Office Memorandum

To: Members of the Executive Board — July 14, 2014

From: The Secretary

Subject: **Zambia—Assessment Letter for the African Development Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in Zambia which was requested by the African Development Bank (AfDB).

If the authorities of Zambia consent to the publication of this assessment, it may be published by the AfDB.

Questions may be referred to Mr. Tsikata (ext. 39601), Mr. Jang (ext. 34169), and Mr. Ismail (ext. 37905) in AFR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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FO/DIS/14/113

Zambia—Assessment Letter for the African Development Bank
July 10, 2014

This note provides IMF staff's assessment of recent economic developments and the outlook for Zambia. It reflects discussions with the authorities during the staff mission to Lusaka May 26—June 6, 2014. The immediate challenge is to address the fiscal deterioration.

Recent Economic Developments

1. **Growth remains strong, with inflation slowly increasing.** Despite a weak harvest, real GDP growth was 6.7 percent in 2013, with strong performance in services, construction, and exports. Inflation was 7 percent in 2013, and has been rising gradually, reflecting higher food prices as well as the large civil service salary increase in late 2013 and recent exchange rate depreciation. Following the recent rebasing of the GDP series, nominal GDP in 2013 is 20 percent higher than the estimate used in the 2013 Article IV Staff Report.

2. **The fiscal deficit increased sharply in 2013,** to 6.6 percent of rebased GDP, up from 2.9 percent in 2012.[1] The underlying deficit was 7.6 percent of GDP.[2] The significant fiscal expansion was driven by fuel and maize-related subsidies and spending on wages and roads. The deficit was financed with treasury securities, drawing down the 2012 Eurobond proceeds, and direct central bank lending to the government.

3. **Government financing costs are rising.** On the domestic market, interest rates have risen by around 800 basis points since end-2012, driven by the sizable government domestic financing needs and tightened liquidity conditions. Treasury bill auctions have been largely undersubscribed in 2014. On the international market, spreads have widened in comparison to other SSA issuers. The recent US$1 billion Eurobond was issued at a yield of 8.625 percent, 300 basis points higher than on the 2012 Eurobond at issuance.

4. **The external position is under pressure.** The current account balance, although still in surplus, deteriorated by 2.4 percent of GDP in 2013, primarily due to a significant rise in non-FDI financed imports and income repatriation by mines. FDI fell by about a third. From end-2013 to late-March 2014, the exchange rate depreciated by around 15 percent, as a decline in copper prices compounded pressures from loose fiscal policy and uncertainty about the outlook. The government responded by tightening monetary policy and revoking two statutory instruments—one that restricted the use of foreign currencies in domestic transactions and another that tightened reporting requirement on foreign transactions—with

[1] The 2013 deficit figure includes 0.8 percent of GDP stemming from Government taking over Food Reserve Agency government-guaranteed debts but excludes the accumulation of pension arrears amounting to 0.5 percent of GDP.

[2] In 2013, the government tightened documentation requirements on VAT refunds, which led to a significant backlog of refunds to mines and other exporters. This backlog was about 1 percent of GDP at end-2013 and has continued to accumulate in 2014.

the aim of attracting foreign currency inflows. Tightened liquidity together with a gradual recovery in copper prices have helped stabilize the exchange rate as of end-June.

5. Monetary policy has carried the burden of fighting depreciation. The Bank of Zambia (BoZ) increased reserve requirements from 8 to 14 percent and the policy rate by 225 basis points. In addition, the BoZ raised the overnight lending facility rate significantly (from 2.5 to 10 percentage points above the policy rate) and expanded the coverage of reserve requirements. BoZ also sold about $500 million in international reserves, which stood at 2.3 months of imports at end-May. The BoZ intends to maintain tight monetary policy to contain 2014 inflation to 8–8½ percent.

Outlook

6. The immediate policy challenge is to contain the 2014 fiscal deficit to the budgeted level and then to establish permanently stronger balances. So far in 2014, the fiscal outturn net of VAT refunds has been broadly in line with the budget, but for the year as a whole there are likely to be again significant overruns on wages, subsidies, and roads. The authorities aim to maintain the deficit at the budget target of 5.2 percent of rebased GDP, and maximum 4 percent in 2015. Planned measures include delaying about 1 percent of GDP in non-road infrastructure investment. Staff welcomes these plans but stresses that additional permanent measures, including containing current spending and bolstering revenues, will be needed to bring the deficits closer to the authorities' medium-term target of 3 percent of GDP. Reducing the deficit to this target would stem the rapid increase in public debt. While the debt-to GDP ratio remains low at around 30 percent of GDP, it has increased by over 50 percent since 2011. In order to support fiscal consolidation efforts, the authorities also need to accelerate administrative reforms especially on the Treasury Single Account (TSA) and cash management. The authorities are in the process of identifying the needed fiscal measures and are making some progress on the TSA. Moreover, they indicated that they intend to resolve quickly the VAT refund issues and prepare a plan to clear the arrears.

7. Provided that the fiscal challenges are effectively addressed, the economic outlook is broadly positive. Growth is expected to remain buoyant at about 6.5 percent in 2014, and increase to over 7 percent in 2015 on the back of higher mining production. However, sustaining high growth rates requires significant fiscal adjustment to build confidence, stem the deterioration in the external and debt positions, and allow a normalization of monetary policy and lower interest rates. Additionally, the business climate needs increased policy transparency, consistency, and consultation with stakeholders.

8. Risks to the outlook are significant. The balance of risks to growth is on the downside due to uncertainties stemming from the weak fiscal position and the remaining need to develop a credible medium-term consolidation plan. Other key risks include potential adverse weather conditions, financial fallout from tightened monetary policy in advanced countries, and a possible sustained decline in commodity prices triggered by deceleration of global demand.

Relations with the Fund

9. Zambia is on the standard 12-month cycle for bilateral consultations under Article IV of the IMF's Articles of Agreement. The Executive Board concluded the 2013 Article IV consultation with Zambia on December 11, 2013. The authorities have requested the IMF team to return to Zambia in September to discuss an economic program that could be supported by a Fund arrangement.

Table 1. Zambia: Selected Economic Indicators, 2011–14

	2011	2012	2013	2014
		Actual	Prel.	Proj.
	(Percentage Change)			
National account and prices				
GDP growth at constant prices	6.4	6.8	6.7	6.5
Mining	-5.2	-2.7	5.9	6.8
Non mining	8.1	8.0	6.8	6.4
GDP deflator	11.6	4.2	5.7	8.0
GDP at market prices (millions of kwacha)	115,353	128,370	144,775	166,474
Consumer prices				
Consumer prices (average)	8.7	6.6	7.0	8.0
Consumer prices (end of period)	7.2	7.3	7.1	8.5
External sector				
Terms of trade (deterioration -)	6.1	-13.4	-7.4	-5.0
Average exchange rate (kwacha per U.S. dollar)	4.861	5.147	5.396	...
(percentage change; depreciation -)	-1.3	-5.9	-4.8	...
Real effective exchange rate (depreciation -)[1]	-2.6	3.3	3.7	...
Money and credit (end of period, unless otherwise specified)				
Domestic credit to the private sector	28.2	37.0	12.6	14.7
Reserve money (end of period)	6.8	51.4	-0.4	32.8
Broad Money (M3)	21.7	17.9	20.8	19.1
	(Percent of GDP; unless otherwise indicated)			
National accounts				
Gross investment	33.5	34.2	33.6	31.9
Government	3.4	6.2	6.7	5.2
Private	30.1	28.0	26.9	26.7
National savings	36.5	37.3	34.3	33.4
Net lending(+)/net borrowing(-)	3.0	3.1	0.7	1.5
Central government budget				
Revenue	17.5	19.1	18.9	19.0
Taxes	15.6	15.0	14.7	15.0
Grants	0.6	1.7	1.9	1.2
Other revenue	1.3	2.4	2.2	2.8
Expenditure	19.3	22.3	25.5	24.2
Expense	15.9	16.2	18.8	19.0
Net acquisition of nonfinancial assets	3.4	6.2	6.7	5.2
Net lending/borrowing[2]	-1.0	-2.9	-6.6	-5.2
Excluding grants	-1.6	-4.6	-8.5	-6.3
Net acquisition of financial assets	1.9	1.7	-1.0	0.7
Domestic	1.9	1.7	-1.0	0.7
Foreign	0.0	0.0	0.0	0.0
Net incurrance of liabilities	2.9	4.6	5.5	5.9
Domestic	1.9	0.9	5.0	1.2
Foreign	1.0	3.7	0.5	4.7
External sector				
Current account balance	3.0	3.1	0.7	1.5
(excluding grants)	2.4	2.4	0.3	1.3
Gross International Reserves (months of prospective imports)[3]	2.8	2.8	2.6	2.4
Excluding FDI-financed imports	3.3	3.1	2.9	2.8
Public debt				
Total central government debt, gross (end-period)	20.6	25.5	28.7	32.4
External	8.3	13.5	13.0	17.8
Stock of domestic debt, gross	12.3	12.0	15.7	14.6

Sources: Zambian authorities; and IMF staff estimates and projections.

[1] Excludes Zimbabwe.

[2] Including discrepancy between the above-the-line balance and below-the-line financing.

[3] Unencumbered reserves only.