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EUROBONDS REPAYMENT: LIMITING THE RISK OF DEFAULT

Based on the report "A Cautionary Tale of Zambia's International Sovereign Bond Issuances"

Shebo Nalishebo & Albert Halwampa

In recent years, the Zambian economy has been growing strongly and the country has increasingly been faced with the need to plug huge infrastructural gaps. However, the slowing down of bilateral and multilateral financing due to austerity measures in developed economies and the World Bank's reclassification of Zambia as a lower middle income country has led financiers to divert concessional loans to other needy countries in the low income bracket. Consequently, Zambia has had to diversify its budget and project financing options by issuing Eurobonds which are commercial borrowings by governments in currencies other than their own - in Zambia's case, it is denominated in US dollars. Since 2012, the Zambian Government has issued two ten-year sovereign bonds collectively worth US$1.75 billion to mainly finance infrastructure projects. These two bonds amounted to 37% of Zambia's external debt in 2014. With an average coupon rate of 6.9%, the two bonds have bullet repayment structures, implying that lump sum principal payments will be paid at the end of their respective ten-year maturity periods. The coupon rate is the interest rate at the time of issuance. Notwithstanding the high interest payments of over US$125 million annually, the bullet structure of the two bonds may have significant repayment risks as the country is expected to pay out the US$1.75 billion within a two-year period (in 2022 and 2024). The country may experience difficulty in repaying or refinancing the face value at maturity if the money is not spent in activities with high economic returns and if there are adverse changes in its exchange rate or international market conditions. The risks are already on the horizon – the recent depreciation of the Kwacha has increased debt servicing costs, while the low copper prices have reduced the much-needed export revenues used to service debt. Has Zambia dug itself into another debt hole? What measures can be put in place to mitigate the risk of a pending default?

Eurobonds have numerous benefits...

Eurobonds offer African countries easy access to monies that are free from the stringent conditionalities that often come with the traditional concessional borrowing. Eurobonds also strengthen macroeconomic discipline as a result of increased scrutiny by international market participants and are used as a benchmark for pricing subnational bonds. If the borrowed funds are spent on projects that offer a greater scope for augmenting revenue earnings and creating employment opportunities, this would accelerate economic growth and reduce the high poverty levels that Africa faces.

... that need to be weighed against the risks ...

However, by issuing Eurobonds, African economies have been exposed to "hot money" that seeks to take advantage of relatively high interest rates in Africa. The Eurobonds issued so far in Zambia have an average coupon rate of 6.9%. Comparatively, most bonds issued recently in developed countries have coupon rates

of less than 2%. With bullet repayment structures, the lump sum principal payments on the two bonds will be paid at the end of the respective ten-year maturity periods. Despite the high interest payments of over US$125 million annually, the bullet structure of the bonds pose significant repayment risks as the country is expected to repay the US$1.75 billion within a two-year period (in 2022 and 2024). Zambia may experience difficulty in repaying or refinancing the face value at maturity if the money is not spent on activities with high economic returns and if there are adverse changes in its exchange rate or international market conditions.

Eurobond issuances are also susceptible to foreign exchange risks given that they are denominated in US dollars. Zambia's exposure to currency risks is high given the country's heavy reliance on copper exports for foreign exchange. Recently, the price of copper has been sliding downwards, reducing the much-needed export revenues used to service debt. The 2013 Extractive Industries Transparency Initiative (EITI) reconciliation report estimates that Copper accounted for 66% of the total export revenues, 9% of GDP and about 30% of tax revenues in 2013.

At the time of the first Eurobond issuance in 2012, the Kwacha was trading at ZMW5.1/US$. Thus the interest payments on this bond were about ZMW207 million in Kwacha terms. The period average exchange rate for the first quarter of 2015 was ZMW6.9/US$. This means the interest payments, in Kwacha terms, on the same bond have now risen by ZMW70 million to ZMW277 million. The same is true for the second bond which, when issued, the Kwacha was trading at ZMW6.2/US$.

... and challenges ...

Concerns about whether Eurobonds are being spent in a way which will promote growth were confirmed in the 2013 Auditor General's report. Some of the issues highlighted by the report with regard to the use of proceeds from the 2012 Eurobond include misapplication of funds, lack of receipt and disposal details, delayed and irregular disbursements of funds. Even though most of the selected projects are high-value and can potentially boost economic growth, the future economic benefits are likely to be delayed due to the 'business-as-usual' approach in the use of the proceeds from the Eurobond. This increases the risk that Zambia will struggle to repay its debts between 2022 and 2024.

In addition to questions about how the funds are spent, Zambia faces legal and institutional challenges in the management of debt. The Loans and Guarantees (authorisation) Act - the main piece of legislation that governs public debt management – clearly sets out the authority to borrow and the borrowing limits. It also gives discretion to the Minister of Finance to set up a sinking fund - this is a fund established by periodically setting aside money for the gradual repayment of a debt. But it excludes clear objectives for public debt management and the requirements of a debt management strategy for achieving these objectives, and ensuring consistency with fiscal and monetary policy through an appropriate coordination mechanism and oversight.

Institutionally, Zambia uses a "product-based organisational structure" (with a focus on external debt, domestic debt and type of lender – bilateral, multilateral, etc.), whereas international best practice suggests using a "functional-based organisational structure" (with distinct front, middle and back offices).

The Front Office should be responsible for the analysis and efficient execution of all portfolio transactions, consistent with the debt management policy and strategy. The core competence of the Middle Office should be the design of a public debt strategy which involves risk/cost modelling and an analysis of macroeconomic and market constraints. Another important but more operational function is monitoring and compliance. The core competence of the Back Office should be operational, involving transaction confirmation, settlements, reconciliation and payments, as well as maintaining records of new contracts, disbursements, payments, debt restructuring and on-lending

All these challenges for managing Zambia's debt are against the backdrop of the challenging domestic and external macroeconomic conditions. Zambia is currently running high fiscal deficits averaging about 5% in the last three years. It has also been dogged by exchange rate depreciation and high currency volatility. Interest rate payments have been on the increase and the dependence on copper makes the country vulnerable to falling copper prices.

... which may impact the country negatively

In the unfortunate event that Zambia defaults, it is likely to have negative implications on growth, trade and investments. This may result in exclusion from accessing credit in international capital markets, a tainted reputation and reduced international trade. The poor economic conditions that trigger a default can be interpreted by the electorate as the result of bad economic policies. Government may

institute austerity measures which would negatively impact the general public and may typically cost the incumbent Government an election.

We can learn from other countries ...

As we consider how to respond to these challenges, we can learn from countries that have either defaulted or are at the brink of a sovereign default:

- a prolonged disregard to fiscal responsibility can have long term economic, social and political consequences - this is what led to the sovereign defaults in Argentina and Greece;
- persistently rising budget deficits, high exchange rate volatility, high inflation and a deteriorating current account are a recipe for accumulation of debt and thereby cause difficulty in servicing debt leading to a default - Seychelles experienced all these for about five years before it defaulted;
- political instability is a recipe for defaults - this was the case with Cote d'Ivoire in 2000 and 2011, following a coup and a disputed presidential election, respectively;
- in Jamaica, the interest payments on debt swelled to a level so high that the country was spending nearly half of its budget just meeting interest payments - there is need to carefully watch the interest burden on the country's coffers;
- Seychelles which is dependent on tourism defaulted in 2008, while Venezuela, dependent on oil, is on the brink of a default - there is need to diversify the economy away from copper.

... on what needs to be done

Zambia is currently on a learning curve from concessional borrowing to more market-based financing, both domestic and external. To mitigate the likely liquidity issues that may arise due to the bullet structures of the two bonds, Government will have to make some tough decisions ahead, including fiscal consolidation, strengthening legal and institutional challenges and considering various available financing options.

1 Address fiscal performance challenges by improving revenue mobilisation measures and rationalising expenditure

Improving revenue mobilisation measures: This is by prioritising the broadening of the tax base through further streamlining of incentives and exemptions, and enhancing Small and Medium Enterprises (SME) and informal sector taxation; strengthening tax administration through modernisation and continuous enhancement of the technical capacity of the Zambia Revenue Authority, tax-payer education, curbing of tax evasion and, through engagement with all key stakeholders, redesign the mining fiscal regime by having a mix of corporate income tax and royalties. These measures will improve efficiency in tax administration and thereby increase compliance by the tax payers, especially for poorly performing tax types such as corporate income tax and domestic Value Added Tax (VAT).

Rationalising expenditure: There is need for Government to rein in spending by prioritising expenditure on growth-enhancing programmes with parliament offering proper oversight to root out all forms of unplanned government spending. Considering that capital expenditures are a significant part of the national budget and the implementation of infrastructure projects usually span over a number of years, there is need to devise a stand-alone long-term infrastructure investment plan to address the historic problems of short-term decision making, uncertainty in funding and financing of infrastructure projects;

2 Institute measures to address the existing institutional and legal bottlenecks in debt management

Short term measures include the finalisation of the draft Medium Term Debt Management Strategy and mechanisms for periodic reviews of the strategy, and building of staff capacity to conduct debt sustainability analyses on an annual basis.

Medium-to-long term measures include the reorganisation of the debt office by functional lines to enhance its risk portfolio monitoring and analysis and enhancing Parliament's oversight role over loan

contraction and holding the executive accountable for debt management (or mismanagement) – currently, Parliament's role is limited to approving debt ceilings, scrutinising and passing annual appropriation Acts and scrutinising the Auditor General's reports particularly in line with the role of the Public Accounts Committee.

In the absence of corporate governance structures and debt monitoring capacity to contain macroeconomic and structural vulnerabilities from increased private sector and parastatal external debt, there is need for the development of guidelines for subnational borrowing.

3 Consider various available financing options

a) **Sinking fund:** Government should consider setting up a joint sinking fund for the two Eurobonds to insulate against future adverse macroeconomic conditions. Since money is fungible, the sinking fund should be set up as a bond buy-back scheme rather than a reserve fund held in trust. This means that Government would actively go into the market and buy back some of the bonds thus reducing the value of the existing debt. This would help in lowering the repayment risk at maturity. Lowering of the repayment risk would also translate into a lower interest rate on future borrowing.

However, the setting up of the sinking fund can be costly. Notwithstanding the traditional view that the sinking fund should be adopted only in the case of a revenue surplus, which is not likely to happen any time soon, a small part of the revenue receipts need to be earmarked for this fund. Once set up, the level of funding to the sinking fund could be scaled up in the medium term. This would be based on the longer-term effects of containing the high fiscal deficit by having more effective tax collection, getting the public sector pay under control, rationalising spending on infrastructure projects, and generally growing the economy.

b) **Debt refinancing:** This involves a change in the terms of an existing debt contract to avoid default, generally with lengthening of maturities of the old debt, preferably with lower interest rates and rescheduling the payment of arrears, if any. With the right timing, Government should consider refinancing the 2014 US$1 billion Eurobond – which was obtained at a higher coupon rate of 8.5% compared to the 2012 US$750 million bond which was issued at a coupon rate of 5.375% - by obtaining another bond with lower coupon rates and longer maturities. There are indications that Government is currently considering this option; and

c) **Widening creditor sources**: To moderate the appetite for Eurobonds, the country should diversify its funding options to include such mechanisms as Public Private Partnerships and borrowing from emerging sovereign donors.

PPPs are perceived as a financing modality to leverage private sector resources to contribute to large-scale infrastructure projects that the Government may not otherwise be able to finance and/or implement.

Financial resources from non-traditional donors to developing countries have surged in recent years, especially from countries such as Brazil, China and India. These countries view their financing as based primarily on the principles of South–South cooperation, focusing on mutual benefits and in many a case without policy conditionalities.

Note: For more information, please refer to the full-length report cited above.

Zambia Institute for Policy Analysis and Research (ZIPAR)
P.O. Box 50782, Lusaka, Zambia
CSO Annex Building
Corner of John Mbita and Nationalist Road, Lusaka
Phone: +260 211 252559
Fax: +260 211 252566
Email: info@zipar.org.zm
Internet: www.zipar.org.zm