

ZAMBIA ECONOMIC BRIEF

BEATING THE SLOWDOWN: MAKING EVERY KWACHA COUNT

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7th ZAMBIA ECONOMIC BRIEF

**BEATING THE SLOWDOWN:
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COUNT**



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IACRONYMS

| | |
|-------|--|
| BoZ | Bank of Zambia |
| CSG | Child Support Grant |
| CSO | Central Statistical Office |
| DfID | Department for International Development |
| ERB | Energy Regulation Board |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| IMF | International Monetary Fund |
| KW | Kilo Watt |
| KWh | Kilo Watt per Hour |
| LCMS | Living Conditions Monitoring Survey |
| MW | Mega Watts |
| PPP | Purchasing Power Parity |
| SSA | Sub-Saharan Africa |
| TEVET | Technical Education and Vocational and Entrepreneurship Training |
| US\$ | United States Dollar |
| VAT | Value Added Tax |
| WBG | World Bank Group |
| ZMW | Zambian Kwacha |

FOREWORD

I am pleased to share the seventh Zambia Economic Brief with a focus section on improving the quality of public expenditure and making every kwacha count. This Brief is part of a series of short economic updates produced twice a year by the World Bank.

Each Brief includes two sections: the World Bank's assessment of recent economic developments and the outlook in the short to medium term, and its analysis of a specific development topic or theme. Previous Briefs covered opportunities for the power sector, mining, jobs, trade, and financial inclusion and can be found on the World Bank's Zambia website.

Since mid-2015, the Zambian economy has come under strain as the global conditions for growth have become much tougher. Added to this are domestic pressures such as the ongoing power crisis and reduced investor confidence. This leaves the government with little room for maneuver, limited fiscal space to compensate for slower growth, and only hard choices.

We now see that the past decade of growth was not sufficiently pro-poor and the benefits have accrued mainly to the richer segments of the population in urban areas. Poverty remains far higher for the ru-

ral population than their urban counterparts, and income growth between 2006 and 2015 was greatest among those with higher incomes and relatively weak for those with lower incomes.

There remains a need to look closely at public expenditure and ensure that its allocation and quality is improved. By making every kwacha count, a return to faster growth will be expedited, and growth itself can be made more inclusive to support households' escape from poverty and to ensure prosperity is better shared in Zambia.

We hope that the findings of this Economic Brief will stimulate a healthy debate around these questions so that Zambia can beat the recent slowdown and shift to a path of more inclusive growth.



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EXECUTIVE SUMMARY

Regional economic developments

The external environment confronting Sub-Saharan Africa (SSA) is expected to remain difficult in the near term. Commodity prices are expected to remain low, and in 2016, growth in the region is forecast to drop to 2.5% from 3.0% in 2015 (World Bank forecast). There is considerable variation in economic performance across countries, with the slowdown concentrated among the region's largest commodity exporters. Growing economic vulnerabilities, amid weakened policy buffers, continue to pose challenges for policy makers.

The balance of risks to the outlook remains tilted to the downside. The global risks include: (i) a sharper than expected slowdown in China (as the country rebalances growth toward consumption and services), (ii) a further decline in commodity prices, and (iii) tighter global financing conditions that would result in higher borrowing costs and reduced sovereign bond access for emerging and frontier countries. On the domestic front, delays in adjustment to external shocks in affected countries would create policy uncertainties that could weigh on investor sentiment and weaken the recovery.

The state of the Zambian economy

Since mid-2015, the Zambian economy has come under strain as external headwinds and domestic pressures have intensified. Zambia is facing tough conditions for growth, which is estimated to have slowed to 3.2% in 2015. The external headwinds include slower regional and global growth (crucially in China) and lower copper prices. Domestic pressures include a power crisis impacting on all sectors of the economy and repeat fiscal deficits that have increased the cost of maintaining macroeconomic stability and reduced investor confidence.

The fall in copper prices and the slower growth were met in 2015 with large shifts in the exchange rate and inflation above 20%. Since fiscal policy has been expansionary, monetary policy has shouldered the burden of moderating inflation. Though costly, monetary policy actions have proved effective, as the

extreme exchange rate shifts of 2015 have so far been avoided in 2016 and inflation has started to decelerate.

The Living Conditions Monitoring Survey (LCMS) finds that despite a GDP growth averaging 7.4% between 2004 and 2014, there has only been a marginal reduction in poverty. The Central Statistical Office (CSO) reports that in 2015, 54.4% of the population were defined as poor and 40.8% of the population were experiencing extreme poverty as per the government's poverty line. Using the US\$ 1.9 per day (2011 PPP terms) measure for international comparison, poverty is estimated at 61.3% in 2015. The poverty measured is largely a rural phenomenon with 77% of the poorest households located in rural areas.

Zambia's economic outlook

GDP growth is forecast to remain close to 3.0% in 2016, before improving in 2017 (4.2%) and again in 2018 (5.0%). For 2016, this assumes new power generation capacity comes on line and a better harvest is achieved. Despite the current slowdown, long-term investment in mineral and non-mineral sectors in Zambia remains attractive.

The outlook for the Zambian economy is underpinned by four main assumptions. First, copper prices remain low, based on World Bank forecasts that suggest commodity prices are likely to remain soft throughout 2016 and 2017. However, if global copper supply better matches demand, and prices recover once again, improved growth could be achieved. Second, uncertainty about whether persistent and growing fiscal deficits can be reined in is met with clear and credible budget policies toward a more sustainable fiscal stance supporting medium-term growth. Third, confidence in the economy is improved via an agreement with the International Monetary Fund (IMF) on a program of support. An IMF program would help in restoring investor confidence and give other cooperating partners greater confidence to provide budget support. Fourth, the impact of the power crisis is less severe than in 2015

as new generation capacity comes on stream.

The outlook is subject to both domestic and external downside risks. Externally, output growth in China that is lower than predicted would weigh on the demand for Zambia's exports, further reducing copper prices, and would severely affect Zambia's prospects.

The main domestic risks are fourfold: (i) that the power crisis does not abate and continues into 2017; (ii) that a lack of fiscal adjustment takes place, so that the cost of macroeconomic stabilization remains high in terms of expensive and limited availability of credit to the private sector; (iii) that an excessively abrupt or disorderly fiscal adjustment takes place, eliminating any improvement of confidence in the economy that a well-planned shift to fiscal sustainability might bring; and (iv) that if fiscal deficits persist and exchange rate uncertainty continues to be a threat to inflation, tight monetary policy will continue to dampen credit growth and reduce economic growth in 2016 and 2017.

Economic policy challenges

Commodity-exporting countries' policy makers face increasing challenges across the globe. Zambia is no exception and must grapple with multiple challenges. Falling copper prices and a power crisis could be met with fiscal buffers, but in Zambia, such buffers were insufficiently built up when the economy was prospering. Furthermore, the debt burden has increased following repeat non-concessional borrowing and the depreciation of the kwacha.

This leaves the government with little room for maneuver, and large fiscal deficits and inefficiencies in government spending persist as sources of vulnerability for the country. Fiscal adjustment would put less pressure on monetary policy and eventually make space for interest rates to be reduced, easing the pressure on individuals and firms. It would also increase the confidence of domestic and international investors.

With market access comes greater scrutiny, and the credibility or otherwise of policy responses to shocks affects interest costs of new borrowing. The Eurobond issuance has also increased international observance of the Zambian economy and events are being watched much more closely than prior to 2012. To help maintain confidence in the economy, and Zambia as an investment destination, better dialogue on the economy should be targeted. A key step includes the timely publication of a debt strategy and the provision of quarterly debt and fiscal numbers on the Ministry of Finance website.

The commodity price shock highlights the need for Zambia to reduce its dependency on copper, a challenge it has been grappling with for over 50 years. Statements about diversification and growing

manufacturing need to be met by a clear and realistic strategy, and by structural reforms aimed at removing impediments to private sector activity and improving the business environment. The Seventh National Development Plan provides a good opportunity to set this agenda.

Making every kwacha count

Fiscal adjustment should be accompanied by a shift in spending priorities that support both the efficiency of public expenditures and long-term inclusive growth. While in many areas this is difficult to achieve, there are obvious areas for attention, including the growing cost of fuel subsidies.

Over the past five years, public expenditure has increased at an annual average of 13.8% (in real terms) and a thorough review of the quality of this expenditure is required. There is need to identify and reallocate under-utilized resources to ensure that every kwacha spent is contributing towards each sector's objectives. Furthermore, the preliminary results from the LCMS 2015 suggest that economic expansion since the early 2000s has not sufficiently benefited the poor. The growth has been exclusive rather than inclusive.

A key area of under-utilized expenditure is the government subsidy of fuel and electricity. It is estimated that fuel subsidies have averaged close to US\$36 million per month between September 2015 and May 2016 and electricity subsidies around US\$26 million per month, a combined total of US\$576 million, putting huge pressure on the budget.

To beat the slowdown, there is a need to make every kwacha of government expenditure count. Ideas aimed to ensure the quality of expenditure improves include: (i) eliminating fuel subsidies; (ii) improving the financial sustainability of the power sector; (iii) protecting the poor during the transition by scaling up the Social Cash Transfer system; and (iv) carrying out a review of public expenditure in key sectors so that the allocation of expenditure can be improved and lessons to boost the efficiency of spending can be found.

SECTION 1 RECENT ECONOMIC DEVELOPMENTS

A. REGIONAL ECONOMIC DEVELOPMENTS

The external environment confronting Sub-Saharan Africa is expected to remain difficult in the near term. Commodity prices are expected to remain low, and in 2016, growth in the region is forecast to drop to 2.5% from 3.0% in 2015. There is considerable variation in economic performance across countries, with the slowdown concentrated among the region's largest commodity exporters. Growing economic vulnerabilities, amid weakened policy buffers, continue to pose challenges for policy makers.

Economic activity in SSA slowed in 2015, with GDP growth averaging 3.0%.

The World Bank's *Africa's Pulse* (April 2016) highlighted a sluggish global economic environment facing SSA¹. The region weakened significantly in 2015, with commodity prices falling sharply and global growth remaining anemic, slipping to 2.4%, from 2.6% in 2014. In this context, economic activity in SSA slowed in 2015, with GDP growth averaging 3.0%, down from 4.5% percent in 2014².

The deceleration in growth was driven by low commodity prices, weak growth in major trading partners, rising borrowing costs, and adverse domestic developments in many countries. This low pace of growth was last experienced by SSA in 2009, following the global financial crisis, and contrasts sharply with the robust 6.8% average annual growth in GDP that the region enjoyed in 2003-08. The slowdown in growth implies that GDP per capita increased by less than 0.5% in 2015, further complicating the challenge of accelerating poverty reduction in the region.

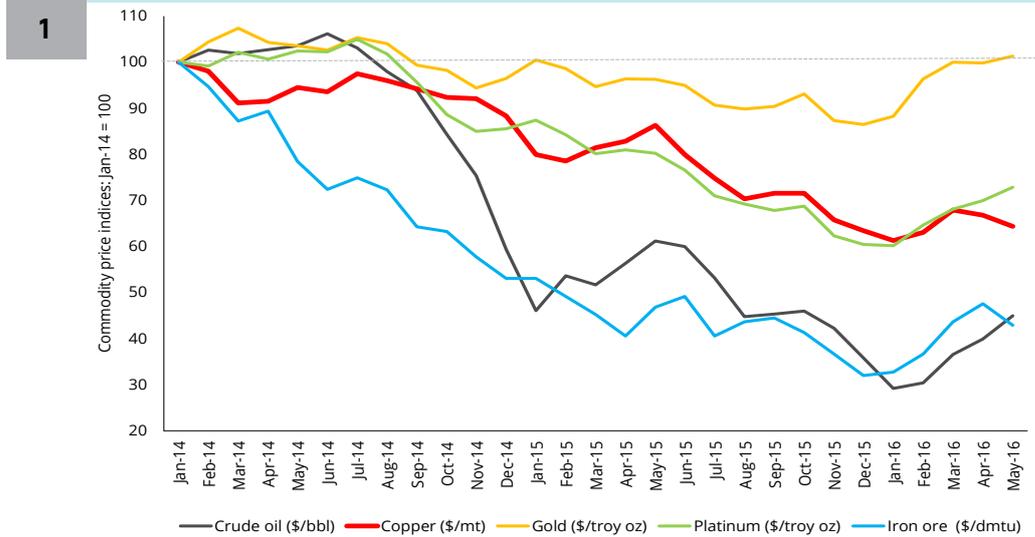
The fall in commodity prices in 2015 (figure 1) represented a significant shock for SSA because of the large share of commodities in exports: fuels, ore, and metals account for more than 60% of the region's exports compared with 16% for manufactured goods and 10% for agricultural products.

Metal prices sustained a steep drop, due in large part to weak global demand.

Oil prices have declined markedly, falling by about 57%, from US\$112 per barrel in June 2014 (Brent Crude) to US\$47 per barrel at end-May 2016 (albeit above a low of US\$31 per barrel in January 2016)³. Prices of agricultural commodities and metals declined in 2015 as well, but at a slower pace than the price of oil. Among non-energy commodities, metal prices sustained a steeper drop, driven by large declines in the prices of iron ore, platinum and copper, due in large part to weak global demand, especially from China and other large emerging market economies.

Going beyond the regional aggregate, there was considerable variation in growth performance across countries. Activity also weakened in non-energy mineral exporting countries, including Botswana, Guinea, Liberia, Sierra Leone, South Africa and Zambia. These countries benefited less from lower oil prices due to sharp declines in the price of metals, including copper, diamonds, iron ore and platinum, their main commodity exports.

Figure 1 Commodity prices softened further in 2015



Source: World Bank Commodity Markets Data

The adverse impact of low metal prices was further compounded by domestic problems.

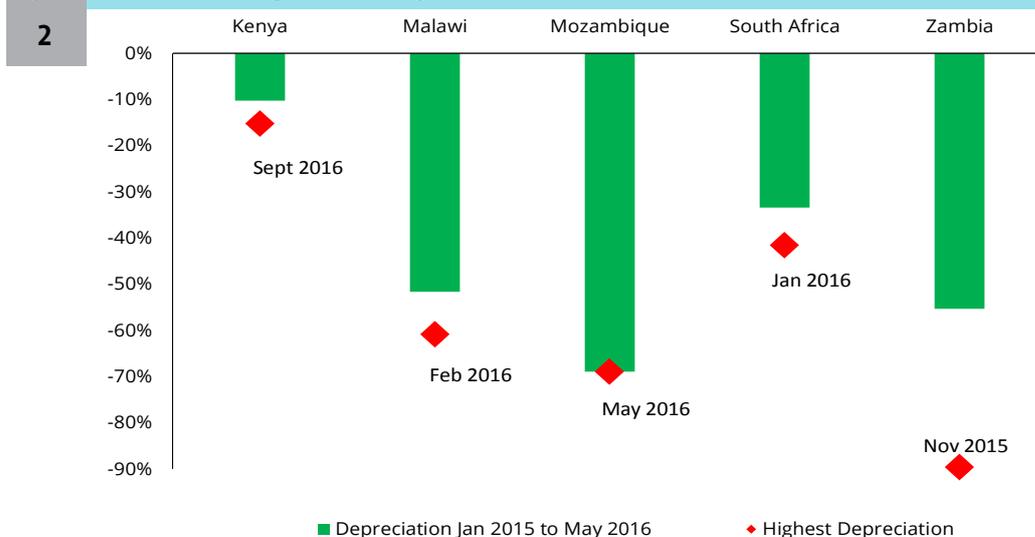
The adverse impact of low metal prices was further compounded by domestic problems. Poor 2014-15 season rainfall in the Southern Africa region (Botswana, South Africa and Zambia) curtailed agricultural production and hydroelectricity generation in 2015.

Worsening current account and fiscal imbalances propagated a depreciation in most resource-dependent currencies.

Worsening current account and fiscal imbalances propagated a depreciation in most resource-dependent currencies in 2015 (figure 2). This depreciation was compounded by a general increase in the demand for the US dollar (US\$) in anticipation of an increase in the US Federal Reserve Rate. Domestic factors also weighed on some currency depreciation.

Headline inflation exceeded central banks' targets in several countries, some of which saw double-digit inflation. Monetary authorities in countries with a flexible exchange rate regime responded by letting currencies depreciate more (Mozambique, Tanzania, and Uganda), and by tightening monetary policy through an increase in reserve requirements and policy rates (South Africa, Uganda and Zambia).

Figure 2 Currencies depreciated against the US\$ in 2015 and 2016



Source: World Bank (2016a)

Compounding the external pressures, fiscal positions weakened across the region.

Compounding the external pressures, fiscal positions weakened across the region. Oil exporters (Angola, Chad, Gabon, Nigeria and the Republic of Congo) faced a substantial decrease in revenues that put pressure on the overall fiscal balance. The fiscal policy response to the revenue shortfalls has varied, highlighting the need for a medium-term

strategy to deal with the commodity price shock. Several countries cut expenditures in the face of declining revenues, with the expenditure cuts matching the reduction in revenues in only a few countries.

Among oil exporters, fiscal deficits are estimated to have increased by an average of 1.5% of GDP in 2015 from their 2014 levels. In other non-resource-rich countries (Ethiopia, Kenya, Madagascar and Malawi), an expenditure overrun and shortfall in revenue (in some cases grants) caused the fiscal deficit to widen. Elevated or rising fiscal and current account deficits signal weaker policy frameworks in a number of countries, thus constraining their policy responses to a more difficult economic environment.

As a result of the limited fiscal adjustment, public debt burdens have risen. New non-concessional borrowing and exchange rate depreciations have contributed to the rising debt levels, and debt ratios in 2015 were well above the levels in 2011–13.

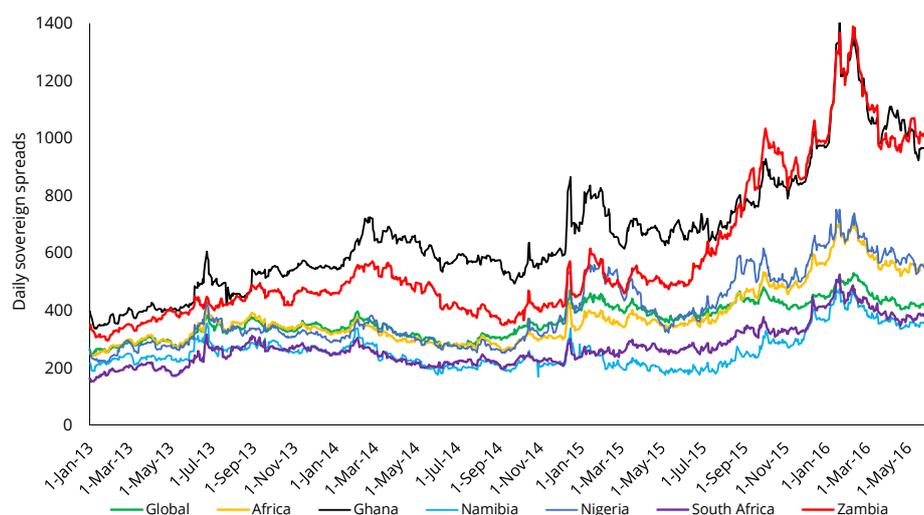
Since 2007, 16 Sub-Saharan African countries, excluding South Africa, have tapped US\$27 billion from international debt markets, typically at fixed interest rates, with bullet repayment structures and in US\$, thereby adding foreign currency risk that countries need to manage. The cost of borrowing increased sharply in 2015 for many sovereigns and the spreads widened in 2015 over uncertainty about government policies and a slowdown in the economies, although there was some reversal of that trend in Q1 2016 (figure 3).

As a result of the limited fiscal adjustment, public debt burdens have risen.

Since 2007, 16 Sub-Saharan African countries, excluding South Africa, have tapped US\$ 27 billion.

Figure 3 Spreads have increased most where market confidence is weakest

3



Source: Bloomberg

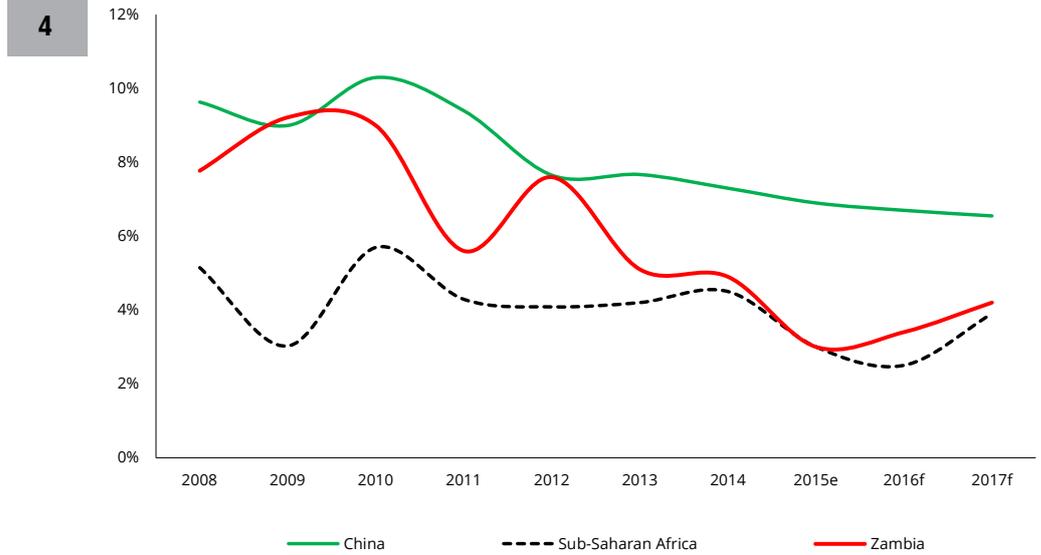
Outlook for Sub-Saharan Africa

The external environment confronting SSA is expected to remain difficult in the near term. Commodity prices are expected to remain low, amid a gradual pickup in global activity, especially in emerging markets and developing economies, while external financing conditions are expected to tighten. Against this backdrop, average growth in SSA is projected to decline to 2.5% in 2016. Over the medium term, the region's growth is forecast to rise to 3.9% in 2017 and 4.4% in 2018, driven by a gradual improvement in the region's largest economies as commodity prices stabilize and policies become more supportive of growth (figure 4).

China's rebalancing, lower commodity prices, and deteriorating growth prospects in many commodity exporters are expected to result in further declines in foreign direct investment (FDI) flows. Domestic policies also weigh on private investment and the tightening of global financing conditions has prompted many countries to delay tapping the international bond market in 2016.

Average growth in SSA is projected to drop to 2.5% in 2016.

Figure 4 Growth in SSA and developing countries has slowed



Source: World Bank (2016a)
 Note: e = estimate, f = forecast

In some countries, further fiscal adjustment may be necessary unless commodity prices pick up swiftly.

In some countries, further fiscal adjustment may be necessary unless commodity prices pick up swiftly or external resources are available to smooth the adjustment. With fiscal deficits widening across the region, other countries, including the low-income non-oil commodity exporters, are also increasingly facing the need for fiscal consolidation to build buffers and resilience.

Delays in adjustment to external shocks could weigh on investor sentiment and weaken the recovery.

Net exports are expected to make a negative contribution to real GDP growth in the near term, despite currency depreciations. Low commodity prices will depress export receipts, especially among oil exporters, even as export volumes rise in some countries. The pull from advanced economies is expected to remain modest, given their moderate prospects for medium-term growth.

The balance of risks to the outlook remains tilted to the downside. The global risks include: (i) a sharper than expected slowdown in China (as the country rebalances growth toward consumption and services), (ii) a further decline in commodity prices, and (iii) tighter global financing conditions that would result in higher borrowing costs and reduced sovereign bond access for emerging and frontier countries.

On the domestic front, delays in adjustment to external shocks in affected countries would create policy uncertainties that could weigh on investor sentiment and weaken the recovery. For most countries in the region, adjusting to the low commodity prices will need to include stronger efforts to strengthen domestic resource mobilization, to reduce overdependence on revenue from the resource sector.

B. THE STATE OF THE ZAMBIAN ECONOMY

Since mid-2015, the economy has come under strain as external headwinds and domestic pressures have intensified. Zambia is facing its toughest economic challenges in at least a decade as growth slowed to an estimated 3.2% in 2015. The external headwinds include slower regional and global growth (crucially in China) and lower copper prices. Domestic pressures include a power crisis impacting on all sectors of the economy and repeat fiscal deficits that have increased the cost of macroeconomic stabilization and reduced investor confidence.

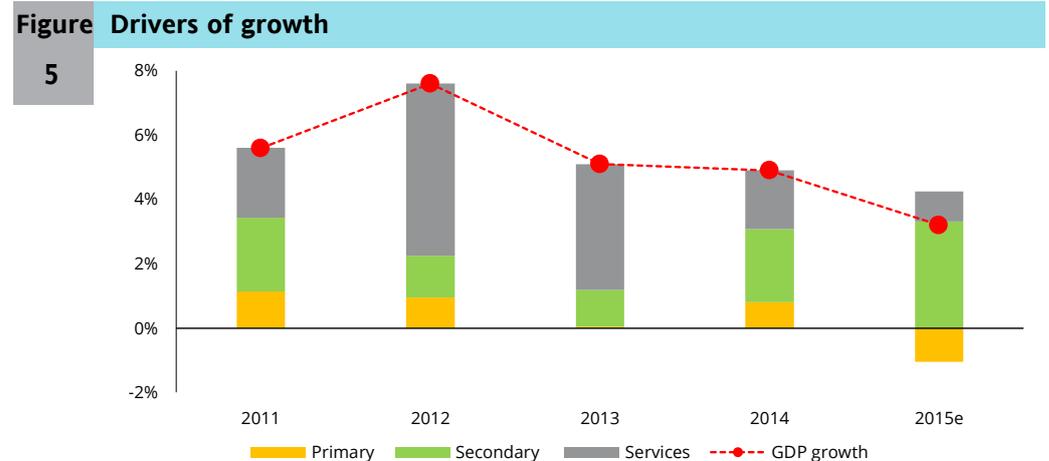
Zambia is facing its toughest economic challenges in at least a decade as growth slowed to an estimated 3.2% in 2015.

Conditions for growth have become tougher

The Zambian economy grew at an average annual rate of 7.4% between 2004 and 2014, above the overall growth rate of SSA, on the back of high copper prices, foreign direct investment in the manufacturing and mining sectors, government investment in infrastructure, and expanding private sector investment in construction and services. Times have changed and since mid-2015, the economy has slowed considerably as global headwinds and domestic pressures have intensified. Zambia is facing its toughest economic challenges in at least a decade and according to preliminary data from the government, growth slowed to an estimated 3.2% in 2015⁴ (figure 5).

The external headwinds include slower regional and global growth (crucially in China which purchases 45% of global copper production) and a US\$ that has strengthened against the kwacha, causing a substantial increase in the cost of imported final goods and inputs. Domestic pressures on 2015 growth were linked to a poor 2014-15 harvest, a power crisis that has impacted on all sectors of the economy, and tight credit conditions.

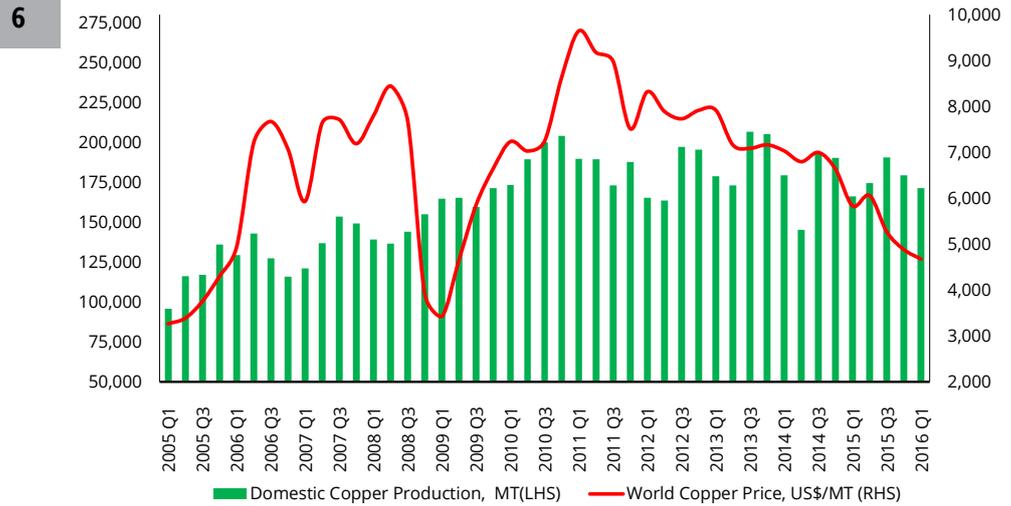
Domestic pressures on 2015 growth were linked to a poor 2014-15 harvest, a power crisis and tight credit conditions.



Source: World Bank (2015) and staff projections

The slowdown and rebalancing in China, and the fall in international commodity prices, is having a ripple effect globally and particularly so in Zambia. The negative effect on Zambia comes via lower copper prices that have been falling since 2011. The Zambia economy remains dependent on copper mining, including for 77% of its exports, and the decline in global copper prices, falling 52% between a peak in Q1 2011 and Q1 2016, has weighed heavily on the economy (figure 6)⁵.

Figure 6 Copper prices have plummeted over the past five years



Source: CSO and World Bank Pink Sheets

Global copper prices have fallen 52% from a peak in 2011.

The US\$ value of copper exports dropped by 31% in 2015 on account of lower global prices.

Low copper prices meant that copper mining companies have since mid-2015 begun looking globally to scale-back operations. In addition to lower prices, the mining sector is being impacted on by the current power crisis and the back-log of VAT refund payments⁶. Given these challenges, several Zambian operations were closed for care and maintenance in Q4 2015 and substantial redundancies made (7,700 in 2015).

Despite the challenges and closures, in 2015 production from the copper mines increased marginally from 708,259 metric tons (mt) in 2014 to 710,560 mt in 2015. Nevertheless, the US\$ value of copper exports dropped by 31% in 2015 on account of lower global prices. Despite a Q1 rally, copper prices have remained soft and production declined by 4.6% in Q1 2016 (relative to Q4 2015), reflecting both the global copper prices and domestic constraints (most notably power outages).

The agricultural sector declined by 7.7% in 2015 compared to a growth of 8.0% in 2014, harming rural households' income. This was on account of low and poorly distributed rains during the 2014-15 season. Maize production fell by 21.9% in 2015, contributing to increased food inflation of 26.5% in April 2016 (year-on-year), up from 8.1% in September 2015. The situation is expected to improve in 2016 as early government forecasts for the harvest suggest an increase of 10%, relative to 2015, given better levels and distribution of rainfall during the 2015-16 season (box 1).

Growth of the construction sector was estimated as 18.9% in 2015, on account of public sector infrastructure projects.

Preliminary national accounts data from the government for 2015 suggests that the secondary sector (non-mining industry, construction and manufacturing) grew by 10.8% in 2015 compared to 6.5% in 2014⁷. This improvement was reportedly driven by the construction sector, where growth more than doubled to 18.9% in 2015 on account of public sector infrastructure projects. Growth in manufacturing also reportedly rose to 4.4% in 2015 from 4.0% in 2014, on the back of a strong performance in 'chemical, rubber, plastics, and wood' products and growth in 'water supply, sewerage and waste management'. Growth of the services sector dropped from 5.2% in 2014 to 3.0% in 2015. Slower expansion occurred across the sector, with the exception of financial services which grew by 8.3% in 2015, following a decline of 3.6% in 2014.

Firms across the country suffered higher costs of production in 2015, linked to the onset of the power crisis and higher costs of imported inputs associated with the depreciation of the kwacha. In July 2015, ZESCO increased the extent of rolling black-outs (load-shedding) to at least 8 hours per day on a rotational basis for the majority of its household, commercial and industrial customers. Although it is not subject to load-shedding, ZESCO also requested the mining industry to curtail its load by up to 30%. This was in order to manage a power deficit that, as at March 2016, was estimated at 1,000MW, representing close to 50% of Zambia's peak demand. On June 07, 2016, ZESCO announced that it intended to reduce load-shedding to 4 hours per day due to

The shortfall in electricity supply has been growing since 2012, resulting in load-shedding.

improved water in-flows at the recently commissioned 120MW Itezhi-Tezhi power plant and increased electricity imports.

The cause of the power crisis was a reduction in hydroelectric generation due to low water levels at the country's main reservoirs. To reduce the adverse impact of the power deficit on the economy, the government started importing expensive emergency power in the latter part of 2015. This has helped boost electricity supplies, but in turn also increased the level of the government subsidy and placed additional pressure on the budget. A more extensive discussion of the power sector is contained in the December 2015 Economic Brief: [Powering the Zambian Economy](#).

Box 1 Late but not less rainfall

The 2014-15 agricultural (October-March) season was characterized by rainfall deficits resulting in markedly below average end-of-season vegetation (World Food Program⁸). This reduced 2015 agricultural production and has increased the prices of food items. The drier weather patterns have been strongly influenced by El Niño, active in the region for the past two rainy seasons. Furthermore, climate change has increased the frequency of floods and droughts over the past three decades and will continue to have an impact on climate-sensitive sectors such as rain-fed agriculture, fishing, and forestry.

El Niño-induced weather patterns in the 2015-16 season have resulted in poor rains and a maize deficit elsewhere in Southern Africa (particularly in Malawi, South Africa and Zimbabwe). There were similar concerns for Zambia as rains started late and national rainfall was below average from November to December 2015. However, rainfall improved and was above average from February to April 2016. A recent crop survey, carried out by the Ministry of Agriculture, forecasts that this season's maize production in Zambia might be about 10% higher than what was recorded from the previous season⁹. Similar forecasts are made for rice, ground nuts, millet, cotton, sweet potatoes and beans.

An overall depreciation of 62% was recorded between the start of 2015 and end-May 2016.

The kwacha

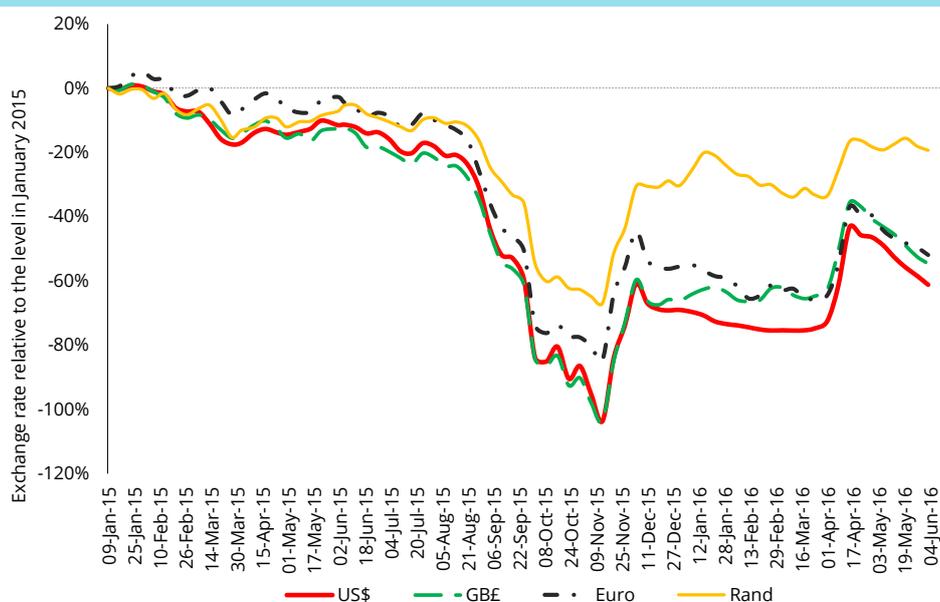
Global headwinds have combined with domestic pressures and ebbing confidence in the economy, resulting in huge shifts and foreign exchange market turbulence, raising many questions about the performance of the kwacha (box 2). There have been five distinct phases of movement in the kwacha to US\$ exchange rate between January 2015 and end-May 2016 (figure 7).

- i. There was an overall depreciation between January 2015 and mid-August 2015, where the kwacha depreciated by 21%, moving from ZMW 6.5 to ZMW 7.9 per US\$.
- ii. Next followed huge volatility. In the 10 weeks to end-October 2015, the kwacha depreciated by 60% to ZMW 12.5 per US\$. By November 10, 2015, the exchange rate reached ZMW 14.1 per US\$, but by the end of that month it had recovered to ZMW 10.3 per US\$, an appreciation of 27% in 19 days.
- iii. Between December 2015 and end-March 2016, the exchange rate was more stable, fluctuating between ZMW 10.3 and ZMW 11.4 per US\$. This period followed an aggressive tightening of monetary policy in November 2015.
- iv. The kwacha then appreciated by 18% between end-March and mid-April 2016, as the demand for the US\$ eased as firms made their annual tax payments.
- v. By mid-April 2016, this trend reversed and the kwacha began to depreciate against the US\$ again and reached ZMW 10.4 per US\$ at the end of May 2016. An overall depreciation of 62% was recorded between the start of 2015 and end-May 2016.

In 2016, businesses have reported increased difficulties in sourcing foreign exchange, following tighter liquidity and a marked reduction in the net supply of US\$ (especially from mining companies). According to the Bank of Zambia (BoZ), the net supply of foreign exchange dropped from US\$829 million in Q4 2015 to US\$212 million in Q1 2016¹⁰.

Figure 7 Despite a recovery the kwacha has depreciated relative to early 2015

Fiscal policy has been loose, and expenditure has increased from around 22% of GDP in 2012 to an average of 24.5% since then.



Source: Bank of Zambia

Box 2 The kwacha

There are five important factors to understand when making an assessment of the kwacha. The first is global and concerns global copper prices. As copper prices fall, the kwacha typically depreciates and as copper prices rise, it typically appreciates. The second is also global and reflects the relative strength of the US\$ against other currencies. The US\$ has strengthened against other currencies since early 2014, following the expectation that the Federal Reserve would increase interest rates (a move they made in December 2015). Third is a domestic factor and concerns Zambia's foreign exchange markets being 'thin' (i.e. there are often times of low demand), and so relatively small purchases of foreign currency can move the exchange rate considerably. The fourth factor relates to government regulation and control of the market via the central bank. The BoZ intervenes in the market and also closely monitors the trading of foreign currency. The market can also move when the government makes large payments (for example when capital project payments are due). Lastly, seasonal factors can impact on the rate. A good example is when monthly and annual tax payments are due: firms will need to move from US\$ positions to kwacha in order to meet their tax obligations.

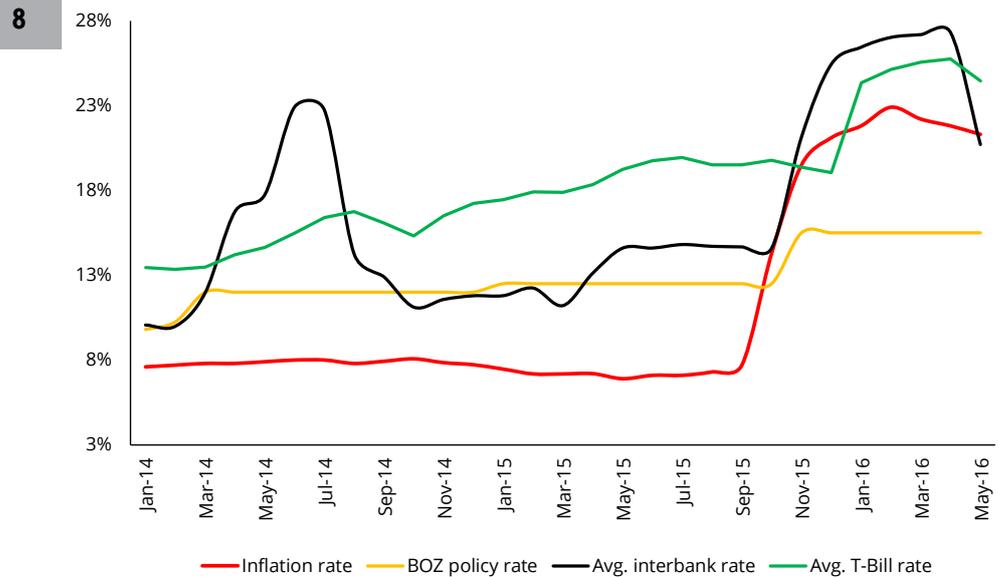
Furthermore, when thinking about the kwacha, it is also important to note that a weak kwacha does not necessarily mean a weak economy and vice-versa. For example, an appreciating kwacha makes Zambian exports more expensive and imports relatively cheaper. Since many inputs for producing domestic goods are imported, when the currency depreciates production costs rise for many firms. What is important however, is the stability of the exchange rate which helps with making sound investment and business decisions.

Tight monetary policy is taming inflation

Between January 2012 and September 2015, inflation remained stable at an average rate of 7.2%. In 2015, inflation fell consecutively during Q1 and Q2. However, since mid-2015, inflationary pressures began building up due to the depreciating kwacha and the electricity shortages. In October 2015, inflation rose sharply and year-on-year inflation jumped to 14.3% in October, breached 20% in December, and has remained above 21% between December and May 2016 (figure 8).

The high inflation is linked to the depreciation of the kwacha and an increase in food inflation (box 3). Zambia experiences a relatively high rate of pass-through from the depreciation to inflation, as many food products are imported and firms producing goods for the domestic market often import many of their inputs. For example, the price of secondhand cars increased by 54% in year to April 2016 and refrigerators by 38%¹¹. Production costs have also risen as a result of the power outages, while a reduced supply of selected food items and an increase in customs duty on cigarettes and motor vehicles have also played a role.

Inflation reached 21% in December and has remained above 20% as of May 2016.

Figure 8 Inflation has declined since its February 2016 peak

Source: Bank of Zambia

The high inflation is linked to the depreciation of the kwacha and an increase in food inflation.

Inflation has started to decelerate in 2016. The recent monthly report by the CSO suggests year-on-year inflation declined to 21.3% in May 2016 from 21.8% in April and 22.2% in March¹². This was on the back of slowing non-food inflation, which fell to 16.5% from 17.9% in March 2016, driven by a decline in vehicle imports.

With improved exchange rate stability, inflation has started to decline.

While fiscal policy has been expansionary since 2014, monetary policy has shouldered the burden of moderating inflation. Several monetary policy measures have been taken to tighten liquidity. In Q1 2015, the BoZ increased the statutory reserve ratio to 14% from 10%. In August 2015, the statutory reserve ratio was increased further to 18%, but the policy rate remained constant at 12.5% until November 2015, when it was increased to 15.5% and when caps on lending rates were also removed (figure 8). The BoZ also increased the overnight lending facility rate from 18.5% in October 2015 to 21.5% in November 2015 and to 25.5% in December 2015, as well as restricting access to this lending facility to once a week. Given the reduced volatility of the kwacha (at least between December 2015 and March 2016) and subsequent lower monthly inflation, the central bank kept rates on hold at its February and May 2016 quarterly Monetary Policy Committee meetings. In May 2016, the BoZ forecast that inflation had peaked and would decelerate in 2016 towards single digits¹³.

Tight monetary policy has helped moderate inflation, but at a cost. Commercial bank liquidity has tightened leading to a sharp increase in the interbank rate to 27.3% in April 2016 from 14.6% in October 2015. Low liquidity combined with the higher interest have increased the cost of borrowing at a time when the growth of the economy is slowing and firms are being hit hard by the power crisis. It is currently more expensive and harder to access credit than in 2015. For example, credit extension has declined from ZMW 47.6 billion in Q4 2015 to ZMW 45.8 billion in Q1 2016.

Box 3 The price of food

Food inflation has been the key driver of the sharp increase in overall inflation since October 2015. Before then, average food prices had been below non-food prices from January 2013 to September 2015. This is despite a 4.0% contraction of the agriculture sector in 2013. However, in October 2015, food inflation doubled to 16.2% from 8.1% in September 2015, and further to 25.0% in December 2015. Food inflation has continued to rise and has averaged 26.2% during the first 5 months of 2016.

There are multiple factors impacting on prices. First are the weather conditions which impact crop production and the supply of food, especially maize meal (the staple food). Second, and applicable to maize, are price controls (the Food Reserve Agency buys, stocks and sells maize to selected millers). Third are the prices of food in other countries (for example if prices are higher across the border then exports will likely

increase). Fourth, many food products are imported and the exchange rate influences their price. Further, many major food retail outlets' costs have increased and been passed on to the consumer. Costs have increased due to the use of generators during the power crisis and often their rent is indexed to the US\$, which has therefore increased as the kwacha has lost value.

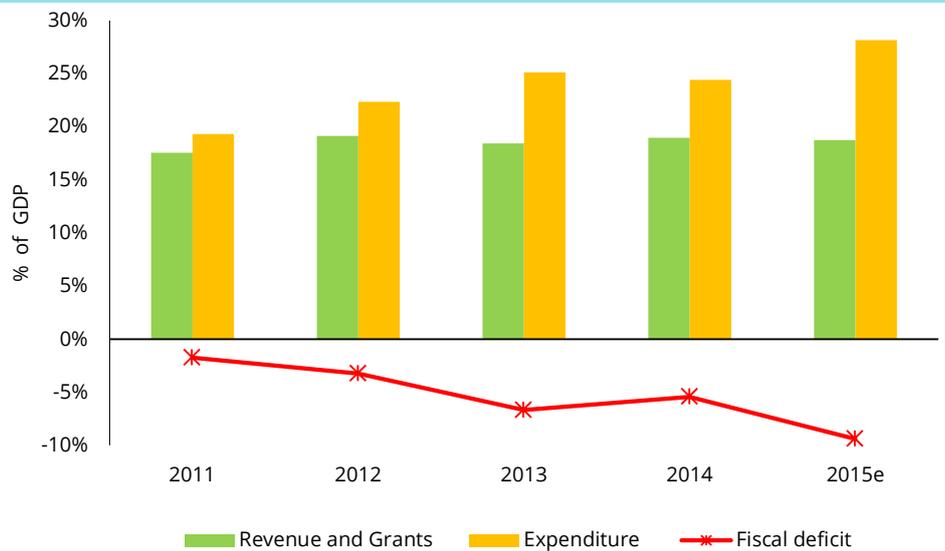
There have also been large shifts in the prices of particular food items and goods. The CSO reports that between April 2015 and April 2016, national average prices for the following goods have increased by over 30%: Roller mealie meal (30%); maize grain (35%); tomatoes (114%); onions (38%); dried beans (30%); sugar (35%); table salt (37%); and hammer mill charges (45%)¹⁴.

Over the past five years, public expenditure has increased 13.8% per year (in real terms).

Repeat large fiscal deficits

Over the past five years, public expenditure has increased at an annual average rate of 13.8% (in real terms). Expenditure reached 28.1% of GDP in 2015, up from 19.3% in 2011 (table 1). These higher levels of expenditure have exceeded revenues, and large fiscal deficits have been realized (figure 9). The Ministry of Finance reported that in 2015, the fiscal deficit rose sharply to reach 9.4% of GDP, up from 5.5% in 2014 and from a low of 1.8% in 2011¹⁵. External borrowing has plugged most of the gap between what was spent and what was earned in tax. External financing was increased to 7.7% of GDP in 2015 from 4.7% in 2014, following the issuance of Eurobonds in each of the two years.

Figure 9 Growing and repeat fiscal deficits



Source: World Bank (2015) and Ministry of Finance

Expenditure for Q1 2016 was ZMW 11.8 billion, representing 23% of the annual budget.

The increased expenditure in 2015 was driven by large increases in three areas. First are the increasing costs of debt servicing, as a result of the non-concessional borrowing at high interest rates (including the third Eurobond) and the depreciation of the kwacha (external debt is serviced in foreign currency). Debt interest payments increased by 28% in real terms from their 2014 level. Second, subsidies increased by 97% (in real terms) to ZMW 4.9 billion in 2015, including the government stepping-in to moderate the prices of fuel, food and electricity and also to provide farmers with agricultural inputs aimed at improving yields. Third is capital spending, which increased by 30% in real terms to ZMW 12,773 billion in 2015 for the completion of infrastructure projects.

Preliminary data suggests that public expenditure in Q1 2016 was ZMW 11.8 billion, equivalent to 23% of the 2016 annual budget¹⁶. Of this, 36% has been spent on public sector salaries, 31% on intergovernmental grants (which includes subsidies), 18% on interest payments, and 9% on goods and services. Intergovernmental grants and interest rate payments received 60% and 30% respectively of their entire 2016 budget allocation in Q1, reflecting payments for electricity importation, agriculture subsidies and debt service costs. During Q1 2015, the government spent ZMW 3.3 billion and ZMW 717 million servicing domestic and foreign debt respectively. The increased cost of domestic debt service resulted from lower auction sizes in Q1 2016, which meant that many bonds and bills were not rolled over and had to be repaid.

Domestic revenue declined slightly to 18.7% of GDP in 2015 from 18.9% in 2014.

Domestic revenue declined slightly to 18.7% of GDP in 2015 from 18.9% in 2014, but increased in nominal kwacha terms. Weaker performances of income tax and VAT drove the decline. Meanwhile, grants fell by 74% but contributed just 0.2% of revenues in 2015. In Q1 2016, revenue and grants totaled ZMW 13.3 billion, or 31% of the revenue target for 2016. Income taxes performed slightly above expectations for the quarter, but VAT provided only 17% of the expected annual total.

| Table | Fiscal trends | | | | |
|----------------------------|---------------|-------------|-------------|-------------|-------------|
| 1 | 2011 | 2012 | 2013 | 2014 | 2015e |
| Revenue and Grants | 17.5 | 19.1 | 18.4 | 18.9 | 18.7 |
| Domestic revenue | 16.9 | 17.4 | 16.9 | 18.2 | 18.5 |
| Tax revenue | 15.6 | 15.0 | 14.7 | 15.5 | 14.4 |
| Non-tax revenue | 1.3 | 2.4 | 2.2 | 2.7 | 4.2 |
| Grants | 0.6 | 1.7 | 1.5 | 0.8 | 0.2 |
| Expenditure | 19.3 | 22.3 | 25.1 | 24.4 | 28.1 |
| Current expenditure | 15.9 | 16.2 | 18.8 | 19.1 | 20.7 |
| Wages and Salaries | 6.4 | 7.3 | 8.2 | 9.5 | 8.8 |
| Goods and Services | 3.9 | 3.6 | 3.3 | 3.0 | 2.8 |
| Interest Payments | 0.9 | 1.4 | 1.5 | 2.2 | 2.8 |
| Social Benefits | 0.8 | 0.7 | 0.5 | 0.4 | 0.5 |
| Subsidies | 2.5 | 1.5 | 3.5 | 2.0 | 3.9 |
| Other | 1.4 | 1.7 | 1.8 | 1.9 | 2.0 |
| Public investment | 3.4 | 6.2 | 6.3 | 5.3 | 7.4 |
| Fiscal deficit | -1.8 | -3.2 | -6.7 | -5.5 | -9.4 |
| Financing | 1.8 | 3.2 | 6.7 | 5.5 | 9.4 |
| Domestic financing | 0.6 | -0.4 | 6.3 | 0.8 | 1.7 |
| External financing | 1.2 | 3.6 | 0.4 | 4.7 | 7.7 |

Source: Ministry of Finance and World Bank projections
Note: e = estimate, f = forecast

The repeat fiscal deficits of the past four years have been financed by external non-concessional borrowing.

Public debt levels have increased

The repeat fiscal deficits of the past four years have been financed by external non-concessional borrowing. In July 2015, Zambia issued its third Eurobond for US\$1.25 billion (with an average tenor of 11 years) at a considerably higher cost than previous issues (the yield at issue was 9.375%). The Eurobond issues now total US\$3 billion and have sharply increased overall debt levels. The Eurobonds are associated with repayment risks, given the bullet structure of the first two bonds (they each need to be repaid in one single year) and foreign currency risks¹⁷.

Large exchange rate depreciations carry the risk of balance sheet effects, especially where there is substantial offshore foreign currency borrowing by the government and corporations. Foreign currency risks have become a reality in Zambia, as a weaker kwacha has increased the cost of servicing external borrowing.

The depreciating currency has pushed the kwacha cost of repaying and servicing this external debt much higher. At the end of 2015, total public sector debt had risen to 52.7% of GDP (based on estimates of 2015 GDP), driven by an increase in external debt to 38.7% of GDP in 2015 from just 17.9% in 2014.

At the end of 2015, total public sector debt had risen to 52.7 % of GDP.

Participation by foreigners in the domestic debt market has declined on account of risk aversion towards emerging and developing countries, and increased foreign exchange risk. Tighter liquidity has also constrained the participation of domestic commercial banks in the domestic debt market, and the size of the auction was halved from ZMW 900 million to ZMW 450 million in January 2016. However, non-bank financial institutions have increased their participation in Q1 2016 and as liquidity conditions have improved, the auction size was lifted to ZMW 700 million on May 12, 2016, although subscription only reached 59%. The May 2016 bond auction (conducted quarterly) also saw an increased issuance of ZMW 703 million, up from ZMW 228 million in February 2016.

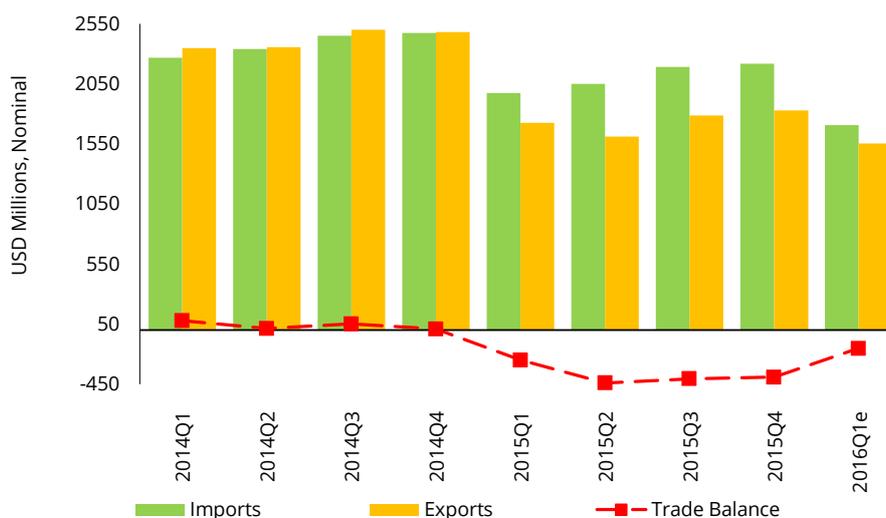
After growing strongly since 2010, non-traditional exports declined by 23% in 2015.

Lower exports have put pressure on the balance of payments

Zambia relies on copper for 77% of its exports, and as global prices have fallen, the current account surpluses enjoyed in recent years were replaced by deficits in 2015. Trade deficits have been recorded in each of the quarters since Q1 2015, led by a decline in the value of copper exported to international commodity firms and directly to China, following lower global demand, softer global copper prices, and an increase in the value of imports following the depreciation of the kwacha (figure 10). The value of copper exports in 2015 was US\$5,234 million, 31% lower than their level in 2014, despite the marginal increase in 2015 copper production. Preliminary data suggests that the US\$ value of copper exports fell by 19% in Q1 2016 relative to Q4 2015¹⁸.

After growing strongly since 2010, non-traditional exports (i.e. goods other than copper and cobalt) declined by 36% in 2014, before declining by a further 23% in 2015 to reach US\$1,865 million. In Q1 2016, non-copper exports declined by 3.3% compared to Q4 2015. Non-copper exports include maize, tobacco, sulphuric acid and precious stones. The recent decline follows poor crop production in the 2014-15 agricultural season and uncertainty about the availability of permits to export maize. Key non-copper export destinations are the Democratic Republic of Congo (7.7% of exports and mainly sulphuric acid for mining) and South Africa (6.8% of exports). At the same time, the total value of imports declined by 12% to US\$8,433 million in 2015 from US\$9,530 million in 2014. Higher prices for imported goods in kwacha terms have led to substitution effects and in Q1 2016, the volume of imports has continued to fall further and decreased faster than exports. Consequently, the trade deficit has started narrowing.

Figure 10 Trade levels reduced and a deficit emerged in 2015



Source: World Bank (2015) and Central Statistical Office (2015)

The benefits of recent GDP growth have accrued mainly to the richer segments of the population in urban areas.

Prosperity has not been shared equally

The benefits of recent GDP growth have accrued mainly to the richer segments of the population in urban areas and poverty remains largely concentrated in rural areas. In April 2016, the CSO launched preliminary results from the LCMS 2015¹⁹. Their survey provides estimates of living conditions for Zambia's 3 million households. Consumption is chosen as the preferred welfare indicator and is assessed via four main components: food, nonfood, durable goods and housing.

The LCMS finds that despite a GDP growth averaging 7.4% between 2004 and 2014, there has only been a marginal reduction in poverty. The CSO reports that in 2015, 54.4% of the population were defined as poor and 40.8% of the population were experiencing extreme poverty as per the government's poverty line. Using the US\$1.9 per day (2011 PPP terms) measure for international comparison, poverty is estimated at 61.3% in 2015²⁰. The poverty measured is largely a rural phenomenon with 77% of the poorest households located in rural areas.

C. ECONOMIC OUTLOOK, RISKS AND POLICY CHALLENGES

GDP growth is forecast to remain close to 3.0% in 2016, before improving in 2017 (4.2%) and again in 2018 (5%). For 2016, this assumes new power generation capacity comes on stream and a better harvest is achieved. For the medium-term, it assumes copper prices remain low, suggesting that if global copper supply better matches demand, and prices recover once again, improved growth might be achieved. Despite the current slowdown, long-term investment in mineral and non-mineral sectors in Zambia remains attractive.

GDP growth is forecast to remain close to 3.0% in 2016.

The outlook is subject to both domestic and external downside risks.

Commodity-exporting countries' policy makers face increasing challenges across the globe.

Medium-term outlook

Reflecting the external headwinds and domestic pressures, the expectation is that GDP growth will remain close to 3.0% in 2016, before improving in 2017 (4.2%) and again in 2018 (5.0%). The outlook for the Zambian economy is underpinned by five main assumptions:

- i. Copper prices remain low, based on World Bank forecasts that suggest commodity prices are likely to stay soft throughout 2016 and 2017²¹. However, if global copper supply better matches demand, and prices recover once again, improved growth could be achieved.
- ii. Persistent and growing fiscal deficits are, by clear and credible budget policies, geared toward a more sustainable fiscal stance supporting medium-term growth.
- iii. Confidence in the economy is improved via an agreement with the IMF on a program of support. An IMF program would help in restoring investor confidence and give other cooperating partners greater confidence to provide budget support.
- iv. The impact of the power crisis is less severe than in 2015 as new generation capacity comes on stream.
- v. The 2015-16 harvest is better than in 2014-15.

Risks to Zambia's economic outlook

The outlook is subject to both domestic and external downside risks. Externally, lower than predicted output growth in China would weigh on the demand for Zambia's exports, further reducing copper prices, and would severely affect Zambia's prospects. Furthermore, the strengthening of the US\$ in the event of an increase in interest rates by the Federal Reserve, would also likely lead to further volatility of the kwacha and depreciation pressures. Tighter global financing conditions would also increase the cost of tapping international debt markets in 2016 and 2017.

The main domestic risks are fourfold. First that the power crisis does not abate and continues into 2017. This could occur via delays in new generation coming fully on stream or a slower than expected recovery of generation capacity at the main hydro-power plants. Second, that a lack of fiscal adjustment takes place, so that the cost of macroeconomic stabilization remains high, in terms of expensive and limited availability of credit to the private sector. Without fiscal adjustment, exchange rate uncertainty will continue to be a threat to inflation and tight monetary policy will continue to dampen credit growth and reduce economic growth in 2016 and 2017. Third, that an excessively abrupt or disorderly fiscal adjustment takes place, eliminating any improvement of confidence in the economy that a well-planned shift to fiscal sustainability might bring. Fourth, if exchange rate uncertainty continues to be a threat to inflation, tight monetary policy will continue to dampen credit growth and reduce economic growth in 2016 and 2017.

Policy challenges

Commodity-exporting countries' policy makers face increasing challenges across the globe. Zambia is no exception and must grapple with multiple challenges as the economy slows down. Falling copper prices and a power crisis could be met with fiscal buffers, but in Zambia, such buffers were insufficiently built up when the economy was prosper-

ing. Furthermore, the debt burden has increased following repeat non-concessional borrowing and the depreciation of the kwacha.

This leaves the government with little room for maneuver, limited fiscal space to compensate for slower growth and recent job losses, and only hard choices. Large fiscal deficits and inefficiencies in government spending persist as sources of vulnerability for Zambia. Austerity measures announced in November 2015 that were intended to strengthen the fiscal position and help the government meet its targeted fiscal deficit are not yet in place or have been reversed. The government's target for the 2016 fiscal deficit is 3.8% and the theme of the 2016 budget address was *'Fiscal Consolidation to Safeguard Our Past Achievements and Secure a Prosperous Future for All'*, but as the growth of the economy has slowed further and expenditure pressures have increased, this target is unlikely to be met²². Actions to support a shift to a more sustainable fiscal stance remain a priority and the post-election budget will be crucial in setting out such a path.

Fiscal adjustment would put less pressure on monetary policy and eventually make space for interest rates to be reduced.

Fiscal adjustment would put less pressure on monetary policy and eventually make space for interest rates to be reduced, easing the pressure on individuals and firms. It would also increase the confidence of domestic and international investors. Any adjustment should involve a shift in spending priorities that support both the efficiency of public expenditures and long-term inclusive growth. While in many areas this is difficult to achieve, there are obvious areas for attention including the growing cost of fuel subsidies.

Policy announcements have been made for cost reflective electricity tariffs and fuel prices, but the reality is a huge outflow of subsidy from the Ministry of Finance. If the stated intentions for meeting the cost of supply with tariffs were realized, then fiscal pressures would ease considerably. Better and pro-poor cushioning can be achieved via investment projects targeted to regions, and via targeted cash transfers, than with fuel subsidies. ***Making Every Kwacha Count*** is the focus of Part II.

Power is essential for the Zambian economy to function. Despite new generation projects, the modeling of different hydrology conditions shows that even in a wet (above average rainfall) scenario, current power shortages will continue through to at least 2018. For 2016, the authorities have decided to increase the import of expensive emergency power options. This puts huge pressure on the budget at current tariff rates, in tough economic conditions.

With market access comes greater scrutiny that affects the cost of new borrowing.

With market access comes greater scrutiny, and the credibility or otherwise of policy responses to shocks affects interest costs of new borrowing. The Eurobond issuance has also increased international observance of the Zambian economy and events are being watched much more closely than prior to 2012. To help maintain confidence in the economy, and Zambia as an investment destination, better dialogue on the economy should be targeted. A key step includes the timely publication of a debt strategy and the provision of quarterly debt and fiscal numbers on the Ministry of Finance website.

In addition, the commodity price shock highlights the need for Zambia to reduce its dependency on copper, a challenge it has been grappling with for over 50 years. Statements about diversification and growing manufacturing need to be met by a clear and realistic strategy, and structural reforms aimed at removing impediments to private sector activity and improving the business environment. The Seventh National Development Plan provides a good opportunity to set this agenda.

SECTION 2 MAKING EVERY KWACHA COUNT

D. RELOCATING UNDER-UTILIZED EXPENDITURE

Uncertainty about whether persistent and growing fiscal deficits can be reined in need to be met with clear and credible budget policies toward a more sustainable fiscal stance. Efforts are needed to ensure that any under-utilized resources are reallocated to where they can have a greater impact, and greater focus is needed on protecting and supporting the poorest households via better public expenditure.

A careful review of public expenditure can help in ensuring the expenditures are better targeted to the poor.

Over the past five years, public expenditure has increased at an annual average of 13.8% (in real terms) and a thorough review of the quality of this expenditure is required. There is need to identify and reallocate under-utilized resources to ensure that every kwacha spent is contributing towards each sector's objectives. Furthermore, the preliminary results from the LCMS 2015 suggest that the economic expansion since the early 2000s has not sufficiently benefited the poor. The growth has been exclusive rather than inclusive. A careful review of public expenditure can also help in ensuring the expenditures are better targeted to the poor.

A key area of under-utilized expenditure is the government subsidy of fuel and electricity. It is estimated that fuel subsidies have averaged close to US\$36 million per month between September 2015 and May 2016, and electricity subsidies around \$26million per month, a combined total of US\$576 million, putting huge pressure on the budget. The respective subsidies are explored below in turn.

Fuel subsidies have reemerged

When asked about fuel subsidies, many people respond that prices are cost-reflective and there are no subsidies in place in Zambia. However, a consequence of the rapidly depreciating kwacha has been a mismatch between revenues from pump prices (paid in kwacha) and the cost of supply of fuel (paid in US\$). This leaves the Ministry of Finance having to pay the difference and the reemergence of subsidy.

Petroleum products (fuel) play a crucial role in Zambia's economy, particularly in the agriculture, transport, and mining sectors. What a reasonable price for fuel is has always been a hotly debated topic. Zambia shifted from having some of the highest fuel prices in Africa (and globally) in the mid-2000s to lower prices in 2008, supported by direct government subsidies and reduced taxation²³. Subsidies were used to pay feedstock import bills and cover refinery and pipeline charges. Frequently, substantial arrears built up, posing a threat to the reliability of future fuel supplies. To remedy this, the government committed to the principle of cost-plus pricing on a cargo-by-cargo basis (i.e. all the costs in the supply value chain are fully recovered by the pump price).

Fuel subsidies have reemerged, putting pressure on the fiscal position.

The elimination of fuel subsidies was subject to vibrant discussion in 2012 and subsequently, prices were increased in April 2013, with a view to removing the subsidy²⁴. However, fuel subsidies have re-emerged since then, putting pressure on the fiscal position. The key factors that determine wholesale and pump prices in Zambia are international oil prices, the domestic exchange rate, the cost of supplying fuel and the level of government subsidy. Fixed costs within the pricing model which do not fluctuate with global oil prices include: freight; TAZAMA pipeline and refinery fees; specific taxes; downstream margins for oil marketing companies, dealers and transporters. The Energy Regulation board (ERB) regulates the energy sector including the supply of petroleum products. The ERB determines wholesale and pump prices based on the cost of each feedstock cargo received. The cost of each feedstock cargo is mainly affected by global crude oil prices and the US\$ to kwacha exchange rate (box 4).

Box 4 Parts of the Petroleum Sector

TAZAMA pipeline: The procurement of the petroleum feedstock is done through an international competitive bidding process. The imported feedstock is in the form of spiked crude oil, transported through the 1,705 Km pipeline (jointly owned by the Governments of Zambia (67%) and Tanzania (33%)).

Indeni Oil Refinery: The feedstock is processed to meet the petroleum product requirements of the market at the Zambian government-owned Indeni Petroleum Refinery in Ndola (in the Copperbelt Province), that was constructed in 1973. The refinery was last refurbished in 2000 after a fire that brought operations to a standstill. The refinery consists of a large reforming unit (214,000 MTS per year), a Hydro-treater for desulphurization of kerosene and lighter fractions, and a Vacuum Distillation Unit (VDU) for specific technical conditions. This facilitates spike crude processing with the aim of minimizing heavy fuel production. The current capacity of the refinery is estimated at 850,000 mt per year.

Ndola Fuel Terminal: Finished products are transferred from the oil refinery via pipelines into storage facilities at the Ndola Fuel Terminal, for loading and transportation (by rail or trucks).

Oil Marketing Companies (OMCs): Refined products are imported directly or collected from the Ndola fuel terminal and distributed to petrol stations and commercial customers for sale. There are 21 registered OMCs in Zambia and currently, a legal requirement mandates that all OMCs operating in Zambia keep an equivalent of 15 days of their working petroleum in stock.

Given that the feedstock is bought in large batches, there can be a lag between the adjustment of pump prices and the costs incurred of importing the fuel.

Since December 2014, there have been four price adjustments in pump prices (table 2). An increase in December 2014 was followed by two decreases in January and May 2015, and then by an increase in July 2015. The main justification has been changes to international oil prices and the US\$ to kwacha exchange rate. Given that the feedstock is bought in large batches, there can be a lag between the adjustment of pump prices and the costs incurred of importing the fuel. Between July 2015 and May 2016, the pump prices have not been changed despite the kwacha depreciating by 36%. Over the same period, global oil prices have reduced from US\$ 63 per barrel to US\$ 48, but the kwacha's depreciation has been greater than the fall in fuel prices, meaning that the government subsidy has increased.

Table 2 Recent Changes to Pump Prices

| 2 | Date | Price Change (ZMW) | Justification Provided |
|---|-------------------------------|--|---|
| | | Petrol to 9.87 (from 8.74) | |
| | 13 th July 2015 | Diesel to 8.59 (from 7.59) Kerosene to 6.12 (from 5.40) | Depreciation of the Kwacha |
| | | Petrol to 8.74 (from 7.60) | |
| | 12 th May 2015 | Diesel to 7.59 (from 6.69) Kerosene to 5.40 (from 4.69) | Depreciation of the Kwacha |
| | | Petrol to 7.60 (from 9.89) | |
| | 15 th January 2015 | Diesel to 6.69 (from 9.18) Kerosene to 4.69 (from 6.77) | Stable Kwacha (December 2014 -January 2015) and drop in international oil prices. |
| | | Petrol to 9.89 (from 10.38) | |
| | 8 th December 2014 | Diesel to 9.19 (from 9.73) Kerosene to 6.77 (from 7.21) | Lower international oil prices and stable exchange rate. |

Source: Energy Regulation Board

As well as tackling the issue of subsidy, there are three underlying challenges associated with the supply of fuel in Zambia that need to be resolved.

As well as tackling the issue of subsidy there are underlying challenges that need to be resolved.

First is the use of the Indeni Refinery, which increases the cost of the fuel for the government or consumer, as it is inefficient and technologically unsuited to 21st century fuel needs (there is no low-sulphur output for example). In addition, any new refinery that may be built, based on Zambia's needs, might be too small to compete with the massive new refineries coming on-line around the world. In light of the worldwide transition towards larger-scale and more efficient oil refineries, it will be important to reevaluate the benefits of continuing to operate a national refinery. There are also often fuel shortages linked to the failure of the refinery.

Second, if Zambia considered a move to a price adjustment system like South Africa's or Namibia's or to let market forces set the price, then institutional coordination would need to be improved between the ERB, the Ministry of Energy and Water Development, and the Ministry of Finance. At present, the ERB sets the price without much consideration of the financial consequences. The Ministry of Finance has to pay the importer but is not engaged in the pricing, thereby increasing the likelihood of budget pressures and arrears accumulation.

Thirdly, there remains a need to increase transparency in national fuel procurement. Increasing the availability and transparency of energy subsidy data is essential in overcoming some of the challenges related to reform. This can encourage an informed discussion and debate regarding the subsidies and government policies toward them.

Electricity costs have escalated with emergency power

To reduce the power deficit, the government began to import expensive emergency power in the latter part of 2015. This has helped boost the supply of electricity, but in turn increased the level of the government subsidy to the power sector, as power tariffs have not been increased to reflect the increased cost, and hence placed greater pressure on the budget.

Electricity tariffs in Zambia have long been a contentious issue. Discussions have centered on setting tariffs at a level that ensures that costs incurred in supplying electricity to different consumer categories are recovered. However, tariffs should also enable investment into the sector, and allow for capacity expansion and the renewal of power plants. Since 2010, there have been four upward tariff revisions approved by the ERB. The most recent was a significant upward tariff adjustment in December 2015 that brought ZESCO's average tariff to approximately US\$10/kWh. This tariff decision was however reversed within a month of its announcement. Electricity tariffs to the mining industry, which are embedded in long-term power supply agreements, have also been revised upwards and beyond the escalation provisions in these agreements. However, a 2014 ERB revision of mining tariffs ended up being challenged in court.

Although tariffs that ensure recovery of costs are crucial for the sustainability of the power sector, there are other important reforms.

With no increase in tariffs and the need to pay for emergency power, the government's electricity subsidy has increased since mid-2015. It is estimated that ZESCO faces a shortfall of at least US\$300 million in 2016 in order to meet the cost of emergency power imports and generation by independent power producers in Zambia who are expected to commission a plant this year. While late rains in the 2015-16 season have helped replenish reservoirs, it is likely that power will need to be imported into 2017.

Although tariffs that ensure the recovery of the costs incurred in electricity service provision are crucial for the sustainability of the power sector, there are other important reforms. These include enhancing efficiency in the power sector; increasing access to electricity, especially in rural areas which remain largely unconnected to the grid; and implementing demand side management measures to optimize the use of electricity.

Protecting the poor during transition

There is potential for budget savings by reducing or eliminating the government subsidy on fuel and electricity, but there is also scope to reallocate some of the funds so that the expenditures are better targeted. The government has been implementing a Social Cash Transfer system since 2003, but it has remained small both in terms of the

Lower fuel and electricity subsidies will result in higher prices, and complementary measures are needed to protect the poor during the transition.

amounts transferred and the number of households targeted. In 2016, the scheme is being scaled-up, but as subsidies have soared, the budget allocation for social protection expenditure fell from 2.6% in 2015 to 2.4% in 2016²⁵.

Lower fuel and electricity subsidies will result in higher prices, and so complementary measures are needed to protect the poor during the transition to better targeted and better quality public expenditure. Global insights and evidence from Zambia suggest that the best way to achieve this is via cash transfers, and some of the savings made from the reduction or elimination of subsidies could be used to bolster social protection and permit a scaling-up of the cash transfer system. Lessons from international experience suggest that by complementing efforts to strengthen the provision of basic social services with cash transfers, better support can be provided to the poorest households (box 5).

Box 5 South Africa's cash transfers

South Africa boasts the largest cash transfer program in Sub-Saharan Africa. It includes several types of means-tested grants targeted to the elderly, poor families with children, foster families, people with disabilities, and war veterans. Roughly 15 million people receive a social grant (about 30% of the national population). The child support grant (CSG) reaches about 10 million people, while the old age grant, which applies to poor people over 60 years of age, reaches about 2 million people. According to household survey data, social grants make up over 60% of the income of the poorest 20% of recipient households, with child grants being the largest contributor. Children who were enrolled in the CSG at birth completed significantly more grades of schooling and achieved higher scores on a math test than children who were enrolled at the age of six. These effects were particularly significant for girls. Enrollment in the CSG reduced the likelihood of illness among children by 9%. The main effects on adolescents were reduced sexual activity and teen pregnancies and less drug and alcohol use²⁶.

E. REVIEWING EDUCATION EXPENDITURE

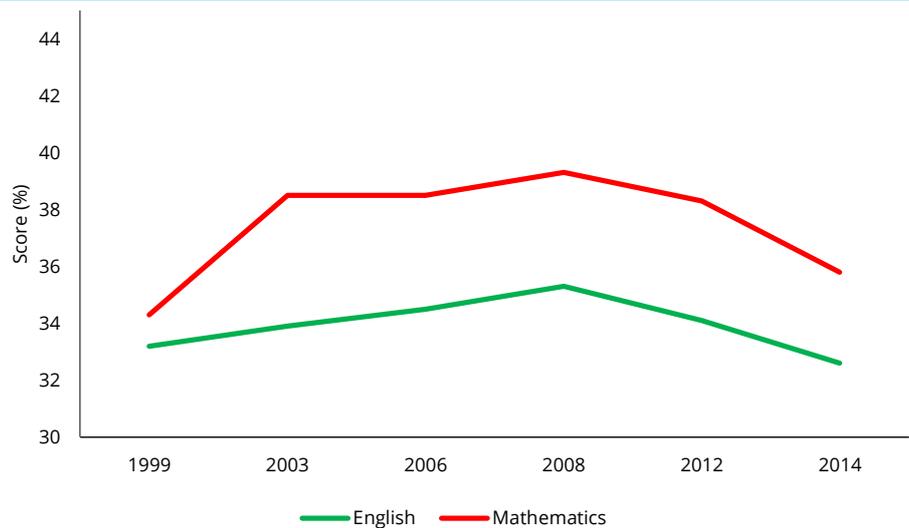
The government of Zambia has shown a strong commitment to educational development by allocating a large proportion of the budget to the education sector. However, a recent Education Public Expenditure Review (PER) finds that with effort, the allocation and execution of the budget within the education sector could become more efficient²⁷.

While tuition fees have been officially abolished, schools continue to collect various fees from students.

Education in Zambia has steadily developed and has been continuously expanding. Zambia's population is growing fast and many more students will require an education. Government expenditure in the sector is guided by an education strategy. The first priority is to provide Education for All, i.e. primary education for each of the growing number of children. Following the success of these policies, the focus has now expanded to include secondary and post-secondary education. As more children have received primary education and graduated, there is a greater demand for high school learning and secondary school enrollment has also increased.

Since 2006, public education expenditure has grown steadily in real terms. The ratio of government expenditure in education to GDP has ranged between 3.7% and 4.4% during the period 2006–13, and exceeded 5% in 2014 and 2015. Government expenditure on education grew from ZMW 1.5 billion in 2006 to ZMW 5.2 billion in 2013, with its proportion of total expenditure ranging between 15.3% and 20.5%. While tuition fees have been officially abolished, schools continue to collect various fees from students, in addition to receiving transfers from the government.

The PER highlights key areas in which the efficiency and effectiveness of public expenditure can be improved²⁸. It suggests that expenditure in the sector had opportunities for meeting improved educational outcomes, but this link – between resources and results – has been weak. This is evidenced by the finding that, despite the growth in funding, the quality of education has not improved. For example, primary education (measured by student learning assessments at Grade 5 level) has remained fairly flat and regressed slightly in recent years (figure 11).

Figure 11 Grade 5 learning has not improved

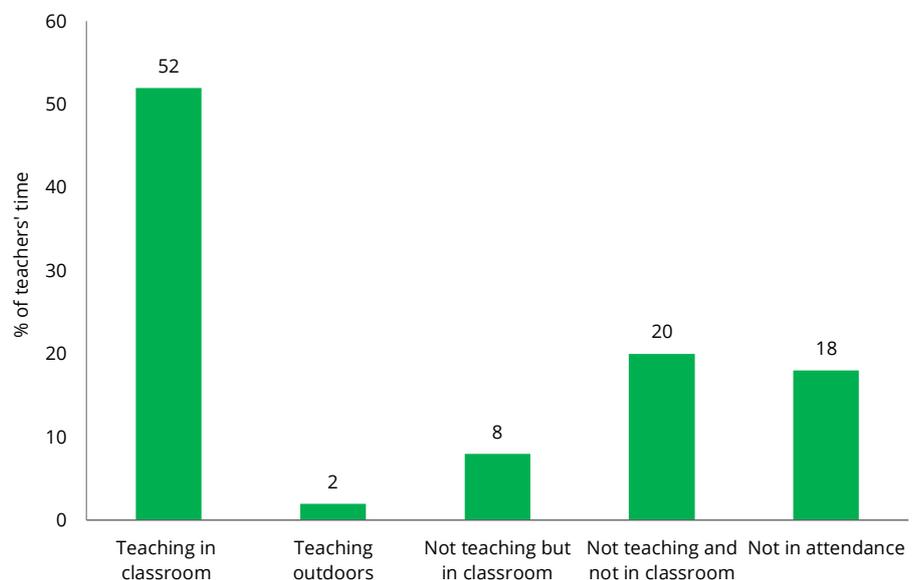
Source: World Bank (2015c)

Efforts are needed to ensure that while the government finds a path to improved fiscal sustainability, the quality of expenditure improves.

Key expenditure challenges for the delivery of better education include an insufficient amount of teaching time, a shortage of text books and the growing need for more classrooms.

Removing barriers to learning

Key expenditure challenges for the delivery of better education include an insufficient amount of teaching time, a shortage of text books and the growing need for more classrooms. The PER reports that teachers are found to spend too small a proportion of their working week actually teaching and there is a high rate of absenteeism (figure 12). This is detrimental to learning outcomes, as a teacher's subject knowledge, a teacher's motivation, and better management of teachers (both supervision and autonomy) are shown to have consistent positive effects on the quality of education. The PER highlights the need for improved teacher supervision and management to reduce absenteeism (18% of teachers' time) and ensure more time is spent in the classroom.

Figure 12 Teachers spend 54% of their working time teaching

Source: World Bank (2015c)

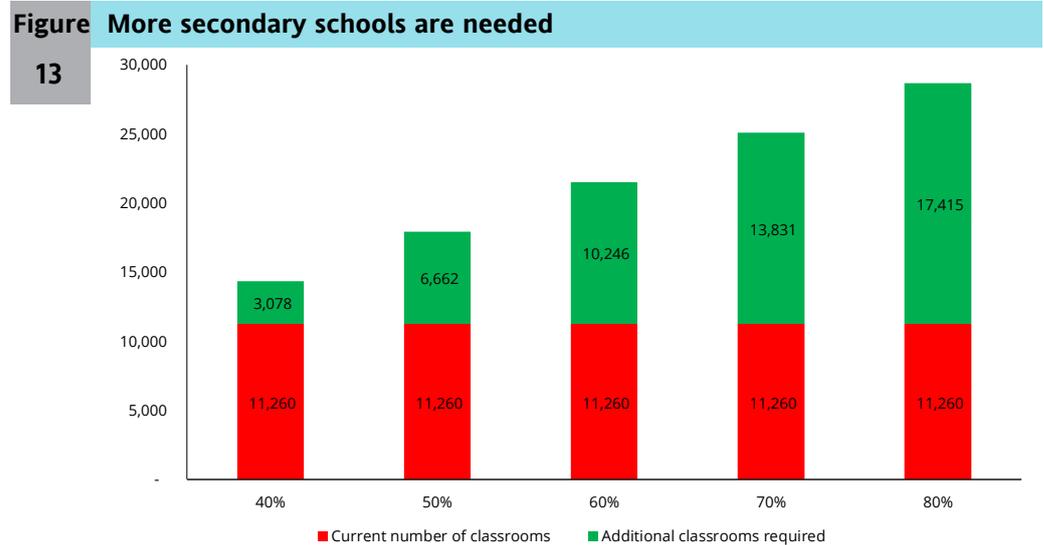
Recent data shows that the textbook ratios deteriorated to 1:5 in both English and mathematics since 2006.

A shortage of textbooks also continues to be a challenge. In 2006, the pupil-textbook ratio improved from 1:5 in English and 1:5 in mathematics to 1:2 in English and 1:3 in mathematics, partly due to financial support received from cooperating partners. However, the recent data show that the ratios deteriorated back to 1:5 in both subjects. The PER suggests three reasons for the shortage in textbooks. First is a lack of recurrent funds made available to supply text books. Second, there is a misalignment of textbook policy, especially between the timing of curriculum development and the

The current number of secondary schools can accommodate only about 30% of the current students in Grades 1–5.

procurement policy. In 2013, the textbook delivery was delayed significantly following the development of a new curriculum. Third is the lack of funds earmarked to deliver the text books to the schools.

The expansion of needs of the education sector remain high. The current number of secondary schools can accommodate only about 30% of the current number of students in Grades 1–5. If just half of the current Grade 1–5 students require secondary schooling in 2020, and classrooms ratios are to be maintained, then a 62% increase or 6,662 new classrooms are required. If 70% of the children were to receive secondary education, then 13,831 new classrooms would be required (figure 13).



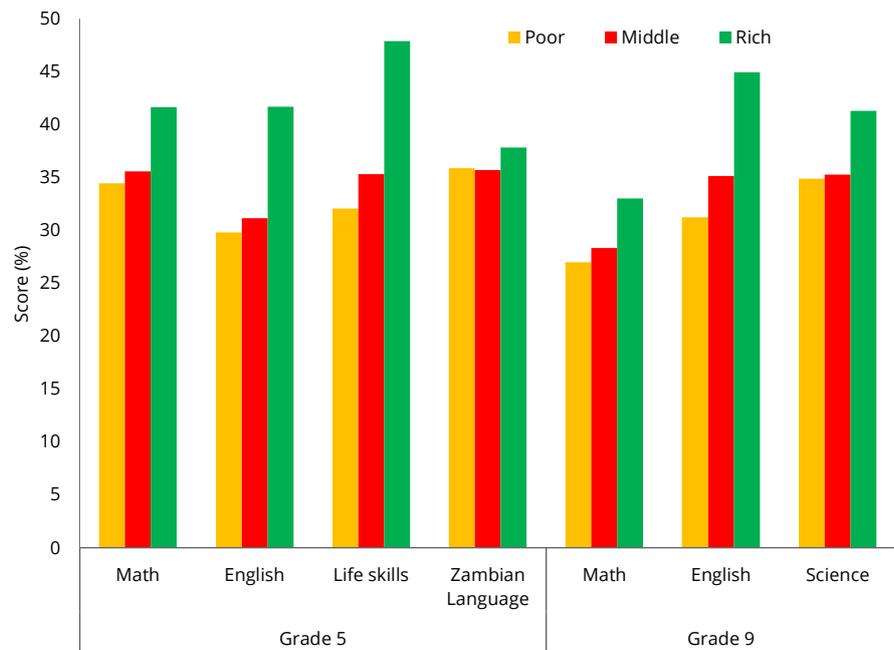
Better targeting

The PER highlights that the quality of education is weakest for the poor. This is driven in part by schools with more students from higher income families receiving higher revenues from fees, and in part due to weaknesses in the school grant system that result in a failure to ensure rural schools have sufficient non-wage funding (figure 14).

Most primary schools do not receive their budgeted amount and 28% of primary schools have not been receiving school grants at all.

The PER finds that most primary schools do not receive their budgeted amount from the school grant system, to the extent that 28% of primary schools have not been receiving school grants at all. A reason cited is that the actual disbursement of primary school grants does not fully follow the budget allocation rule. The problem appears to be a lack of information about the allocation formula. A longstanding problem is that most primary schools do not know the level of grants they are supposed to receive. Transparent and clear guidelines on the grant distribution system should be disseminated to schools via head teachers and complementary training provided. Further, at the beginning of the academic year, an official document setting out the school grant formula in each province along with the expected timing of school grant disbursement should be made publicly available. At the end of the academic year, the actual disbursement of school grants should also be published.

When it comes to higher levels of education, the PER finds an inadequate amount is spent on technical education and vocational and entrepreneurship training (TEVET). While the TEVET subsector produces a high-quality labor force, for which the demand is increasing, it receives the smallest share of the government's total education expenditure, which is also low in comparison to the shares that other African countries spend on TEVET. A better balance of funding is required for higher education and in favor of TEVET.

Figure 14 Grade 5 and 9 learning linked to parents' income

Source: World Bank (2015c)

F. IDEAS FOR BEATING THE SLOWDOWN

To beat the slowdown, there is a need to make every kwacha of government expenditure count. Any fiscal adjustment should be accompanied by a shift in spending priorities that supports both the efficiency of public expenditures and long-term inclusive growth. While in many areas this is difficult to achieve, there are obvious areas for attention including the growing cost of fuel and electricity subsidies.

The following ideas are aimed to ensure that while the government finds a path to improved fiscal sustainability, the quality of expenditure improves.

Efforts are needed to ensure that while the government finds a path to improved fiscal sustainability, the quality of expenditure improves.

i. Eliminate fuel subsidies: Fuel pump prices could be adjusted to better reflect the cost of supply and to help reduce budget pressures in 2016 and beyond. As economic growth has slowed in 2015 and 2016, the trade balance worsens and substantial funds are required for short-term alleviation of the power crisis, the reduction of fuel subsidies provides one of few quick options for relieving budget pressures. A review of the current price setting mechanism is also a priority, as are efforts to fix underlying problems associated with the supply of fuel.

ii. Improve financial sustainability of the power sector: The power crisis has revealed the importance of ensuring that the power sector has sufficient funds for electricity service provision. Inadequate electricity tariffs limit the extent to which the existing generation and grid network is maintained, and the extent to which investments in new generation capacity and network expansion by either ZESCO or private parties can be made. Electricity tariffs that are insufficient to recover the costs incurred in providing electricity and enabling new investment only benefit those with existing electricity connections in the short-term, and in the long-term compromise the quality and reliability of supply. Furthermore, the cost of subsidizing the sector creates significant fiscal pressures.

iii. Protect the poor during the transition by scaling up the Social Cash Transfer system: The government's Social Cash Transfer system should be scaled up to accompany any subsidy removal and provide better support to the poorest households.

iv. Carry out a review of public expenditure in key sectors: A full review of what is being spent in key sectors will help ensure that every kwacha is put to productive use. By comparing objectives and past spending patterns, the allocation of expenditure can be improved and lessons to boost the efficiency of spending can be found.

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