainability.

- We support completion of the fifth review under the PRGF and the extension of additional interim HIPC Initiative assistance to Zambia.

We thank the staff for an excellent report and agree with the thrust of their appraisal. We are also grateful to Mr. Usman for his informative statement. Zambia has turned its economy around in the last two years after a long period of low growth and high inflation. The turnaround in economic performance is the result of a relentless pursuit of sound macroeconomic policies and reforms under the PRGF-supported program, leading to a rebound in growth and substantial reduction in inflation. Notwithstanding these achievements, and as indicated by Mr. Usman, significant challenges remain.

In 2002, the authorities continued their strong record of adjustment and reform in the face of crises in the copper and food sectors, which dampened economic growth and increased inflationary pressures. The authorities have demonstrated a strong willingness to respond promptly when necessary in order to keep the program on track. Accelerating and deepening poverty alleviation will require higher, broad-based growth. This calls for policies geared to achieving sustained macroeconomic stability, addressing structural bottlenecks to growth, and reducing the economy's vulnerability to shocks. While the near- and medium-term government strategies appear appropriately configured to these ends, better policy coordination will be critical to their success. Given the authorities' strong record of policy implementation and commitment to further adjustment and reform, we support completion of the fifth review under the PRGF arrangement and extension of additional interim assistance under the enhanced HIPC Initiative.

The authorities realize that budget consolidation is central to achieving sustained macroeconomic stability and growth and are committed to implementing the requisite revenue and expenditure measures to that end. We welcome their commitment to reining in current expenditure and redressing the expenditure composition in favor of social and capital spending. Far-reaching measures have been taken to that end, including curbing the wage bill and reducing nonessential current outlays. The authorities recognize the need for strong corrective measures, in light of expenditure pressures, to close the substantial financing gap in 2003. In addition to restraining the rise in the wage bill, they also stand ready to take additional fiscal measures, when necessary, to ensure attainment of the macroeconomic targets. We welcome initiatives to improve PEM, including by implementing the Integrated Financial Management Information System (IFMIS) and developing an MTEF. We are pleased to note efforts to find a durable solution to the domestic arrears problem. A more effective control of commitments, the planned data base for arrears, and the Financial Management System (FMS) should help this effort.

The monetary policy stance needs to be strengthened to achieve the inflation and the reserves targets. This calls for strengthening money market operations to reinforce liquidity management. Better coordination between the BoZ and the Treasury should enhance liquidity forecasting and improve the prospect of attaining monetary targets. There is also a need to reduce pressures on borrowing costs for the private sector, including through stronger fiscal performance and improved financial intermediation. We welcome Zambia's liberal exchange system. Adherence to a flexible and competitive exchange rate regime promises to enhance the prospects for diversification and the economy's resilience. A well-functioning interbank foreign exchange market should boost efficiency in foreign exchange allocation.

The financial strain on the ZNCB overshadows the financial system, which is also vulnerable to shocks to the copper sector, insolvency of public enterprises, and potential effects of macroeconomic instability. A prompt resolution of ZNCB's status will contribute greatly to financial sector stability. Staff may wish to elaborate on the authorities' intentions with regard to rural banking. We welcome the authorities' positive response to the FSSA report.

A substantial inflow of external resources has financed a high level of current account deficits over the past years, including the large imports associated with donor financed projects. Recent deterioration in the terms of trade and uncertainties with regard to external assistance, however, call for intensification of efforts to generate domestic resources and diversify exports. Zambia has a commendably open trade regime and scaling back the intra-COMESA trade restrictions imposed recently will be to the mutual benefit of the membership.

Commendable progress has been made in key areas of structural reform, including in the oil sector, public financial management, tracking of HIPC Initiative resources, and the financial sector. Liberalization of the oil market, including full deregulation of retail prices of petroleum products, should boost efficiency and ease pressure on the budget and the financial system. We urge the authorities to accelerate the public enterprise privatization program in line with the schedule agreed with the World Bank. As duly recognized, a prompt privatization of ZNCB is important for financial sector stability and fiscal sustainability. Preparation of modalities to streamline BoZ mechanism for financing government operations will contribute to higher efficiency and transparency. We welcome the improved business environment, including the strong anti-corruption drive, which has won public and donor support. Other governance improvement initiatives, including in public resource management, parliamentary oversight of the budget, fiscal ROSC, and anti-money laundering legislation, also deserve recognition. Plans to utilize Fund technical assistance to improve the quality and timeliness of data should improve policy formulation and analysis.

The weak copper market constitutes a major risk to Zambia's medium-term outlook, calling for a more aggressive economic diversification drive. The July Workshop identified major impediments to diversification, potential opportunities, and requisite actions elaborated in Box 2 of the staff report, which should engage the authorities' priority attention. Zambia should exploit its comparative advantage in the areas of agriculture, tourism, and textiles. The HIV/AIDS pandemic also poses a serious threat to medium-term growth prospects through its devastating effects on labor supply and productivity and its heavy economic and social costs. The authorities have mapped out an appropriate strategy to combat the problem, which deserves much larger assistance from the international community than indicated in Box 1 of the staff report, and we appreciate staff's elaboration on the reasons behind the limited external assistance for combating HIV/AIDS.

Notable initiatives are underway to track HIPC Initiative resources to accelerate HIPC Initiative-financed spending previously plagued by capacity constraints and monitoring difficulties. Timely implementation of the timetable for the concessioning of ZESCO will facilitate reaching the HIPC Initiative completion point. However, lower copper prices have undermined debt sustainability prospects, and Zambia will need significant additional debt relief to achieve debt sustainability. We appreciate staff clarification on how such assistance could be provided. We see extension of additional interim HIPC Initiative assistance for Zambia for 2003 at this time as appropriate and timely since it would facilitate the finalization of the budget and its smooth implementation.

Extending his remarks, the staff representative from the African Department (Mr. Sharer) said that the planned reduction in the import tariff on finished petroleum products had been implemented.

Extending his remarks, Mr. Ísleifsson made the following statement:

This morning I have received some further information on Zambia from my home authorities, and I would like to add a few remarks to our statement.

First, on the issue of the large overruns in the wage bill, I have received information indicating that in November high level public servants were awarded significant salary increases in the range of 50-140 percent. If this information is correct, it casts some doubts on the realism of the authorities' commitment to limit the size of the wage bill. I would urge the staff to follow up on this issue, and would appreciate any comments the staff might have.

On the process of privatizations, differing signals have been sent by Zambian authorities recently. Although the official policy is clear, the president and key members of his cabinet have repeatedly made statements which throw doubts on the government's commitment to the process, particularly as regards the Zambia National Commercial Bank, Zamtel, and ZESCO. I find this most unfortunate.

Furthermore, the report takes due note of the significant shortfalls in Zambian social spending in 2002. In this regard, I would emphasize that the government's increased adherence to spending priorities - in particular in the social sectors as set out in the PRSP - must be ensured in the future. The staff have a key role to play in this respect.

Mr. Vittas made the following statement:

Let me begin by stating that this chair is prepared to support the completion of the fifth review under the PRGF arrangement and the proposed extension of additional interim assistance to Zambia under the enhanced HIPC Initiative. We do so, however, with considerable hesitation. Like Directors who issued preliminary statements, we welcome the recent noticeable improvement in Zambia's macroeconomic performance. We also recognize that the policy record over the past year has been broadly consistent with the understandings under the PRGF-supported program. However, there have also been some significant deviations from program intentions. The most important of this has been the large overrun in the government's wage bill, which has crowded out not only public investment, but also spending on social programs. In that sense, it has undermined one of the main objectives for which HIPC Initiative assistance is granted, namely, poverty alleviation.

The wage overrun, in combination with other questionable public outlays, has also had two other unfortunate consequences. First, it has raised new doubts among the donor community about the resolve of the authorities to pursue the objectives of the PRSP. To that extent, it may have militated against the increase in humanitarian assistance that Zambia needs to address the consequences of the HIV/AIDS pandemic and cope with other adversities such as the recent drought.

Second, through its direct and indirect impact on inflation, the overrun on the wage bill has tended to weaken Zambia's external competitiveness. Although this effect may have been small, it has come at a time when Zambia needs a major boost to its competitiveness to compensate for the effects of the persistent decline in its terms of trade and the withdrawal of Anglo-American, and facilitate a gradual diversification of its production base over time. Given the importance of this consideration, it was disappointing to read in the staff report that the authorities do not consider it politically feasible at this time to reverse the spending decisions of the previous government. The corrective measures taken seem to be inadequate, as they would still leave the wage bill way above the original program projections and more than 2 percentage points higher, relative to GDP, than three years ago. Thus, it is to be hoped that the way will soon be found to lower spending on wages and the military to a level that is more in line with Zambia's present stage of economic development and more consistent with the hardships that a large part of the population is going through. This chair would like to make it clear that containing military spending and allocating to poverty reduction the resources made available under the HIPC Initiative is an essential condition for Zambia to benefit from bilateral debt cancellation.

The other significant departure from the program supported by the PRGF relates to the accumulation of domestic arrears. Although the program has anticipated only a modest reduction in domestic arrears, it is regrettable that, in the event, a significant further increase in arrears has occurred. This experience provides a further illustration of the importance and urgency of implementing strong measures to improve the tracking and overall management of public expenditure.

I have focused so far on the negative aspects of recent developments. Let me now try to restore some balance in my intervention by acknowledging that there have also been several pieces of good news coming recently from Zambia. One of the most positive developments has been the initiation of a new anti-corruption drive by the new president. This drive appears to enjoy strong popular support, which is both understandable and welcome. For this support to be maintained, it will be important to translate the broad intentions into concrete actions and show tangible results before long. In this regard, the recent publication of the report on the investigation of the 1998/99 cobalt sales is a welcome first step. I would appreciate any information that the staff can provide on the main findings of the report, as well as some indication of any follow-up action the authorities intend to take. More generally, I would encourage the authorities to maintain the momentum of their anti-corruption drive while also pushing forward with the implementation of the other transparency and good governance measures envisaged under the program.

Another recent development that deserves praise is the high-level workshop on diversification held last July. The workshop has been useful not only in identifying various factors that have inhibited a broadening of the production and export bases in the past, but also in identifying a set of specific recommendations to increase the momentum of diversification. It would be interesting to hear from the staff whether these recommendations have been fully endorsed by the authorities. It would also be interesting to get the staff's assessment of the progress being made toward their implementation.

Finally, let me briefly comment on the FSAP. I commend the authorities for their participation in the FSAP and their intention to continue to collaborate closely with the World Bank and the Fund in developing a plan to address the weaknesses in the financial system that were identified in the FSSA report. I agree with the staff that the speedy privatization of the Zambia National Commercial Bank and the containment of the losses of the non-bank financial institutions should be the critical priorities in the near term.

With these remarks, I wish the Zambian authorities success in addressing the very difficult challenges they are confronting.

Mr. Daïri, referring to Mr. Vittas's comments, said that donor assistance for HIV/AIDS must never be conditional in any way, as the loss of life from the disease was irreversible. The only condition that was appropriate was ensuring that the resources were indeed used to combat the disease and alleviate the suffering of the sick.

Mr. Vittas clarified that he had been referring generally to the cancellation of bilateral debt. His authorities wanted to ensure that the resources obtained from the debt cancellation were used strictly for social spending.

Mr. Guinigundo made the following statement:

Based on key economic indicators and implemented structural reforms, Zambia has performed relatively well under the PRGF-supported program. Thus, we share the views of Mr. Ondo Mañe and Mr. Daïri. We would like to stress that this performance is made more remarkable because it was achieved despite challenging conditions posed by the drought and by the decision by Anglo-American to stop funding its mining operations in Zambia. The fourth review under the PRGF in May 2002 underscored the challenges and commended the authorities for undertaking macroeconomic stabilization and structural reforms to ensure sustainable growth and economic diversification. Zambia is clearly reaping the benefits of this bold decision. Based on the staff statement issued yesterday, all quantitative and structural performance criteria were met. As the staff rightly points out, this is an eloquent testimony to the authorities' firm commitment to the policy framework supported by the PRGF. We also wish to note that early this year Zambia had accepted its obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. This gives additional confidence to the international community that it will pursue economic policies that will make restrictions of payments and transfers for current international transactions unnecessary.

What else do we want to see happening in Zambia? The staff reported yesterday that, through end-October 2002, the 12-month inflation rate averaged 23.9 percent on account of strong pressures from food prices. Economic growth is expected to slow down this year. Public finance is unfortunately loose in Zambia. In more ways than one, fiscal sustainability holds the key to establishing macroeconomic stability and long-term growth. Mr. Usman's detailed explanation of the authorities' plan to pursue fiscal consolidation and reduce the country's dependence on donor support is very encouraging. Of course, we cannot overemphasize that effective public expenditure control is absolutely necessary. We join the staff, as well as Mr. Shaalan and Ms. Farhan, Mr. Ísleifsson and Mr. Gulbrandsen, in their view that overruns in the wage bill and higher outlays for defense and security, at the expense of domestic capital buildup and social safety nets, are bad policies. They will have adverse consequences on output and inflation and, as Mr. Vittas pointed out, would have serious implications on Zambia's external competitiveness. Thus, the authorities' commitment to strictly limit the wage bill to 8 percent of GDP, by adopting the public service pay reform program, is a step in the right direction. We would only like to see more details on how this will be pursued.

We also welcome the authorities' intention to reorient outlays in favor of infrastructure and social amelioration projects. Broadening the tax base and undertaking any additional discretionary measures are a must to sustain fiscal sustainability and market confidence in public policy. The medium-term expenditure framework is also critical in assuring the success of fiscal restructuring. Establishing a comprehensive database of arrears is essential to avoid further accumulation of such arrears. Also, the development of a two-year plan for clearing existing arrears is a welcome step. It will be useful, however, if the staff could give us an idea of the phasing of the public service pay reform program and the reorientation of social spending. Increasing revenues is also a priority action as the program envisages an increase of up to one percent of GDP. How soon can we expect these initiatives to bear fruit in terms of putting Zambia's public finance on stronger footing? This point needs to be underscored in light of Table 5 of the staff report, which places wages and salaries as percent of GDP at a constant 8 percent for 2003 and 2004. Capital expenditures, however, are projected to decline in the next two years. Do these numbers suggest that we can expect a brighter fiscal picture only after 2004? With respect to the plan of the authorities to limit the wage bill from the projected 8.6 percent of GDP to only 8 percent of GDP for 2003, we wonder if this is feasible in view of the fact that firing redundant workers does not come without fiscal costs. There will be attendant costs in terms of separation pay and other compensation benefits.

On monetary conditions, with an average inflation rate above 20 percent, the high lending rates of the commercial banks cannot be expected to decline along with treasury bill rates, at least until this year when consumer prices are expected to remain at double digits. The market's perception of fiscal problems and inflationary expectations will make it difficult to bring down commercial interest rates. To strengthen monetary management, we urge the authorities to continue innovating the financial markets with new instruments and facilities, as well as improved methodologies. Consistent with this chair's previous position on exchange rate intervention, we support the authorities' view that this should be limited to smoothing short-term fluctuations and safeguarding the reserves position.

One of the strongest points of the Zambian authorities is their capacity for reform. We therefore encourage the authorities to sustain their commitment to structural reforms, particularly the privatization of oil sector entities and railways, as well as of ZNCB. We are also encouraged by the government's zero-tolerance policy toward corruption. This is a heroic aspiration, and we wish the authorities well.

Finally, we have a few additional questions. First, the staff says that Zambia will face difficulties in achieving debt sustainability at the completion point under the HIPC Initiative because copper prices are expected to be lower than programmed. If additional debt relief is not provided, and copper prices decline in 2003 and 2004, what can we expect to happen in Zambia? In respect of the privatization of the ZCCM, when do the authorities expect the new copper mines to come on stream? How near is the near future? In the absence of any mitigating circumstances, what is the staff's recommendation to mitigate the situation in Zambia?

Second, we wonder why gross international reserves, rather than net international reserves is being used as a performance criterion for the program.

Third, while we agree with privatization in principle, we wonder if the staff is considering the appropriate timing for disposing the public shares in these entities, now that equities markets and the investment climate around the world have generally limped for most of the past two years.

Fourth, in Box 2 of the staff report, the July 2002 high-level workshop on diversification suggested, among others, "finding an innovative solution to provide long-term concessional finance to small business and export-oriented agriculture to increase the momentum towards diversification." We find this difficult to square with the staff's call for avoiding distortionary government intervention. We wonder whether the authorities have accepted the specific recommendations of the workshop.

We are happy to support the completion of this fifth review under the PRGF and the Zambian authorities' request for additional interim assistance under the enhanced HIPC Initiative.

Ms. Vtyurina made the following statement:

We commend the Zambian authorities for the progress under the program achieved so far. Yet, while it is good news that Zambia's program is on track, the approach taken to meet the targets under the program on the fiscal side raises certain concerns. While we support this review, we anticipate significant improvements in the implementation of the program by the next review and before the new arrangement is sought. Having said this, we are concerned that this may not be easily possible as the government's efforts seem insufficient on certain fronts, especially fiscal, macroeconomic projections are overly optimistic, external environment is vulnerable and the effects of Anglo-American plc's pullout from the copper production are yet to be felt fully.

On fiscal policy, as the staff and other Directors, we are disappointed by the granting of excessive wage increases, which, together with weak expenditure management, led to the cuts in poverty related and capital expenditures and the accumulation of domestic arrears. Needless to say, such practices defeat the purpose of the PRGF-supported program and HIPC Initiative. As this is a recurring event, I wonder why the floor on HIPC Initiative-financed spending is not a quantitative benchmark. While it is important to have a benchmark on publishing an annual report on the use of

HIPC Initiative debt savings, this does not seem to be enough to ensure the appropriate allocation of these savings.

The prospects for 2003 budget are not particularly encouraging, as they demand significant efforts from the authorities not only in achieving a budget target but also in covering a substantial financing gap. While the authorities have already taken some steps to ensure the attainment of these goals, we are not convinced that these would be adequate and see a large possibility of further priority expenditure cuts. Thus, we urge the authorities to implement most of the recommendations proposed by the staff, including those in para 43. In regard to the latter, however, I am a bit confused regarding one area of the staff's advice, that is, to lay off all workers hired since January 2002. The reason I am perplexed about such advice is not only because it does not seem to be politically and socially acceptable, as the authorities rightly indicated, but also because it does not fit well with the usual Fund advice on civil service reform, which generally entitles early retirement, non-replacement of those departed, social safety net provisions, retraining programs, etc. Further, such blunt recommendation does not bode well with the poverty reduction concept promoted by the Fund and concept of the stability of low paid public sector jobs. I would welcome the staff comments on this issue as well as some information on the unemployment level, as I could not find it in the papers. The only number I saw in the staff paper for the last review was an unemployment level of 27 percent in 1998 according to LCMS Survey.

Macroeconomic assumptions under the program for 2003/04 seem to be on the optimistic side as most of them ride on the presumption of recovery in mining and agriculture and continued growth in tourism, manufacturing and trade. Yet, the problems with restructuring of KCM and its recent reduction in its estimate of copper output will most likely negatively affect growth despite the expected increase in world prices or copper and cobalt.

The difficulties in distributing inputs to small-scale farmers, recent poor weather in the maize producing provinces, and high levels of farming debt seem to indicate little prospect for agricultural recovery in 2003. Manufacturing growth is also expected to weaken due to regional competition and slowing demand from the mining sector. While there are good indications for tourism growth and while government consumption will remain strong, external analysts put GDP growth at much lower that the staff's 4 percent, with some predicting 2.7 percent and 2 percent for 2003 and 2004, respectively.

Loose fiscal policy with its inefficient spending is at the root of tight monetary policy. The latter prevents investment growth and has limits on subduing inflation. Inflation has increased recently and the prospects of it hitting the program targets are slim. Most likely, it will hover in the 15-22 percentage range due to uncertainties of the 2002/03 harvest and doubts about achieving a significant reduction in fiscal deficit. Further kwacha depreciation and monetary easing could also cause higher inflation. Unfortunately, the staff's 5 percent inflation target for 2004 does not look realistic, and I hope that for the sake of being well prepared for the adverse circumstances, projections on growth and inflation are revised soon.

It was reported in the last staff paper that, in the attempt to reduce budget deficit and thus interest rates, the Bank of Zambia, together with the Ministry of Finance and National Planning, is developing a domestic debt management strategy to be implemented by end-December 2002. I would be interested in the staff's update on this front.

It appears that the Bank of Zambia in its desperate efforts to contain inflation has come out firmly against the "dollarization" of the economy. In October, businesses were banned from quoting prices in dollars (a hedge against depreciation), and have been warned of heavy fines if they continue. Many businesses that operate with a time lag in ordering and receiving goods complained that they loose out from depreciation if they do not quote prices in dollars. The central bank, on the other hand, is convinced that such practices fuel depreciation and thus inflation. Since the dollarization phenomenon is widespread in the developing and emerging market economies, and the Fund has a substantial experience in this area, I wonder what advice the staff is giving to the government regarding the possible approaches to dealing with dollarization of the economy.

There has also been information that the government has been working on a five year Transitional National Development Plan (TNDP), which will complement the PRSP. It is expected to endorse themes already developed in the PRSP but will also look at the sectors not covered in the PRSP, such as judiciary, defense and foreign affairs. While it is not clear why the government embarked on producing a document in tandem with the PRSP, it is obvious that there will be likely delays in the implementation of many of initiatives under the PRSP due to the lack of capacity within the government. It seems rational that all available capacity should be utilized to achieve the goals of the PRSP, especially improving governance and boosting social expenditures. I would welcome the staff comments on this issue as well.

We welcome the FSAP conducted in Zambia. While the conclusion that systemic risks stemming from the financial system are limited, at least in the short-term, could be perceived as a favorable one, unfortunately, in Zambia's case, this is a result of thin financial markets and low financial intermediation rather than a healthy financial sector. Without a doubt, the country cannot expect high growth rates unless it develops an efficient banking sector. Thus, we are glad that the authorities intend to collaborate closely with the IFIs on designing a strategic plan to further develop the financial system. We only hope that this TA is used more efficiently than that provided in previous years in other areas.

Finally, I would like to say a word on privatization, as it fits well in the context of Article IV consultation. Privatization, if appropriately executed, can play a vital role in achieving such goals as raising enterprise efficiency, supporting economic growth and providing revenue to the state from the original sale and subsequent taxation afterwards. Zambia, as many other developing countries, is in need of privatization of several industries and banks. Yet, the aftermath of the privatization of the most significant economic sector in Zambia—mining, which accounts for 56 percent of foreign currency earnings—shows that the aforementioned goals are far from having been accomplished. On the contrary, the withdrawal of Anglo-American plc (AA) from the mining sector will cast a shadow over economic prospects for the next few years.

Allow me to point out three issues in relation to AA's withdrawal from KCM:

First, the social impact will be profound as future jobs losses could reach as high as 11,000. Annex 1 of the last staff report has shed some light on the social consequences of mine closures, which have a potential of being truly devastating. Thus, I would ask the staff to comment on the issue of social safety net provisions in the case of mine closures, which is no longer a distant possibility.

Second, the AA's withdrawal caused further apprehension in the business community that Zambia will be hurled back into another serious economic crisis, given the importance of copper for the economy and the tarnished history of the privatization of copper industry. In the same vein, if the AA is bailing out of the investment because the prospects are grim, what are the assurances that other investors would be interested in such business? In this context, while the government is promising not to take over the mines' ownership, I would ask the staff to elaborate on the interim framework of the ownership as well as on the details of the original contract.

Third, the government is only getting one sixth of the requested amount as an exit payment from AA, whose original sales agreement also included a loophole in the case of force majeur to free itself from any environmental and occupation liabilities. In addition, the AA impeded the process of attracting other bidders by not allowing due diligence until the transitional agreement was signed. Despite the reached agreement, it does not seem to be as successful as it appears in the papers.

Having considered these issues, questions come to mind regarding corporate social responsibility and the success of the mining privatization program in Zambia led by the IFIs. Frankly, there seems to be a failure on both fronts. While private companies, of course, are free to make their own business decisions, they should nonetheless realize their corporate responsibility not only to its shareholders but to its employees as well. In regards to the IFIs' involvement in the privatization, I would like to read the following excerpt from a well-respected Oxford Analytica on this topic: "Development experts who tracked the privatization process [in Zambia] argue that it was flawed and resulted in one of Africa's biggest privatization failures. It will also hit the credibility of the Fund, the World Bank and other Western agencies pressing governments to sell off state assets. Anglo-American's decision to quit Zambia is a huge embarrassment for them..." While this may be too harsh of a conclusion on the part of outsiders, it, nonetheless, should gain appropriate attention of the IFIs, which seem to be missing from the papers. Zambia should not be just another case added to the book on the Fund's experience with privatization, but it should be as study case, which will help to provide a better advice to its other members on privatization of commodity industries. One can only hope that this chapter in the end will not be as grim as the one by G. Masiye's on the effects of privatization in Luanshya, cited by the staff in Annex 1 of the paper for the last review.

The staff representative from the African Department (Mr. Sharer) made the following statement:

There was a question on whether the HIPC Initiative completion point trigger on the privatization of ZESCO might undermine the government's bargaining position during the negotiations. We have been quite careful, exactly for this reason, not to include any requirement to complete ZESCO's privatization in the program conditionality. The program's conditionality therefore does not require the completed privatization of ZESCO, but merely the issuance of the international bidding documents for the sale of the government's controlling interest in the company. This is the same conditionality with respect to the Zambia National Commercial Bank (ZNCB).

There was a question in the preliminary statements on the privatization of ZNCB and the authorities' plans to develop rural banking. The privatization of ZNCB will remove a significant risk to the overall financial system. It is also necessary to improve rural banking. As the FSSA points out, ZNCB, with its few rural branches, has been extremely ineffective in addressing the needs of the rural community. The provisions for ZNCB's privatization require the buyer to keep the rural branches for a year while the government develops a plan for a specialized rural finance institution. This rural finance institution will not extend credit, but will link the rural areas to the cash economy by performing transfer payments and serving as cash points. Even if the government ends up subsidizing the few rural branches while the rural finance institutions is being established, the cost will be relatively modest.

There was a question on how to make public expenditure management more effective. This goes to the core of the issues facing Zambia today. The improvement of public expenditure management is an ongoing process. Quite a lot has been achieved in the past two years in this area in Zambia, which are outlined in Box 4 of the staff report. Certainly, more needs to be done. The main problem in the fiscal area in 2002—the wage overruns and the allocation of expenditures—had nothing to do with public expenditure management. It was a political decision to award the large wage increases and make the supplementary hiring just weeks before the election, and it was a political decision that the wage increases for the military could not be withdrawn once given.

Zambia has a dearth of human capital and administrative resources, and this situation has been aggravated by 20 years of bad economic performance. These problems were exacerbated in the past year by disruptions to administration in connection with the elections and the anti-corruption drive. There have been large-scale changes in staffing, particularly at the Ministry of Finance, where the entire top structure has been changed. Financial shortfalls and external shocks also undermine progress in this area. But Zambia receives a lot of assistance from donors. If the IFMIS can be successfully implemented—which will be a difficult process—it would be a major step forward.

There was a question on the pension system and whether its financial condition could impact the 2003 budget. Currently, the pension system has a financing gap based on the actuarially estimated liabilities, which are around 1.7 percent of GDP. The World Bank is working closely with the authorities on a reform plan that would significantly reduce the estimated liabilities. This is a very complicated process, as a constitutional provision provides certain guarantees to public sector pensions. A modification of this provision is one of the factors being considered by the authorities and Bank staff. Beyond this, there is the issue of whether to meet the liabilities through cash payments or by issuing government securities, which would spread the payments out over time.

There were some questions on the possibility for additional need for debt relief for Zambia under the HIPC Initiative, particularly if copper prices declined further. Zambia is envisaged to reach completion point toward the end of 2003. The Bank and the Fund will be assisting the authorities with a new debt sustainability analysis based on end-2002 data, which will be undertaken as soon as data become available. At this stage, all data and estimates are very preliminary. Hence, discussion of the debt situation should await the availability of those data.

There was a question on the HIV/AIDS problem and how to address it. The design and implementation of programs to combat HIV/AIDS raise a range of difficult issues, including raising domestic awareness of the problem, addressing behavior patterns, dealing with medical issues, and managing the social issues. Many donors are helping the authorities through more than 130 separate projects. It is not a simple question of providing money, however, and Fund staff have no expertise in this area. We did make every effort to ensure that conditionality in the Fund-supported program did not hinder the effective implementation of the projects in that area.

On the cobalt report and the broader issue of anti-corruption policies, Fund staff first raised the issue of cobalt underpricing a few years back based on a declining trend in export unit values compared to world market prices. The authorities have taken up the issue, but it has been a long and difficult process, which was complicated by a number of legal hurdles. The authorities have met all their commitments to the Fund, as reflected in the Letters of Intent at each stage of the process, and the cobalt report has now become a public document after it was tabled in parliament. The authorities have said that they would refer the report, once it is finalized, to the legal authorities for review and appropriate action. Now that the report has been finalized, the legal authorities are looking into the matter.

The report shows very bad corporate governance, poor practices, violations of the corporation's rules, the holding of "sub-Board" meetings, and the signing of contracts without proper review. I am not sure, however—without venturing any legal opinions—that the documentation in the report meets legal standards for prosecution and assets seizure. But the authorities' anti-corruption drive is vigorous, and the president has stated several times his firm commitment to zero-tolerance for corruption: many senior officials have been dismissed; the anti-corruption drive is aggressively conducted at all levels, not just against the politically visible officials; an anti-corruption commission is following up on the cases to punish wrongdoing, including through confiscation of assets; and a special high-level task force of respected elder citizens has been formed to look at the whole issue and recommend systemic reforms. But the process is expensive. The cost of the cobalt report, for instance, was extremely high and had to be funded by the European Community. Hence, there is a danger of raising expectations too much. The issues cannot be resolved very quickly without continued support from the donor community.

Regarding the high-level workshop on diversification, the government has endorsed the findings of that workshop. A special working group has been formed for the copper belt, which is the region with the greatest potential because of its skilled manpower and mining infrastructure, which is the best in Zambia. We are somewhat concerned about some of the proposals like the setting up of export processing zones and the granting of tax breaks. The authorities should consider those proposals carefully. Some of the proposals, like land reform and judicial reform, are quite long-term. It should be pointed out that the critical reforms that will help diversify the economy already form part of the key elements of the PRSP and the PRGF-supported program: macroeconomic stability, market-determined prices, a properly functioning financial system, public expenditures geared toward productive outlays, privatization, and other structural reforms.

Regarding the question on public sector wage determination, a World Bank-supported project, the Public Service Capacity Building Project (PSCAP), is ongoing and aims to improve the efficiency of public sector management including organization, staffing, employment rules, and others. Although the project is long-term, the reforms that will reduce wage costs in 2003 to 8 percent of the budget have to be implemented in 2003. The Letter of Intent says clearly that the authorities will limit the general salary increase agreed with unions to an amount consistent with a wage bill increase to at most 8 percent of the budget. Insofar as the authorities can implement savings before the agreement with the unions, this provides scope for a higher general wage increases, which shall be consistent with the aggregate increase in the total wage bill of 8 percent. There is considerable scope for reducing costs by removing ghost workers from the payroll. However, the 8 percent limit for 2004/05 is not a firm target at this stage.

There was a question about the use of gross international reserves rather than net international reserves as a performance criterion. Using the gross measure is more transparent in the case of Zambia, as it is the measure that the authorities already use and target. But the two measures are really equivalent because the liabilities to the Fund are known, and the central bank cannot borrow commercially to meet its reserves target. Only borrowing from the World Bank and from other donors on IDA terms is allowed.

There was a question about why HIPC Initiative spending is not a quantitative benchmark for the PRGF-supported program. It is not really possible to load up the program with many different quantitative benchmarks and performance criteria; there is already a significant number of performance criteria and benchmarks in the program compared with others. At any rate, HIPC Initiative spending is part of overall budget implementation, and there is a clear commitment on the part of the authorities to increase spending of HIPC Initiative resources back to 2.2 percent of the budget. However, this is an ambitious target. Since debt relief from the HIPC Initiative is high for Zambia, the implied HIPC Initiative spending is also high. The staff's view is that the level of HIPC Initiative spending should not be made a performance criterion under the program.

There was a question on the realism of the growth and inflation forecasts. The staff considers the forecasts rather realistic: in view of

> Zambia's poor performance in the past, the potential for growth from simply reversing the policy stance is very large. The sharp improvement in the growth performance over the past three years has taken place even as the country grappled with HIV/AIDS, external shocks, low copper prices, and the drought. Hence, if the policy stance is adhered to, the targets for growth and inflation are highly attainable.
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> There was a question about mine closures and social safety net provisions for affected workers. Zambian law contains considerable social safety net provisions for people in paid employment. A worker who has been separated can get a full month's salary for every year of employment with a rather high base amount. This is in fact one of the barriers to greater efficiency in the Zambian labor market. Of greater concern is the need to improve the safety nets for those who are not in paid employment.

Mr. Daïri wondered about the seeming insufficiency of commitment on the part of the international community to help Zambia in its efforts to combat the HIV/AIDS epidemic. Box 1 of the staff report showed that only \$356 million of the required \$560 million over three years had been committed, with the government committing \$150 million and cooperating partners and the Global Fund committing only \$114 million and \$92 million, respectively.

The staff representative from the African Department (Mr. Sharer) replied that the \$92 million that had been committed by the Global Fund was also being funded by donors. The current shortfall did not necessarily indicate a lack of commitment on the part of the donor community, as there were many complex issues that needed to be addressed first.

The staff representative from the Policy Development and Review Department (Mr. Kincaid), responding to Mr. Guinigundo's question on targeting Zambia's gross international reserves instead of its net international reserves, said that, as Mr. Sharer had pointed out, there was not much distinction between net reserves and gross reserves, given Zambia's limited access to commercial borrowings. Nonetheless, in the Technical Memorandum of Understanding, the definition of gross reserves actually netted out assets held by the central bank that were in any way encumbered or were owed to domestic residents. Moreover, the target for gross international reserves would be adjusted for short-term borrowing undertaken by the central bank, as well as for any excess balance-of-payments support received by the authorities. Hence, with the adjustments, the measure for gross reserves was almost equivalent to that for net reserves. It was also important, from the Fund's perspective, that, given Zambia's history of external payments arrears, the targets focused on the gross level and on the liquidity of the reserves, in order to forestall a recurrence of external payments arrears.

Ms. Vtyurina remarked that there did not seem to be a real reassurance that the miners would be paid if the mines closed down. Although social safety nets were provided for in the law, she wondered where the money would come from to pay the workers. She also inquired about who would take over the ownership of the mining company if the government was not going to renationalize it.

Ms. Vtyurina inquired about the status of the domestic debt strategy that the authorities were developing. She also asked about the unemployment level.

The staff representative from the African Department (Mr. Sharer) replied that the probability that the workers' entitlements would be higher if the copper mines remained in private hands; the government had historically been rather lax in meeting payments it owed to government workers. The courts in Zambia were vigorous in pursuing private sector complaints, particularly the complaints of individuals against private companies. Hence, in that sense, there was greater reassurance that the workers would get the benefits due them.

The staff did not have further information on the unemployment level, as Zambia's labor statistics were weak, the staff representative continued. The authorities' domestic debt strategy would come under the ongoing reform of the government accounts.

The withdrawal of Anglo-American had not been due to a lack of confidence in Zambia; the problems in the copper sector obviously presented difficulties, the staff representative said. In fact, Anglo-American had just bought a substantial minority stake in one of the other mining companies in Zambia. As the authorities had committed to the Fund and to other donors that they would not renationalize the mines or subsidize the company—and, if they were forced into such a position, to do so only with the financial assistance of donors or by implementing specific tax measures—a rather complicated arrangement had been worked out in the meantime, which left KCM's ownership largely with the other minority shareholders. Some of the shares had been placed into a trust for the workers, and some were being held by the management of KCM, which Anglo-American had allowed to stay on for a certain period. A new strategic partner was being sought, in cooperation with donors. A major international financial institution had been hired, and a legal prospectus had been prepared and issued, or was in the process of being issued. Thus far, there had been expressions of interest from four or five major companies. The government's interest was to have the strategic partner move into the entire block of KCM's assets without having to split it up.

Mr. Daïri wondered whether, pending completion of the agreement with a prospective buyer, measures had been taken to protect the company's assets.

Mr. Ralyea wondered how it was possible for the new owners to have acquired ownership in the company without putting in resources of their own. It also seemed as though, to some extent, the government was in effect setting up roadblocks to further divesting KCM. Part of the deal with Anglo-American had included the acceleration of payments of $20 million from KCM's key customers to cover current expenditures. That amount would constitute lost revenues for the future owner. Finally, the government's decision not to split up the assets of KCM might hinder the sale of KCM to a new majority owner.

The staff representative from the African Department (Mr. Sharer) replied that ownership of KCM had not been passed on to the new owners. Anglo-American's equity had reverted back to the government, but it had been placed in a trust designed to keep its management out of government's hands.

The $20 million receivables would be used to finance KCM's prospective gap for 2002/03 arising from declining copper prices and the structure of its investments, the staff representative explained. It would have been better if the prospective buyer could take over the entity as a whole with substantial cash resources. The diminished cash assets would certainly be reflected in a lower acquisition price. However, the authorities' aim was to find a strategic investor to keep the company as an ongoing entity, and they did not expect to get a large amount of money from the sale of the company shares. The government had a strong interest to sell the company as a going concern because of the Konkola Deep Mining project, which experts in the sector considered to be a large body of high grade copper ore that could be developed someday.

Ms. Vtyurina asked why it was the authorities and not Anglo-American that were trying to sell off the latter's share in the company.

The staff representative from the African Department (Mr. Sharer) explained that the reason why it was the government that was trying to sell off Anglo-American's equity in the mining company was because the proceeds would go to the government under its agreement with Anglo-American, which also limited the company's liabilities. That agreement had been the most realistic under the circumstances.

Mr. Brooke made the following statement:

> While we share some of the reservations that have been expressed this morning by some Directors, in general we have a more positive assessment of the progress made under the PRGF arrangement. As such, we strongly endorse the staff's assessment and policy recommendations, and we support the completion of the program review and the disbursement of interim HIPC Initiative assistance.
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> As the staff notes, the authorities have responded well to the difficult circumstances that they faced in recent times with the fall in copper prices, the severe drought, the problem of HIV/AIDS, and the difficult and unsustainable debt position. Recognizing these challenges, we strongly agree with the staff that the key policy priorities facing the authorities are, first, measures to alleviate the effects of the drought; second, vigorous implementation of the preventative and curative programs for HIV/AIDS; third, reducing the domestically financed component of the fiscal deficit, to help restore debt sustainability and support monetary policy and its objective of reducing inflation; and, fourth, implementing structural reforms to improve the climate for investment and reduce the role of the state in the economy—through

privatization and improvements in government—as well as all the actions associated with the PRSP and the recommendations of the FSAP.

As Mr. Ísleifsson noted in his statement, given the difficulty of the debt situation facing Zambia, it will be critical for the authorities to keep the Fund-supported program on track to ensure continued HIPC Initiative relief and disbursement of Fund assistance. We are very pleased with the on-track performance over the past two years, particularly given the authorities' performance in prior years.

I have only a few more specific points to raise. On fiscal policy, we very much endorse the point that has been made about the need to improve public expenditure management, and we feel that in addition to the areas identified by the staff, another aspect that needs further consideration are the policies concerning procurement.

On the issue of wages, we very much share the staff's view that the wage bill should be constrained to meet the target of 8 percent of GDP in 2003, and we welcome the authorities' commitment and intended actions to achieve this. We certainly share the concerns that have been expressed by the staff and by other Directors about the apparent knock-on impact of the wage increases on HIPC Initiative-related social spending. We also noted, however, the staff's observation that some of the delays in committed social spending were due to weaknesses in capacity, and we would therefore be interested to hear from the staff about what actions the authorities are taking to improve that situation to be able to actively deliver on their renewed commitment, as noted in Mr. Usman's statement, to increase social spending up to the targeted levels.

We very much welcome the introduction of Box 4 in the staff report on the actions to strengthen the tracking of poverty-reducing spending. As we noted in the discussion in Tanzania, this is a very helpful addition to program documents, and we hope it can be expanded to all other PRGF cases.

On governance, we very much welcome the authorities' resolute stance to fight corruption. This is a clear break from past performance and a move in the right direction. As noted by the staff, however, it will be important for the anti-corruption commission to ensure that judicial and legal processes are followed fully. We recognize the resource constraints that this would entail, and, therefore, the authorities' efforts would probably need to be prioritized on cases where successful prosecutions are most likely. This would send a very useful reinforcement of the signal that the authorities are giving regarding their zero-tolerance for corruption. We agree with the staff that improvements in transparency are needed to complement these efforts.

On the FSAP, we very much welcome the indication in Mr. Usman's statement that the authorities concur with the main findings of the FSAP review. There are a significant number of problems that have been identified, and, in this regard, we support the formulation of a national financial development strategy. We urge the authorities to continue to work closely with Fund and Bank staff in agreeing to this strategy in the near future and move on to implementing agreed actions. We hope we can receive further information about this in the next program review, with a timetable for such actions.

Finally, we noted—and the staff has commented on this in his remarks—that the debt dynamics remain very vulnerable and have been adversely affected by the decline in copper prices. It will therefore be important to undertake a careful debt sustainability analysis with an assessment of the need for topping-up debt relief.

We wish the authorities every success with the challenges in the period ahead.

Mr. Vermaeten made the following statement:

The authorities should be commended for meeting all quantitative and structural performance criteria. They have managed to steer the economy generally in the right direction despite being faced with incredible challenges such as Anglo-American's pull out, declining copper prices, a drought, unpredictable levels of donor assistance and the HIV/AIDS pandemic. On top of that, they have made commendable efforts to address corruption (its nowhere near stamped out territory). Since I broadly agree with the staff report, I would like to restrict my remarks to three areas: ownership, public expenditure management, and the staff report.

Let me begin with some comments on ownership and commitment. Notwithstanding the significant accomplishments of the authorities, we are still left with a sense of unease about whether the authorities are fully committed to carry through on the key reforms that are needed to improve the economy and reduce poverty. Zambian leaders have not been convincing as some other African leaders in committing to a market economy, to macro stability and to good governance – and we fear that difficult long-term decisions will continue to be avoided, or only undertaken when the authorities are forced to do so by the donor community.

During this fifth review, we again see some signs of weak ownership and reform commitment, and this has been articulated well by Mr. Vittas and Mr. Ísleifsson.

For example, Zambia's military expenditure exceeded targets, while HIPC Initiative expenditures were less than projected, leaving the social expenditures to government revenue ratio well below the average of other African heavily indebted poor countries. And unfortunately, the Letter of Intent from their Minister of Finance provided little comfort that the authorities are taking full ownership of these slippages. For example, in paragraph 3, the Minister of Finance writes that "the composition of expenditure and the continuing accumulation of domestic arrears were worrisome." We recognize that some problems are a legacy of the last administration, nevertheless, one gets the sense that the authorities wish to imply that they are powerless to effect spending composition or arrears accumulation.

Another example is the authorities' response to the tremendous fiscal pressure, which has been compounded by their refusal to accept genetically modified maize. Despite the urgency of the fiscal situation, the authorities have ruled out staff's modest suggestions as "not politically feasible".

For the next review , we would like to see Zambia demonstrate commitment to reform that goes beyond just the letter of the agreement. More specifically, we strongly urge Zambia to meet its eight percent wage of GDP, to increase HIPC Initiative related expenditures to at least 2.2 percent of GDP and to reduce military spending.

In the medium term, Zambia must go beyond lurching from one condition to the next to win favor amongst donors. Instead of IFIs loading on more conditions, Zambia needs to show that there has been a fundamental mind shift towards implementing good policies before it merits receiving irrevocable debt relief. In this respect, our chair wants to continue to be flexible in interpreting what is necessary to reach the HIPC Initiative completion point, but it should be clear to Zambia and other HIPC countries that being flexible does not mean that we intend to lower the benchmark.

The second area I would like to touch on very briefly is public expenditure management (PEM). In short, while important steps have been taken, more is needed. Progress on PEM is key to enact the PRSP, to improve the overall pro-poor bias and transparency of the budget process, and as a means to build donor confidence. And Zambia has lots of scope to improve as it ranked last among the 24 HIPC countries in the recent Fund-Bank review of expenditure management systems. If there is a follow up PRGF arrangement, we think PEM improvements should factor in as key conditions, and if possible, progress should also be linked back to the PEM review.

The third and last area I would like to comment on is the current and future staff reports on Zambia. The staff's report is comparable in quality and in style to many other Article IV documents. And like other Directors, we certainly appreciate the efforts by staff. We would, however, like to challenge the staff to go even further.

First, more needs to be done to clarify the growth strategy. Zambia has paid heavily for not having a clear and determined strategy to crease lasting growth. It watched as its copper production fell from 700,000 metric tons in 1976 to 320,000 metric tons in 2001. If Zambia is lucky, and copper prices do rebound significantly as projected in the *WEO*, the debt-to-export ratio after HIPC Initiative relief will still stand at 200 percent. Over the medium term, the rather optimistic base case projections rely on a 30-percent rise in the price of copper to bring down debt ratios, while the PRSP acknowledges that implementation is dependent on even higher levels of donor support. Zambia's outlook to a large extent still rests on the whims of international copper market and the generosity of donors. What is needed instead is a clear plan to attract investment, lower cost structures, build competitiveness, diversify experts and capture new markets. I know some of this has already been done in the PRSP – but there is a need to better discuss, integrate and build this strategy more directly into staff documents, and devise baselines from which to measure progress and implementation..

Second, and consistent with the Independent Evaluation Office's (IEO) review on prolonged use of Fund resources, greater effort needs to be taken to distinguish the Article IV aspects of the report from the review component. The report to me does not seem like we have looked at Zambia with a fresh pair of eyes. And my sense is that too much of the story is told around the existing program and conditionality, and not enough time is devoted to the bigger picture. Again, consistent with the IEO report, it would also be helpful to have a more explicit analysis of program ownership, and to have a section that provides a longer term overview of the Fund's involvement with Zambia.

Third, and last, the Minister of Finance's twelve page Letter of Intent is strikingly familiar in style and content of the staff's own report. The Zambian authorities – and for that matter, most other program countries – need to put a greater effort into helping write the Letter of Intent to more clearly demonstrate ownership.

I have probably focused too much on the empty part of the proverbial glass, but let me reiterate in conclusion that we also recognize that much of the glass is already full. The authorities have made much progress and we urge them to publish this document, both as a testament to the progress they have made and as another helpful step toward building ownership and increasing transparency.

Mr. Komatsuzaki made the following statement:

> At the outset, I would like to thank the staff for their comprehensive and excellent analysis in the staff paper, and Mr. Usman for the useful information provided in his statement.
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> While the developments of the Zambian economy since the last review might not have been as bad as the worst-case scenario, as the copper sector fared better than expected, Zambia faces extremely difficult economic prospects. With the projected decline in the mining sector, growth in the non-mining sector is all the more urgent now. Lower projections on copper exports are threatening the debt sustainability prospects of Zambia. While we can go along with the proposed decision, we would emphasize that the margin of error is small for the authorities, and that economic prospects remain unfavorable without any development in the non-mining sector. This chair feels somewhat uncertain about the commitment of the authorities, especially on fiscal expenditure management and privatization. We appreciate the staff's clarification this morning, and hope our uncertainty will be resolved as time goes by.
>
> One of the obstacles of diversification identified in the High-Level Workshop on Diversification, whose recommendations we share, is macroeconomic instability. On the fiscal side, the key issue is how to deal with the expenditure pressure from various sources. The already onerous situation was worsened by the regrettable expenditure misallocation, as the wage bill and defense expenditure overshot the targets at the expense of social outlays. This is especially regrettable considering the widespread poverty and seriousness of HIV/AIDS pandemic in Zambia. A firmer expenditure control must take place, and the adoption of the medium-term expenditure framework by the Cabinet and its implementation has to be completed as soon as possible. We understand that the public expenditure management is an ongoing effort, but this makes it all the more important that the authorities have strong commitment.
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> On the monetary front, monetary policy should continue to be prudent to further lower inflation. Several measures taken by the authorities to improve the coordination of monetary and fiscal policy are welcome in this context.
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> There are other structural obstacles to diversification. Poor infrastructure and governance are major factors among them.
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> Privatization is one important element for improving the infrastructure. Losses on state enterprises put pressure on the budget situation as well. Privatization has to maintain its momentum in cooperation with the World Bank. In this context, it is worrisome that Appendix IV of the staff report

suggests that the privatization program has slowed down and that policy reversals are possible. We note that the time of the writing of Appendix IV appears to have been before end-October, however, and we wonder whether the assessment has changed since then.

On governance, the authorities' drive in recent months to enhance governance and fiscal transparency is commendable. We encourage the authorities to persevere with their efforts despite the mounting domestic political pressure.

On reading the FSSA, two aspects stand out; the relatively minor role the financial sector plays in financial intermediation, and the weakness in public financial institutions. Regarding the former, enhancing financial intermediation is a long process involving many elements of the economy, such as macroeconomic stability, strategy to provide financial services to a broader part of the economy accompanied by strengthening of financial supervision, and overall improvement of the business environment. Regarding the latter, an important area in this context is privatization of public financial institutions. We concur with staff in urging the authorities to move quickly to privatize the ZNCB. The FSSA suggests there is no plan yet to address their condition other than the ZNCB. We urge the authorities to act decisively.

With these remarks, we wish the authorities every success.

Mr. Yeritsyan made the following statement:

I am glad that the momentum of clear progress in implementing structural reforms, which we have noted during the last program review discussion, has been maintained. Meanwhile, the program targets have been fully met, which demonstrates the authorities' commitment and ownership of the program. The staff also notes that the program targets for the end of the year remain within reach. On this basis I support the proposed decisions.

I support the staff appraisal, which provides a sound basis for a well streamlined and well focused policy framework. I also commend the staff for making efforts to step back from program implementation and for taking a fresh look at implemented policies in the context of the Article IV consultation. A clear lesson could be drawn from the report that timely and thorough implementation of the program could have brought better macroeconomic results. Nevertheless, I would also expect to get some conclusions whether or not additional policy measures or different sequencing in implementing macroeconomic policies would have helped the authorities to facilitate the achievement of their long-term macroeconomic goals.

Further in my intervention, I will emphasize some fiscal and monetary and financial sectors issues that deserve greater efforts on the part of the authorities and that, most probably, would suggest new streamlined policy measures in the future.

As regards the fiscal sector, I strongly endorse staffs conclusion that the key macroeconomic policy challenge is to achieve a sustainable fiscal position. This necessarily should be achieved through both revenue enhancing and public expenditure management efforts. Especially the inadequate public expenditure management and lack of capacity in planning and public finance management are the main constraints in attaining the PRGF and HIPC Initiative benchmarks. In this context, I would like to make the following specific comments:

It is critical to combine all fiscal management efforts under the MTEF, and approve it as soon as possible. It would certainly help to synchronize fiscal management measures in different policy papers produced by the government and associate them with streamlined and monitorable outcomes. For example, one would assume that full implementation of expenditure management and transparency measures proposed under Fund program conditionality should resolve similar outstanding issues in tracking poverty reducing public spending presented in Box 4 of the staff report. However, in my view, there is a large discrepancy in their status of implementation.

It is important to assess the implementation of structural measures on the basis of the achieved final outcome, wherever it is possible. As an example again, I expect to assess the implementation of the structural measure to address the unexpected occurrence of old expenditure arrears on the basis of their actual occurrence but not on the basis of extensive set of measures described in the staff report and in the LOI.

It is also important to pursue a comprehensive wage bill reform by strengthening appropriation and reporting rules of public wages. By analyzing how the system works, we might find that overspending on salaries is not limited to defense and security services.

Finally, it is of the utmost urgency to facilitate capacity building in public finance management at all levels of the government—the Ministry of Finance as well as line ministries. In this context, cooperating partners have to improve their coordination and harmonization of procedures within the authorities' PRSP, in order to reduce the administrative load at the Zambian government's side. Therefore, as a step in this direction a group of like-minded countries, in cooperation with the EC and the World Bank, is actively involved in preparing joint multi-year poverty-oriented direct budget support as of 2003.

With regard to monetary and financial sector policies, I support the points raised by Mr. Brooke. I welcome the completion of the FSSA report, which highlights all critical areas of reform. Therefore, I look forward to more measures in the authorities' program with the Fund to implement these reforms, especially in the areas of increasing independence of the Bank of Zambia (BOZ), improving coordination between the government and the BOZ, developing sufficient financial infrastructure addressing extensive lending to, in most cases, non-viable public enterprises and strengthening banking supervision and regulation. Enhanced transparency of monetary and financial policies, as well as pursuing a clear exit mechanism for nonviable financial organizations are essential to achieve longer term sustainability in these reform efforts.

On governance, I welcome the concurrence between the staff and the authorities that the privatization of public entities would help eliminate a major source of governance problems in Zambia. However, it is doubtful that in the Zambian context, given very little foreign interest, it would be possible to find domestic investors that would improve management of companies, and thus, governments direct or indirect involvement in the companies will continue. Therefore, measures to improve the business environment substantially and mitigate the cost of doing business in Zambia should precede the privatization, in order to be able to attract strategic foreign investors. For the time being the authorities could develop a strategy with the help of the WB to strengthen governance in the state owned companies.

In conclusion, Zambia has a long way to go in completing its transition to a functioning market economy, but macroeconomic stability achieved through independent monetary policy and a sound financial sector, as well as fiscal discipline and improved governance, are the keys to establishing a firmer momentum of recent achievements.

Mr. Moreno made the following statement:

We would first like to thank the staff for the well-written and comprehensive set of papers for today's discussion, and Mr. Usman for his informative statement.

The Zambian authorities deserve recognition for their prudent macroeconomic policies and their commendable progress on structural reforms, which have helped alleviate the effects of the external shocks that have affected the economy in 2002, namely, the developments on the copper sector and the droughts that have affected the agricultural sector. The main challenge for the authorities will continue to be economic growth and poverty reduction as well as continuing their efforts to alleviate the effects of the HIV/AIDS pandemic. We believe that macroeconomic prudence, improved governance and fiscal management, and efficiency-enhancing structural reforms will be key to address these goals. Mr. Usman's statement is reassuring of the authorities' medium-term commitment to this strategy.

We broadly share the staff's assessment and we can support the proposed decisions on the completion of the fifth review under the PRGF and on the additional interim assistance under the enhanced HIPC Initiative. We would like to highlight a few issues that we consider particularly important.

Fiscal policy

We believe that the burden of the adjustment to achieve fiscal sustainability should rely on the revenue rather than on the expenditure side. In parallel, improving the efficiency of fiscal management will also be key in helping ensure sustainability.

In our view, there is not much margin for adjustment on the expenditure side. The main challenge is to reduce the wage bill, which amounts for about a fourth of total expenditures of the central government. Nevertheless, public employment reform should probably be scheduled for the medium and long term given the political and social difficulties of such a reform stressed by the authorities. In this respect we welcome the medium-term pay reform strategy stressed in Mr. Usman's statement. This been said, we share the staff's concerns about wage overruns, and we strongly encourage the authorities to avoid them in the future. The wage bill should not go beyond the projected 8 percent share of GDP and social and capital expenditures should not be scaled back again to cover expenses of defense and security forces.

On the revenue side, we welcome the authorities' commitment to expand the tax base. It is important that the authorities increase significantly the tax revenue to GDP ratio from the current narrow 17.5 percent. In this respect we believe that a mere increase of 0.3 percent in the next two years as projected in Table 5 of the staff report, or even the one percent increase pointed out in paragraph 47, might not be ambitious enough. We would welcome staff comments on the possibilities of targeting higher revenue increases.

The authorities should also improve the efficiency of fiscal management. We welcome the number of measures in this respect described in paragraphs 37 and 55. We also welcome the creation of the new department of Planning and Economic Management with a renewed emphasis on planning, coordinating and monitoring government programs, including the medium-term expenditure framework and PRSP implementation. We encourage the authorities to take full advantage of the available technical assistance, not only in public expenditure management, but also in revenue management. Improving fiscal management, together with other governance measures, such as the anticorruption drive, for which we would like to commend the authorities, will help enhance donor support.

Other issues

We welcome the authorities' good performance on structural conditionality and their continued commitment to the structural reform process. Together with governance issues, the main focus should be to continue diversifying the economy. Here we agree with Mr. Shaalan's and Ms. Farhan's comments on the usefulness of initiatives such as the High-Level Workshop on Diversification, and we encourage the authorities to target their diversification policy to the identified priority sectors.

The HIV/AIDS pandemic in Zambia, with an infection rate of almost 20 percent of the adult population, remains a paramount challenge for the authorities. We are concerned with the US$204 million shortfall, pointed out in Box 1 of the staff report, on the necessary resources estimated by the authorities for combating aids. We would welcome staff comments on the possibilities of covering this shortfall.

With these remarks, we wish the authorities every success in their challenges for the period ahead.

Mr. Boitreaud made the following statement:

I am in agreement with the thrust of the staff's appraisal and commend the authorities for having met all the quantitative and structural performance criteria set under the program, despite adverse factors including the withdrawal of Anglo-American, declining world copper prices, and a severe drought.

On the latter, we hope that the government's Drought Recovery and Mitigation Plan will be successfully implemented with the assistance of the World Bank, through its' recently approved emergency project, and other donors. The situation needs to be closely monitored, given the number of people at risk, about a third of the population of Zambia, and the possible additional stress that it can put on the fiscal position.

We agree with the staff that the authorities response to these crises were broadly appropriate, but that key macroeconomic policy challenges remain, particularly in the area of public expenditure control, governance, and transparency. Like Mr. Ísleifsson and others, we are disappointed by the significant overruns in the wage bill which occurred shortly before the end-2001 elections and were related notably to wage increase to the defense and security forces. We find this all the more regrettable that it was compensated by a shortfall in priority outlays, which clearly is not consistent with the main objectives of a PRGF-supported program. We welcome the steps, as outlined in Mr. Usman's useful statement, undertaken by the authorities to offset the wage bill and urge the authorities to maintain a stringent fiscal policy, while at the same time, improving monitoring and tracking of HIPC Initiative resources and strengthening implementation capacity at the central and local level, especially in social sectors.

Emphasis on the sources of growth, diversification, and creating a favorable environment for private sector development is needed. As mentioned by Mr. Vittas and others, sustaining the efforts in the fight against corruption and enforcement of the rule of law will prove essential in this regard.

Turning to the external outlook and sustainability, the staff estimates that Zambia's debt sustainability is likely to be eligible to additional debt relief at the time of the completion point. I thank the staff for the explanations on the forthcoming debt sustainability analysis and would like to insist on the importance to rapidly provide comprehensive and detailed information to all creditors, including Paris club creditors, on the possible support that might be needed.

Mr. Bischofberger made the following statement:

After a long period of poor economic performance with low growth and high inflation, the overall economic picture has brightened somewhat since mid-2000. The Zambian authorities deserve to be complimented for their achievements over the past two years, which reflect the pursuit of improved macroeconomic policies and progress on the structural front under the PRGF-supported program. Looking forward, however, the recent drought is about to lead to a severe food crisis. Furthermore, the likely impact of the HIV/AIDS pandemic on Zambia's growth potential is a matter of concern. It is encouraging that the authorities seem to be aware of the many challenges they face, as is indicated by Mr. Usman in his helpful statement. Now, it is of utmost importance to translate awareness of challenges into sound policies.

As we are in broad agreement with the staff appraisal and many issues have already been raised, I will confine my comments to five particular issues.

First, on fiscal policy, I fully concur with the staff that a more effective public expenditure management is needed. We share the staff's and other speakers' concern that the offsetting of large overruns in the wage bill for defense and security forces by lower social and capital expenditure undermines the government's credibility in pursuing the poverty reduction goals of the PRSP. Moreover, it is regrettable, that despite efforts to broaden the tax base and to improve tax collection, government revenues are projected to fall from 19.2 percent of GDP to 17.9 percent as noted in Box 1 of the staff report. In this respect, I would appreciate it if the staff could provide some additional information about the unanticipated VAT refunds to the mines that caused the shortfall in VAT collections.

Second, on monetary policy, a tight monetary policy stance is needed to tackle the strong current inflationary pressures and to achieve the inflation objective of the program. Low inflation would not only contribute to macro-economic stabilization, but also to a reduction of the already high degree of dollarization of the Zambian economy.

Third, the weakness of the financial sector remains a serious concern. The fact, stated in footnote 15 of the staff report, that the deficit of the public financial institutions, including the ZNCB, is estimated at 3 percent of GDP, speaks for itself. Speedy privatization in this field is key, as is an overall improvement in financial intermediation in order to foster economic growth. As other speakers have noted, it is encouraging to learn from Mr. Usman's statement about the progress in the sale of 51 percent of the shares of ZNCB.

Fourth, economic diversification should become a priority of Zambia's economic policy. Like other speakers, I strongly encourage the Zambian authorities to implement the diversification strategy outlined in Box 2 of the staff report. Let me emphasize that diversification should start within the agricultural sector by increasing the variety of crops, thereby making the country less vulnerable to climate conditions particularly detrimental to a certain crop. This step of diversification should be fairly easy, as Zambia has abundant arable land, indeed. In the medium and longer term, more diversification across all sectors is needed. Like other speakers, I am worried about the over-reliance on copper exports. Having sufficient natural resources, Zambia should be able to diversify effectively and to overcome its high dependency on donor assistance in the medium term. This, however, requires a strong commitment by the authorities. Fortunately, Mr. Usman's statement brings out that the Zambian authorities seem to be fully aware of the efforts needed.

Fifth, the staff commends the authorities for their anticorruption, good governance and transparency measures. While these measures are commendable, we feel that more needs to be done to fight corruption and to improve governance. We note for example that Zambia's rating in the Transparency International Corruption Perception Index is still very poor.

To conclude, against the background of Zambia's past performance, we are encouraged by the progress achieved under the current program. But this should not distract from the fact that a lot remains to be done to exploit Zambia's economic potential and to permanently improve living conditions.

With these remarks, I support the proposed decisions and wish the authorities every success in their future endeavors.

Mr. Liu made the following statement:

It is encouraging that Zambia has turned its economy around after a long period of low growth and high inflation. All the program benchmarks and criteria have been met despite adverse developments like a severe drought, declining copper prices, and uncertainty caused by the withdrawal of Anglo-American. We commend the authorities for this performance and for the stronger implementation of policy measures. We are also encouraged by the authorities' determination to continue the reform efforts. Against this background, we believe that Zambia deserves continued international assistance, and we fully support the proposed completion of the fifth review under the PRGF and the release of additional interim assistance under the HIPC Initiative. That being said, I would like to make a few brief comments for emphasis.

On the fiscal side, attaining fiscal sustainability will be central to the improved economic performance over the medium term. In this regard, we welcome the measures taken to contain and compress the public sector wage bill, as well as the intention to strengthen the revenue-enhancing measures, expand the tax base and reduce the scope of exemptions and rebates. A further reorientation of outlays toward infrastructure and poverty reduction will be important to achieve this goal.

In the monetary sector, we are encouraged that monetary policy remains geared to achieving the inflation and reserves targets. We welcome the authorities' intention to continue their efforts to enhance the soundness of the banking system and strengthen regulatory and prudential oversight. We also welcome the steps proposed to be taken by the authorities to improve financial intermediation, particularly the design of an appropriate institutional structure for providing rural service.

On structural reforms, we commend the authorities for their achievements so far and welcome their commitment to continue to implement key structural reforms in 2000 and beyond to improve the climate for investment and promote growth. In this connection, we share Mr. Reddy's view that the authorities are right to focus on strategies aimed at diversifying production and exports.

Like Mr. Shaalan and Ms. Farhan and other speakers, we find the boxes in the staff report on diversification and structural reforms very useful. We look forward to implementation of the short- and medium-term actions identified at the recent high-level workshop.

With these remarks, we wish the authorities every success in their future endeavors.

Ms. Ocampos made the following statement:

At the outset, let me thank the staff for the well-focused report on Zambia, and Mr. Usman for his insightful statement. Since mid-2000, triggered by the privatization of the copper mines, Zambia has made significant strides toward economic growth and macroeconomic stabilization, leaving behind two decades of weak macroeconomic performance. The investment climate has improved, the fiscal position strengthened, the inflation rate dampened, and structural reforms have substantially advanced, all this supported by a PRGF arrangement.

This favorable economic performance has been regrettably disrupted this year by the withdrawal of the Anglo-American company from Zambia's mining sector, by record low international copper prices, by a severe drought and by the devastating consequences of the HIV/AIDS pandemic. All these factors have dampened the prospects for economic growth and increased pressures on macroeconomic stability. Notwithstanding these adverse outcomes, the authorities should be commended for their firm commitment with the program and its implementation reflected in that all but one of the performance criteria was met. In this context, we support the proposed decision, including the completion of the fifth review under the PRGF arrangement and the additional interim assistance under the enhanced HIPC Initiative. Since we broadly agree with the thrust of the staff appraisal, allow me to make some specific comments for emphasis.

On fiscal policy and debt sustainability

Since Zambia remains highly dependent on external assistance and vulnerable to lower copper prices and weather-related shocks, maintaining the reform momentum is critical to achieving sustainable growth and effective reduction of poverty. In particular, a sustainable fiscal balance may be the cornerstone of debt sustainability and crucial to leave enough room for needed social spending and the expansion of basic infrastructure. We are somewhat concerned by the staff assessment that Zambia may face difficulties in achieving debt sustainability at the completion point due to lower-than-envisaged copper prices. In this regard, our view is that in addition to the strengthened domestic efforts, further assistance from the international community may be necessary as well.

Although we commend the authorities for the progress made in the consolidation of the public finances keeping the overall fiscal performance broadly on track, we are deeply concerned with the large overruns in the wage bill, which has increased by 2.8 percentage point of GDP from 1999 onward. As a result, lower social and capital expenditures have jeopardized the government's credibility on reducing poverty and its commitment with macroeconomic stability and growth. In this context, we are glad to learn from Mr. Usman's statement about the recently implemented measures to put a lid on the public sector wage growth. We encourage the authorities to complement these measures by implementing the civil service strategy elaborated along with the World Bank aimed at reducing the size of the payroll, by introducing the medium term expenditure framework and by adhering as soon as possible to the planned strategy to streamline non-priority outlays. These actions will be crucial to bring budgetary expenditure in line with available financing and restore HIPC Initiative spending according to the authorities' pledge.

On the structural reform agenda

We commend the authorities for the progress in implementing structural reforms, particularly the privatization of enterprises, the trade liberalization, and the advances to increase competitiveness and productivity that has been evident in the increase of the copper production. Nonetheless, Zambia's vulnerability to exogenous shocks underscores the importance of accelerating the diversification of its productive base. Further progress in the structural area to foster economic diversification remains therefore critical, as well noted in Box 2 of the staff report.

A predictable macroeconomic environment and provision of basic infrastructure and services including financing services are the cornerstone to activate Zambia's productive potential. As to the financial system, we are glad to learn that the authorities are going to implement measures in line with the FSSA mission, which are critical to strengthen the solvency and soundness of the financial system and deepen its intermediation capacity in rural areas, as pointed out by Mr. Usman. This is of utmost importance since the financial sector is still beleaguered by the continued operations of loss-making state-owned financial institutions that may spread to other financial institutions and jeopardize even more the fiscal deficit through their contingent liabilities. We are, however, confident, that a speedier restructuring or privatization process, in particular the sell of ZNCB, may soon be concluded.

Finally, on trade policy, we commend the authorities for the maintenance of Zambia's liberal trade regime and we hope that differences between commercial partners that led to the imposition of intra-regional non-tariffs barriers may soon be bridged, so as not to fade hopes for regional trade integration. By commending the authorities for the steps already taken to combat corruption which are critical in fostering the rule of law and improving business climate in Zambia, we wish them every success in the implementation of their ambitious economic program.

Mr. Al-Nassar made the following statement:

Following a satisfactory performance in the past two years, the Zambian economy weakened in 2002. The combination of the severe drought and the further decline in copper prices have hindered economic growth and increased inflationary pressures. Despite these exogenous shocks, Zambia is continuing its economic adjustment and reform. Indeed, the PRGF-supported program remains broadly on track. The authorities also remain committed to face future challenges with equal determination as noted in Mr. Usman's statement.

I am in broad agreement with the staff appraisal and will limit myself to a few remarks for emphasis.

On the fiscal front, while noting the authorities' effort to achieve the 2002 fiscal target, I share the staff's concern regarding shifting the composition of expenditures. This needs to be corrected in the context of the 2003 budget. However, given the expenditure pressures, it will be difficult to restore the spending on social sector and poverty reduction programs consistent with the PRSP without a substantial fiscal effort. Here, I welcome the authorities' commitment to limit the size of the wage bill and to mobilize additional revenue by improving the efficiency of tax collection and broadening the tax base. Scaling down non-priority spending and strengthening public expenditure management are also essential to this end.

On external policies, the market-determined exchange rate regime is appropriate. The authorities' intention to enhance the efficiency of the foreign exchange market by introducing a broad-based interbank market is welcome. In this regard, I support the authorities' request for additional Fund technical assistance. However, the large current account deficits and the deterioration in the terms of trade are concerns. Therefore, it is essential to improve the competitiveness by restructuring the economy. In this connection, promoting domestic saving, privatization, and export diversification are priorities.

On monetary policy, I agree on the need to maintain a tight stance in order to achieve the program's inflation target. In this connection, addressing the financial problems identified by the FSAP mission is a priority. Here, I am reassured by the authorities' commitment to halt the financial deterioration through speedy privatization of the Zambia National Commercial Bank (ZNCB) and careful monitoring of smaller banks. The authorities are also encouraged to limit the continued losses of the state-owned nonbank financial institutions.

To conclude, the Zambian authorities have demonstrated strong commitment to economic adjustment and reform under the current program.

The progress made deserves the international community's support. I, therefore, endorse the proposed decisions.

With these remarks, I wish the authorities further success.

Mr. Macía made the following statement:

After two decades of hardship imposed by exogenous conditions and by non-supportive policies, Zambia is now taking firm steps that should enhance per capita income and curtail poverty.

Since 2000, macroeconomic policies have been strengthened, there has been progress in structural reforms, and significant improvement in the financial sector; furthermore, some privatizations have been undertaken. Private sector participation has been enhanced, inflation reduced almost by half, and positive external conditions allowed for some accumulation of gross reserves. However, challenges remain in terms of fiscal consolidation, especially expenditure control and wage management, since food imports, increases in social sector outlays, and the PRSP's investment goals exert considerable pressure on the fiscal stance. We are pleased that all quantitative criteria and benchmarks have been met, though domestic arrears remain a pending issue. We encourage the authorities to stay a tight fiscal course.

Further growth is envisaged in 2002/04 based on improved mining activity, a rebound in agricultural production, and commitments for infrastructure investments. Fiscal sustainability remains a critical concern, with public wages, debt servicing, pension fund commitments, and transfers to state-owned entities potentially compromising the fiscal accounts. We expect definitive steps to curtail the payroll, initiate budget commitment controls, and strengthen public expenditure management. Measures to improve tax collections and broaden the tax base are promptly needed.

Zambia remains heavily dependent on external assistance and debt relief. We are encouraged with the prospects of higher copper prices, investments in the copper sector, and the continued inflow of private capital. We expect support to be maintained from bilateral and multilateral institutions, including the HIPC Initiative, to allow Zambia to achieve debt sustainability. Regional integration is crucial, and the authorities should remove the few nontariff barriers that exist, deal with the maize export ban, and reopen its regional markets for textiles and sugar with SADC and COMESA backing. Challenges remain in the financial sector. The NBFI's issues need to be tackled, the BoZ should be granted full autonomy and budget independence to strengthen its supervisory capabilities, and the privatization of ZNBC should be pushed forward.

We commend the authorities on their anticorruption drive, welcome the publication of reports, the allocation of resources to the audit bureau, the work of the anti-corruption commission, the tracking system on HIPC Initiative expenditures, and the MTEF framework to be presented shortly for cabinet approval. We support the staff's recommendations on the completion of the fifth review, and the extension of additional interim HIPC Initiative assistance for 2003.

Mr. Vafaev made the following statement:

The authorities' efforts aimed at achieving the macroeconomic stability, improvement of fiscal and monetary policies, and alteration of poor economic performance of last decades should be commended. The fact that the Zambian authorities met all quantitative criteria and almost all benchmarks and implemented structural measures envisaged by the program also demonstrates the level of their commitment to conduct essential reforms.

However, we share the staff's opinion that attaining the program's objectives for poverty reduction will depend critically on achieving the targets for growth and inflation as well as effective implementation of public expenditure programs consistent with the priorities in the PRSP. In this regard the recent shift in composition of expenditures characterized by the overrun in the wage bill, mainly for the defense and security forces at the cost of lower social expenditures is very much worrisome. Against this background we urge the authorities to strengthen public expenditure management through implementation of corresponding short-term and medium-term measures mentioned in the LOI in close consultation with the staff. We believe that maintenance of spending on HIPC Initiative-financed projects in line with program target has crucial importance for Zambia with majority of population living below the poverty line. Recurrences in this area have to be considered as violation of the spirit of the HIPC Initiative.

The composition of expenditures also indicates the need to speed up the implementation of governance and transparency measures under the program. Above all, we urge the Zambian authorities to publish, on a regular basis, the government budget and the HIPC Initiative expenditure tracking report. In this regard and given the record on governance and accountability, we would appreciate from the staff some indication on the use of the large inflows of donor assistance to fight the HIV/AIDS pandemic.

Furthermore, we are concerned by the accumulation of domestic payments arrears. Actions in this area should not be limited by completion of comprehensive data base of domestic arrears, but be followed up by efficient measures aimed at clearance of arrears.

The role of financial sector and especially of the banks dominating in this sector in providing financing for private sector could be increased through more flexible banks liquidity management complemented with development of efficient system of non-bank institutions.

The situation in the copper sector is worrisome. As the situation in the sector is crucial to Zambia, we would like to get more details on the current stand of Konkolla Copper Mines: could staff tell us about the intentions of Anglo-American (AA) and elaborate on the budgetary implications of the recent agreement with AA?

Progress in implementation of the structural reforms is encouraging. But the need to diversify the economy remains important. Therefore we welcome the Zambian authorities efforts in the diversification process and encourage them to work on implementation of short- and medium term actions identified at the High-Level Workshop on Diversification. However, we should be careful in advising the establishment of tax-free export processing zones to encourage exports and to stimulate sluggish regional centers, as they usually come with sizeable negative side effects. They reduce not only tax revenues, but also jeopardize the tax system as a whole by weakening the payment discipline of taxpayers not being able to profit from tax exemptions.

We appreciate the update on Zambia's prospects to achieve sustainable debt levels under the HIPC Initiative. Clearly, Zambia's external debt dynamics will not only depend on the copper price, but critically also on the authorities new lending policy, their foreign debt management, and the rate to which the country's growth performance can be further strengthened.

We urge the authorities to reinforce their efforts in order to improve utilization of extensive technical assistance provided by international donor community particularly in he areas of public expenditure management, compilation of national accounts statistics, banking and financial sector.

With these remarks, we agree to complete this review and support the extension of additional interim HIPC Initiative assistance for 2003.

Mr. Çakir made the following statement:

At the outset let me thank the staff for their well-written papers and Mr. Usman for his helpful statement.

Despite declining copper prices and other adverse developments, the authorities managed to meet all relevant performance criteria and structural benchmarks except that for the reduction of domestic arrears. I broadly agree with the staff's appraisal and support the proposed decision.

The program does face some risks, as I will point out, and I also have some questions for the staff. Like some other speakers, I regret that, because of the high wage bill mainly due to salary increases for the armed forces, the fiscal balance could only be achieved by reducing social spending and capital expenditures. We welcome the authorities' intention to hold the line on expenditures during the coming fiscal year while introducing corrective measures. But we wonder if the Ministry of Finance has sufficient administrative capacity to accomplish all the expenditure and tax reforms planned for the coming year.

Zambia's growth, like its fiscal performance and debt sustainability, is closely linked to the behavior of world copper prices. Despite copper's major economic role, Zambia is more of a price taker than a price maker, in the sense that it cannot influence copper prices by varying its production levels. I therefore wonder whether the state copper company could hedge itself in the futures markets without incurring exorbitant costs. If so, they may be able to avoid some of the effects on their economy of copper price volatility. Some comment by the staff would be appreciated.

Like many other developing countries, Zambia must work toward diversifying its economy away from a single export. The workshop on diversification should help Zambia identify promising sectors that can take some of the load off the copper sector. For example, the incentives being given to tourism are beginning to pay off, as is shown by the new hotel investments being made by international companies.

On monetary policy, we join the staff in urging the authorities to keep monetary policy tight in order to achieve the program's inflation targets. But we would urge the authorities to approach the development of treasury-bill and bond markets with caution. It is true that once established, such markets could increase the efficiency of monetary management. But the authorities have a long way to go before they can achieve fiscal sustainability, and the possibility of financing the budget by issuing treasury bills could delay the introduction of fiscal reforms, if it leads the authorities to become good debt managers instead of facing their fiscal problems. In addition, the domestic banks may prefer lending to the government instead of providing badly needed intermediation for additional investment projects.

My last question concerns political developments. Does the staff see a risk that the recent legal challenges against the president and the ruling Movement for Multiparty Democracy could lead to political instability?

Finally, like other directors, we encourage the authorities to publish these reports.

Mr. Ralyea made the following statement:

The Zambian authorities achieved favorable results during the current review period despite a difficult external environment. Nonetheless the authorities' work is just beginning. Many of the key reforms we flagged at the time of the last review remain "works-in-progress." The authorities have taken some steps to implement these reforms, but we cannot emphasize enough the need to proceed more aggressively with the reform effort, particularly if the Board might consider a completion point for Zambia in the future.

The staff projects a rather significant fiscal financing gap for 2003. To close the gap, we encourage the authorities to rely primarily on fiscal adjustment.

The growth in the wage bill stands out as a sore spot in the implementation of otherwise appropriate macroeconomic policies. Simply put, sustainable sources of funding are not available at this time to support the current wage bill and fund development-related spending. In that regard, we would welcome the staff's comment on Mr. Ísleifsson's statement that the authorities recently increased significantly the salaries of high-level government employees.

The lack of control over wages and wage-related spending points to a broader need for the authorities to track expenditures. As we noted during the last review, we would like to see substantial progress in strengthening expenditure management, in particular the tracking of poverty-reducing expenditures and the use of HIPC Initiative resources, and the development of a Medium-Term Expenditure Framework. A better expenditure management system would also support the government's anti-corruption initiative, which we welcome. As the authorities seek to implement that initiative, we urge them to follow due process in the prosecution of those charged with corruption. At a minimum, adherence to the rule of law would serve to deflect criticism of the initiative.

Given the difficulties the authorities have in tracking expenditures, it is with some reservation that we support additional HIPC Initiative interim assistance. A strong argument can also be made for the authorities to undertake additional adjustment to achieve debt sustainability if Zambia were to seek HIPC Initiative completion point treatment. Specifically, Footnote 10 of the staff report appears to suggest that poor economic policies since the decision point have contributed to the deterioration in the projected level of the NPV of debts-to-exports ratio.

Turning to the financial sector, we support the authorities' desire to create a modern and efficient financial sector that serves the needs of all sectors of society. A key milestone toward this end would be the privatization of ZCNB. We understand that resolution of the bank is close at hand and expect that ZCNB will be in private hands by the time of the next Board discussion of Zambia. We also urge the authorities, the Fund, and the World Bank to collaborate closely on implementing the many sound recommendations contained in the FSAP report, including those related to non-bank financial institutions and central bank independence.

The more aggressive divestiture of other state-owned enterprises would be helpful. We encourage the authorities to concession ZESCO expeditiously. We also urge the government to consider selling KCM in pieces if this will maximize the welfare of Zambia.

Finally, we appreciate the staff's mention in the report of the status of the authorities' efforts to implement recommendations of the Fiscal ROSC and various technical assistance missions. In subsequent reports, we encourage the staff to deepen coverage of this issue so that the Board can get a better picture of how the Zambian authorities are using Fund technical assistance resources. In a similar vein, we strongly encourage the authorities to consent to publication of the staff documents.

Ms. Phang made the following statement:

Like other speakers, I support the completion of the fifth review under the PRGF and the extension of additional interim assistance for Zambia under the enhanced HIPC Initiative as Zambia has performed well and has complied with practically all the performance criteria and structural benchmarks. I agree with the thrust of the staff's appraisal and I associate myself with the views expressed in the preliminary statements of Mr. Ísleifsson and Mr. Shaalan and Ms. Farhan. I will not repeat those points but would like instead to focus my comments on FDI in Zambia.

As is well known, FDI is very important for developing countries for its contribution to the developmental efforts of the country, but it is especially important for Zambia in view of its high debt situation. FDI is a non-debt channel for inflows of much needed foreign capital, expertise and technology transfer. As such, I join Mr. Çakir in asking staff to explain the reasons behind the pull-out of Anglo-American as it does not augur well for investor confidence.

Secondly, I note from Box 2 of the staff report, on the diversification of the Zambian economy, that the establishment of export processing zones (EPZs) is one of the incentives recommended for attracting investment. The experience of many other developing countries has demonstrated that EPZs tend to encourage dualism in the economy and they also tend to discourage the development of intersectoral and interfirm linkages. Strong interlinkages are critical for encouraging spillover effects which will enhance growth and improve the distributional impact on the economy.

With these comments, I wish the Zambian authorities continued success in their program.

Mr. Daïri considered that, while it was regrettable that there were expenditure overruns due to the wage increases in the past year, it ought to be recognized that, as indicated in the authorities' Letter of Intent, the wage increases had been the result of decisions that had been made in the past year by the previous administration.

It would also be useful to have an appendix in the next staff report describing the process of privatizing ZCCM and the costs to be borne by the government, and the reasons for Anglo-American's withdrawal and the lessons from the experience, Mr. Daïri continued.

Mr. Vermaeten agreed with Mr. Ralyea that Zambia had a long way to go to reach the HIPC Initiative completion point. It was not appropriate to load up conditionality on the PRGF-supported program, as it was important for the authorities to have greater ownership of the program.

Mr. Çakir considered that the agreement between the government and Anglo-American had placed all the downside risks on the government.

The staff representative from the African Department (Mr. Sharer), commenting on the possibility for further wage increases, said that he had no further information regarding the matter.

On improving the implementation of HIPC Initiative expenditures, it should be recalled that HIPC Initiative outlays were related to the PRSP priorities, and, therefore, the spending delays went beyond the general problems of public expenditure management, the staff representative explained. The PRSP process involved consultations with stakeholders. In addition, there were more complex administrative arrangements for spending HIPC Initiative resources than for regular items in the budget. The Ministry of Finance was responsible for allocating HIPC Initiative resources, but it had eight technical committees. Local governments were also much more involved in project negotiations, and donors were involved in the design of pro-poor projects. There also had to be a system for monitoring the use of the resources. Hence, spending HIPC Initiative resources was not straightforward. Therefore, in addition to helping the authorities improve public expenditure management generally, donors were assisting the authorities to reach the target level of spending under the HIPC Initiative of 2.2 percent of the total budget. Projects for 2003 were now being prepared to match the implementation capacity of line ministries.

The anti-corruption efforts should be prioritized and extended to the state enterprises, the staff representative considered. The staff would discuss with the authorities the key areas that should be focused on, particularly in the state enterprise sector.

Privatization was a controversial issue in Zambia, the staff representative remarked. However, based on the staff's discussions with the authorities, particularly at the Zambia National Commercial Bank, the authorities appeared to be committed to privatization. They has submitted detailed benchmarks and structural performance criteria in the privatization area to the Fund in the past two years—all of which had been met. The policies in the Letter of Intent had been endorsed by the president after being discussed and approved by the cabinet.

Regarding the staff's advice to lay off the government workers who had been hired in January 2002 and to rescind the wage increases, the staff felt that it was appropriate to rectify the situation early, the staff representative explained. The workers had been appointed by the previous administration just before the elections. However, the current authorities considered the staff's proposed action politically infeasible, and they would therefore have to resort to other measures in the 2003 budget to limit the wage bill to 8 percent of the budget.

Regarding the prospects for higher revenues, Zambia, with its revenue-to-GDP ratio at a little below 18 percent, already performed better than Kenya, Malawi, Mozambique, Tanzania, and Uganda, whose average revenue effort was 15.5 percent, the staff representative stated. There was scope for raising revenues somewhat through improvements in tax efficiency and by broadening the tax base. The staff had discussed a number of detailed proposals with the authorities, based on ongoing technical assistance work from the Fund and others. The revenue-to-GDP ratio, however, was unlikely to increase significantly.

The establishment of export processing zones (EPZs) had significant downside effects in terms of revenue loss and weak linkages with the rest of the economy, the staff representative agreed. There had not been any specific proposals for the introduction of EPZs in Zambia.

The unanticipated VAT refund was related to a dispute between the mining companies and the government, which the government had lost, the staff representative explained.

Concerning the questions on the mines, the previous staff report had included a detailed discussion of the implications on the Zambian economy of mine closures, the staff representative said. Anglo-American's pullout had not been due to problems in Zambia, but to the sharp decline in copper prices in international markets, which had made it difficult for the company to meet its cash-flow projections, despite the on track production and productivity growth. A new management of KCM had also come on board, which had then made the decision to pull out. The authorities had committed not to take ownership of the mining company or to subsidize its operations in the meantime and, if such subsidization became necessary, to coordinate very closely with donors for concessional support. A number of Zambia's closest donors had been sympathetic in the past and could again help Zambia at the current juncture. As a last resort, the authorities could cover the subsidy with additional revenue measures, possibly the VAT. The decision to hedge against price fluctuations would be for the mining company to make, not the government.

Improving the efficiency of domestic money markets had been an important structural objective of Zambia's Fund-supported program, and the authorities had received considerable technical assistance from the Fund, which had worked extremely well, the staff representative remarked. Domestic money markets had now become much more efficient. Nonetheless, while the increased efficiency in the domestic money markets was a major success under the program, achieving fiscal consolidation remained crucial.

On the suit brought by the opposition parties to throw out the results of the last elections, the staff did not know if those suits would be successful, the staff representative stated. It should be noted that Zambian courts had shown independence in the past.

Mr. Usman made the following concluding statement:

> Let me begin by thanking the staff for the candid and comprehensive report and for the thorough manner in which they responded to all the questions raised during this discussion. I would also like to thank colleagues for their support and their constructive remarks and favorable advice. I will certainly, as usual, faithfully convey them to my Zambian authorities.
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> My Zambian authorities have clearly persevered these past couple of years, under severe adverse conditions, to keep the program on track. They are resolute and committed to stay the course of reforms to consolidate the gains made so far, in order to achieve higher growth and higher levels of poverty reduction. They are painfully aware, as correctly pointed out by Mr. Reddy, Mr. Shaalan and Ms. Farhan, Mr. Ondo Mañe, Mr. Daïri and several other Directors, that major challenges still remain, particularly in improving public expenditure management and fiscal discipline, staying the course of structural and financial sector reforms, improving the business environment, diversifying the economic base to reduce reliance on copper and on foreign aid, and achieving debt sustainability. They are also conscious of the fact that the Zambian economy will still continue to be vulnerable to external shocks associated with volatile copper markets, droughts, continued reliance on and unpredictability of aid flows, and the inherent weaknesses of the financial sector. In this regard, I would like to underscore the point made by Mr. Brooke on the likelihood of a possible need to top up assistance under the HIPC Initiative.
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> On wages and wage overruns, I will convey to my authorities the concerns of Mr. Ísleifsson, Mr. Vittas, and several other Directors. Like the staff, I am not aware of any recent wage increases.
>
> On the other issues, I would like to reiterate my authorities' commitment to implement any additional measures to safeguard HIPC Initiative spending and address the overall fiscal deficit.

In conclusion, I would like to reassure Directors that my Zambian authorities intend to rededicate themselves with renewed determination. They hope that they can continue to count on the understanding and support of the international community and the Fund.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the improvement in economic performance since mid-2000, after two decades of high inflation, low economic growth, and declining per capita income. They commended the authorities for the sharply improved fiscal and monetary policies and substantial progress with structural reforms, which contributed to the stronger performance. However, they noted that in 2002 Zambia has been adversely affected by the withdrawal of the copper-mining company Anglo-American plc, declining world copper prices, and a severe drought, all of which curtailed economic growth and increased inflation somewhat, and which illustrated the inherent vulnerabilities facing the economy. In this regard, Directors underscored that important challenges remain in the period ahead—including HIV/AIDS, economic diversification, and food security—and that steadfast implementation of proper policies will be required to improve the investment climate and promote economic growth.

Directors welcomed the authorities' commitment to achieving fiscal sustainability by strengthening their revenue effort and containing overall expenditure. However, they expressed concern about remaining weaknesses in expenditure management. In particular, they regretted overruns in the wage bill in 2002, stemming mainly from wage awards in 2001 to defense and security forces, which have been accommodated by reducing spending elsewhere, especially in the social sectors. While acknowledging that the shortfall in social and HIPC Initiative-financed expenditure mainly reflected capacity constraints in line ministries, Directors urged the authorities to strictly implement the fiscal policies agreed under the program, including the resumption of HIPC Initiative-financed spending. They stressed that strengthened expenditure control will be essential to ensure adherence to budgetary targets and avoid accumulation of domestic arrears.

Looking ahead, Directors emphasized caution in formulating the 2003 budget in view of the uncertainties related to the food situation—which resulted from the severe drought—world copper prices, and donor assistance. They urged the authorities to increase revenue efforts and welcomed the authorities' commitment to limit the size of the wage bill by adopting the public service pay reform program. Directors also urged the authorities to improve policy implementation to mobilize additional external budget support. They welcomed the government's commitment to increase spending on HIPC Initiative-financed programs in 2003, stressing that this is crucial for reducing the high incidence of poverty in Zambia. Directors also considered it essential to vigorously implement reforms that can ensure observance of budget limits and improve public expenditure management more generally. In this connection, Directors stressed the importance of strictly adhering to the commitment to keep the wage bill no higher than 8 percent of GDP. They looked forward to the endorsement of the medium term expenditure framework by the Cabinet, which can also help to improve the quality of public expenditures. Directors also highlighted the need to reform the pension system, and welcomed the World Bank's efforts in this area.

Directors considered the monetary policy stance to be broadly adequate to achieve the inflation target. However, they urged the authorities to monitor the situation closely in light of recent inflationary pressure, and to tighten monetary policy if necessary. They noted that over the past year there has been a substantial improvement in the operations of the treasury bill market, but stressed that better coordination between the central bank and the Treasury would enhance liquidity forecasting and improve monetary targeting. There is also a need to reduce borrowing costs for the private sector, by lowering inflation and thus inflationary expectations, but also through improved financial intermediation. Directors supported maintenance of a flexible exchange rate regime to facilitate timely adjustments to changes in Zambia's external environment, and considered that the current rate is broadly appropriate. They welcomed the intended move to create an inter-bank foreign exchange market in 2003.

Directors urged the authorities to follow up vigorously on the implementation of the recommendations of the recent FSAP mission. They noted with satisfaction that the ZNCB was recapitalized recently in preparation for its privatization. Directors considered prompt privatization of ZNCB to be important for financial sector stability and fiscal sustainability. Directors welcomed the authorities' intention to address the weaknesses of the financial sector, consistent with budgetary priorities, and supported the authorities' request for technical assistance in this area. Directors urged the authorities to use effectively technical assistance being provided by the Fund and other donors in this area and in general.

Directors underlined the importance of deepening structural reforms. In particular, they considered that much remains to be done to improve the business climate. In this connection, improving the efficiency and accountability of state enterprises, as well as further privatization to raise the performance of the industrial sector, and regulatory and judicial reform should be high on the reform agenda. Also important will be the implementation of a broad diversification strategy to accelerate economic growth and reduce the economy's vulnerability. Directors commended the authorities for maintaining a liberal trade regime.

Directors emphasized the importance of improving governance by enhancing the transparency and accountability of government operations. They welcomed the launching of an anti-corruption drive, the submission of the cobalt report to the parliament, and the regular publication of information on government budget implementation and use of HIPC Initiative resources. They encouraged the authorities to enact the Anti-Money Laundering Act and to take further action to combat the financing of terrorism.

Directors noted the government's effort to incorporate part of the PRSP priority expenditure in the 2002 budget and the progress made in tracking social and poverty related expenditure. They welcomed the authorities' intention to restore HIPC Initiative spending to 2.2 percent of GDP in 2003, noting that the PRSP provides a framework for the allocation of resources freed up under the HIPC Initiative. They emphasized the need to implement the triggers for reaching the completion point under the enhanced HIPC Initiative, especially to improve the level and quality of social sector expenditures.

It is expected that the next Article IV consultation with Zambia will be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002.

Additional Points Relating to the Fifth Review Under the Poverty Reduction and Growth Facility; and to the Extension of Additional Interim Assistance under the Enhanced HIPC Initiative

Directors welcomed the continued improvement in Zambia's economic performance under the program, despite the difficult external and domestic economic environment. They commended the authorities for concluding a satisfactory agreement with the foreign company that has announced its withdrawal from the copper mines, noting in particular that the agreement does not include a government take-over of the mines.

Directors also noted that the shortfall in social and HIPC-financed expenditures mainly reflected capacity constraints, and they welcomed the authorities' commitment to quickly implement the agreed corrective measures, including restoring HIPC-financed expenditure in the second half of 2002 to levels consistent with the poverty reduction goal of the PRSP. Directors emphasized that effective control of expenditure will be essential to ensure adherence to spending priorities in favor of economic infrastructure, social sectors, and poverty reduction, and to avoid accumulation of payment arrears. They stressed that adhering to the 2002 fiscal policy targets and maintaining an appropriately tight monetary policy will be a key to achieving the macroeconomic targets of the program.

Directors noted several structural reforms that are critical for the success of the program. These include speedy privatization of the Zambia National Commercial Bank; preparation of a plan to address the weaknesses in the financial sector, including those in the state-owned nonbank financial institutions; completion of the oil sector reform; and continued improvement in transparency and accountability in government operations to improve governance.

Directors noted that Zambia is likely to face difficulties in achieving debt sustainability at the completion point under the HIPC Initiatives due to falling copper prices, and that significant additional debt relief may need to be considered beyond that provided under the HIPC Initiative. In this context, they again stressed the necessity of ensuring that the program stays on track by steadfast implementation of policy measures.

The Executive Board took the following decisions:

Poverty Reduction and Growth Facility—Review Under Three-Year Arrangement

1. Zambia has consulted with the Fund in accordance with paragraph 2(g) of the three-year arrangement for Zambia under the Poverty Reduction and Growth Facility (PRGF) (EBS/99/35, Sup. 1, 3/26/99) and paragraph 39 of the letter dated May 9, 2002 from the Minister of Finance and National Planning of Zambia in order to review program implementation.

2. The letter dated November 8, 2002 from the Minister of Finance and National Planning of Zambia (the "Letter"), together with its Technical Memorandum of Understanding (the "Technical Memorandum"), shall be attached to the PRGF arrangement for Zambia, and the letter dated March 10, 1999 from the Minister of Finance and Economic Development of Zambia, as modified, shall be read as supplemented and modified by the Letter and its attached Technical Memorandum.

3. Accordingly, the PRGF arrangement for Zambia shall be amended as follows:

a. the following shall be added as new paragraphs 2(aaaaaa) and 2(bbbbbb):

"(aaaaaa) Zambia will not request the eleventh disbursement referred to in paragraph 1(ccc)(vii) above if the Managing Director of the Trustee finds that the data as of December 31, 2002 indicate that any of the ceilings and floors referred to in paragraphs 2(a)(i) to 2(a)(iv) of this arrangement as specified in Table 1 of the Letter and in the Technical Memorandum, were not observed; or" "(bbbbbb) Zambia will not request the eleventh disbursement referred to in paragraph 1(ccc)(vii) above if the Managing Director of the Trustee finds that Zambia has not carried out its intentions with respect to the structural performance criteria specified in Table 2 of the Letter and in the Technical Memorandum; or"

b. Paragraph 2(ccccc) of the arrangement shall be renumbered as 2(cc) and the following shall be added as new paragraph 2(ccc):

"(ccc) Zambia will not request the eleventh disbursement referred to in paragraph 1(ccc)(vii) above if it has taken any of the actions specified in paragraph 2(c) and (d) of this arrangement, or if the central government or the Bank of Zambia collateralizes or guarantees at any time any loans for ZESCO or ZNOC, as defined in Table 1 of the Letter; or"

c. the following shall be added as new paragraph 2(gg):

"(gg) Zambia will not request the eleventh disbursement specified in paragraph 1(ccc)(vii) above until the Trustee has determined that the sixth review referred to in paragraph 34 of the Letter has been completed."

4. The Fund decides that the fifth review contemplated in 2(g) of the arrangement for Zambia under the PRGF is completed. (EBS/02/189, 11/14/02)

Decision No.12889-(02/117), adopted
November 27, 2002

Enhanced Initiative for Heavily Indebted Poor Countries—Additional Interim Assistance

The Fund as Trustee (the "Trustee") of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations (the "Trust") decides:

(a) that satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Zambia's other creditors continue to be in place, and

(b) that the Trustee shall disburse to Zambia as additional interim assistance the equivalent of SDR 117.2 million, which shall be made available by the Trustee to Zambia in the form of a grant that shall be paid no later than three business days after the adoption of this decision to the account for the benefit of Zambia established and administered by the Trustee in accordance with Section III, paragraph 5 of the Trust Instrument; the proceeds of the grant shall be used by the Trustee to meet Zambia's debt-service payments on its existing debt to the Fund as they fall due, in accordance with the following schedule: 69.5 percent of Zambia's principal obligations falling due between January 1, 2003 and December 31, 2003, and

(c) For the purposes of Section III, paragraph 3 (d) of the Trust Instrument, the condition for the disbursement under (b) above is that Zambia has met (i) all of the end-June 2002 quantitative performance criteria as specified in paragraph 2 (aaaaa), (ii) the end-May and end-September 2002 structural performance criteria as specified in paragraph 2 (bbbbb) and (iii) the continuous performance criteria as specified in paragraph 2 (cc), of the three-year PRGF arrangement for Zambia. (EBS/02/189, 11/14/02)

Decision No. 12890-(02/117), adopted
November 27, 2002

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/116 (11/22/02) and EBM/02/117 (11/27/02).

2. FRAMEWORK ADMINISTERED ACCOUNT FOR TECHNICAL ASSISTANCE ACTIVITIES—SWEDEN TECHNICAL ASSISTANCE SUBACCOUNT

In accordance with the terms and conditions of the Instrument establishing the Framework Administered Account for Technical Assistance Activities (Decision No. 10942-(95/33)), as amended, the Fund hereby approves the establishment of the "Sweden Technical Assistance Subaccount," which shall be used by the Fund to administer resources to be contributed by the Government of Sweden, as described in EBS/02/191 (11/18/02)

Decision No. 12891-(02/117), adopted
November 25, 2002

3. EXECUTIVE BOARD COMMITTEES—NOMINATIONS

The Executive Board approves the proposal by the Managing Director renewals in membership and changes in committee assignments as set forth in EBD/02/153 (11/15/02)

Adopted November 22, 2002

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 02/84 and 02/92 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/02/146 (11/22/02) and EBAM/02/147 (11/25/02) is approved.

APPROVAL: February 4, 2003

SHAILENDRA J. ANJARIA
Secretary