

Reversing Zambia's high risk of debt distress

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Executive Summary

A load of unsustainable debt hangs heavy over Zambia. Zambia is part of a list of 25 low income countries considered at high risk of debt distress in 2018. Government's efforts to reduce the country's infrastructure gap as well as bring down poverty and inequality have resulted into large spending overruns, a growing subsidy bill and a substantial public sector wage bill over the last five years. Alas, domestic revenues remained low and stagnant. So Government resorted to massive external borrowing to finance arguably unsustainable expenditure. This approach to spending pushed borrowings to about 59% of GDP as at end of 2017, which is in the territory of unsustainable debt levels. In October 2017, the IMF issued a red flag that Zambia was at high risk of debt distress, implying that the country was likely to breach the thresholds for debt and debt service indicators and, should it continue on the same trajectory, it would likely default on its debt service obligations.

This high debt has consequences for growth and poverty reduction efforts. Increased domestic borrowing by Government from October 2015 resulted in reduced lending to the private sector as businesses and Government competed for credit, and thereby hampered economic growth. Further, with interest payments reaching 23% of domestic revenues and personal emoluments as high as 54% of domestic revenues in 2017, other priority spending as well as spending on social protection were crowded out, thereby

hampering efforts to reduce poverty. This was despite the removal of fuel and electricity subsidies in 2017, whose savings did not result in a corresponding increase in spending towards poverty reduction and empowerment programmes. Additionally, the high debt has made future borrowing more risky and more expensive, limiting opportunities to borrow, to invest or restructure debt going forward.

Zambia's surging public debt is largely skewed towards costly commercial external debt due to issuing Eurobonds and increased export and suppliers' credit. This poses significant repayment and currency risks. The bullet repayment structure of the first two Eurobonds means that the principal will have to be repaid at the end of the term of each loan in 2022 and 2024. Significant risks are thus faced as the country is ill-prepared to make such lump sum payments. Further, interest payments are payable in US dollars, so when the local currency depreciates substantially (as it did in 2015), the cost of servicing this debt increases. Moreover, while average interest rates on Eurobonds seem low at around 8%, the effective borrowing costs (interest rate *plus* average annual rate of depreciation) averaged 26% in 2016.

Realising these challenges, Government has taken steps to manage and stem the growing debt by devising and publishing a medium term debt strategy (MTDS). The 2017-2019 MTDS will enable Government to plan and negotiate the best available new borrowing and financing options to fund

economic development, growth and poverty reduction, while keeping debt costs and risks as low and as sustainable as possible in the medium term. The Strategy has three main characteristics:

- **It prioritises a higher share of domestic debt in the total debt portfolio and increases longer-dated government securities.** With lessons from the 2015 'mini-economic crisis', the strategy seeks to reduce dependence on foreign financing, deepen the domestic debt market and reduce exchange rate risk exposure. But, as this paper highlights, increasing domestic debt – combined with high levels of arrears – has led to swift and severe crowding out of private lending and investment. This suggests that domestic lending markets are still too shallow to support the ambitions of the Strategy while maintaining lending to the private sector.
- **It sets out to maximise concessional and semi-concessional debt.** This is an alternative to riskier and more expensive non-concessional loans. Also, it catalyses the improvement of fiscal and economic governance as concessional loans are conditional. However, Official Development Assistance (ODA), given in form of grants and highly concessional loans, may no longer be a reliable source of external financing for Zambia. ODA has been dwindling over the years following Zambia's classification into

a lower middle income country as aid preferences shift towards low income countries and countries in post-conflict situations.

- **It also seeks to reduce operational risk by enhancing debt management capacity.** For most parts of 2017 and the first half of 2018, there have been suspicions and mistrust regarding the scope and level of public debt, which may point to inherent weaknesses in debt management capacity as there were a lot of adjustments made to the debt numbers. Within the Strategy, improved capacity will be achieved through restructuring the debt office and ensuring the credibility of debt data. Changes at the senior level and new hires in the Debt Office point to efforts to strengthen the debt management capacity. Effective public debt management will also help preserve debt sustainability, and protect Government's reputation among investors.

Zambia's new blue print for debt management is a good start. It offers an opportunity for Zambia to deepen its domestic markets, reduce contagion that arises with huge foreign debt portfolios, and enable the country raise the required domestic financing. However, the plan does not spell out clear intentions to reduce the rate of debt accumulation, neither does it specify measures to ease debt distress and return Zambia to low levels of risk. Thus it remains unclear if the adopted plan will help Zambia in the trajectory of keeping debt within sustainable levels and reduce debt distress to moderate levels.

Hence on its own, the MTDS is not enough to stem the rising debt challenge. It needs

to be supported by commensurate actions to deliver its objectives and extra effort to reverse the high risk of debt distress. The austerity measures on debt announced by the Minister of Finance in June 2018 are good steps towards debt reduction but require steadfast commitment and additional steps to be actualised. The paper therefore recommends the following:

- **Managing Zambia's debt requires a return to fiscal sustainability.** Fiscal sustainability in a simple and practical way indicates a point in time when the country is able to cover its recurrent expenditures within its domestic revenues. This will ensure that borrowing is undertaken only for capital expenditure. Ultimately, reducing the risk of debt distress requires strong and sustained fiscal consolidation: limiting spending overruns, improving domestic resource mobilisation (by removing hurdles to growth mostly faced by the private sector), exercising restraint on commercial debt and obtaining only concessional and semi-concessional borrowing as outlined in the debt strategy. Cardinal to this is that debt should be utilised on high-return capital projects.
- **With a track record of half-hearted implementation of reforms, public debt management needs to be backed by legislation.** Government should use legal tools to support debt management, and the revised Loans and Guarantees (Authorisation) Act would be a good vehicle. The Act should include measures that mandate a review of the MTDS on a rolling basis through regular debt sustainability analyses, combined with the periodic setting of the MTEF to create a coherent

fiscal strategy for Zambia. Additionally, the law should include a clarification of the definition and scope of debt. The scope should include all types of public debt and consider including contingent liabilities of the country so as to cover all debt instruments that may be considered as 'hidden' obligations of Government.

- **Periodically set fiscal rules.** The Act should specify the setting out of fiscal rules on Government budgetary allocations which will influence political decisions of the executive and the legislature in the management of fiscal affairs. The use of nominal amounts in ceilings does not take into account other important parameters. Therefore, we propose the introduction of ceilings expressed in relation to the size of the economy (i.e. as percentages of GDP). Further, the law should be clear that all public debt-related activities should be carried out in compliance with the Debt Strategy with legal consequences of non-compliance enforced.
- **Government needs to expedite the development of a secondary market for government securities to enhance liquidity in the securities market.** As secondary markets develop, transaction costs are lowered and liquidity increases, so investors gain the confidence needed to invest in long-term government securities. Additionally it allows for the lengthening of the maturity periods of government debt stock, which reduces the frequency of new issuance and assists in the budget planning process. This leads to a deepening of the domestic debt markets and mitigates the inherent risks of using a

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domestic debt market as the channel for increased debt. Without increased participation through secondary markets, undersubscriptions in government securities may force Government to revert to the utilisation of external debt sources. Going by the below-par government securities auctions of the first half of 2018, Government may have more recourse to external financing and thus not achieve the intended objective of increasing the share of domestic debt to 60% of the debt portfolio.

- **For the secondary market to function properly, a deep and diverse investor base is required.** With the Government securities market dominated by commercial banks and a few pension houses such as NAPSA, more needs to be done for the debt market footprint to expand. Government should allow additional instruments, institutions and infrastructure within the framework to open up the market to other financial investors and the wider populace. Retail (individuals) and corporate bond

participation in the debt market is almost non-existent at the moment. Encouraging participation of retail investors, primarily through mutual funds that pool money from many investors to purchase securities and/or selling securities in accessible environments such as over the Post Office counters and mobile money would be a good start.

- **Additionally, Government should reduce the crowding-out effect.** Government borrowing from commercial banks is one of the main reasons behind the crowding-out of private credit, coupled with Government's rapid accumulation of arrears which contribute to high interest rates. Illiquid suppliers may try to bridge the delays in payment from Government by borrowing from banks and other financial institutions. As banks and other financial institutions provide credit to companies owed by the Government, they bear the brunt of non-payment leading to a rise in non-performing loans (NPL). This has left

banks unable to extend credit to new customers. Credit growth to the private sector is likely to contract in real terms because of tightened credit conditions arising from the rise in NPLs. To offset the risks of non-recovery, banks are likely to pass the cost of arrears onto other private borrowers by adding a premium to their lending rate.

- **Government should help reduce information asymmetries between lenders and borrowers.** Small and Medium Enterprises (SMEs) and other private sector players are faced with reduced commercial bank lending. Government's incorporation of the Credit Guarantee Scheme Limited, designed to diminish the risk associated with lending to SMEs and planned to be operationalised by September 2018, is commendable. If the scheme works, it will enhance the growth of the financially-marginalised SME sector which has been a key known source of employment and income, and may work to spur growth in the economy.

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Acronyms

BOZ	Bank of Zambia
BWI	Bretton Woods Institutions
CPIA	Country Policy and Institutional Assessment
DSA	Debt Sustainability Analysis
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries
IDM	Investment and Debt Management
IMF	International Monetary Fund
MOF	Ministry of Finance
MTDS	Medium Term Debt Strategy
MTEF	Medium Term Expenditure Framework
NAPSA	National Pensions Scheme Authority
NPLs	Non Performing Loans
ODA	Official Development Assistance
PDM	Public Debt Management
T-bills	Treasury Bills
UNCTAD	United Nations Commission for Trade and Development
ZIPAR	Zambia Institute for Policy Analysis and Research

1 Zambia's Burgeoning Debt Problem

Zambia targets to become a prosperous middle income nation by 2030. In an attempt to diversify, industrialise, modernise and decentralise the economy, Government embarked on various infrastructure projects such as roads, bridges, hospitals and schools, more so in Lusaka and the Copperbelt and created over 40 new districts¹. Additionally high wage adjustments were undertaken to cushion the cost of living for public servants, whereas allocations to agriculture subsidies increased with the belief that the subsidies were pivotal in improving production in the agriculture sector. However, these attempts have not come without cost; the several public investment programmes have mostly been front-loaded with borrowed resources while wage increases escalated the wage bill to about 50% of domestic revenues.

The increase in spending has not been accompanied by a corresponding increase in domestic revenues, which remain low and sluggish. Thus, to bridge the financing gap, Government resorted to massive external borrowing to finance arguably unsustainable expenditure. Realising the unsustainability of this policy path, fiscal adjustment measures were pronounced and have been undertaken from 2016. A temporary wage freeze was carried out in 2016, while the restriction of recruitments to frontline staff mainly in the health and education sectors,

coupled with a payroll clean-up exercise, helped in keeping the wage bill flat at around 47% of domestic revenues in 2017. The gradual move to full cost recovery tariffs for the energy sector also reduced overall spending on subsidies in the same period.

However, these gains made have been eroded by still rising debt contraction and the corresponding increase in interest payments. By end of 2017, Zambia's external debt was at US\$8.7 billion, while domestic debt, including arrears, was at K61.1 billion (Ministry of Finance, 2018). This translates into a public debt stock of 59% of GDP with external debt at 34% of GDP². In contrast in 2011, external debt stood at US\$3.2 billion while domestic debt was at K15.1 billion (Ministry of Finance, 2012). This means that during the last seven years, on average, the country has added US\$1.1 billion and K9.2 billion per year to the stock of external debt and domestic debt, respectively. The effect of which is that interest payments on total public debt have increased from less than 1% of domestic revenue in 2011 (or about K1 billion) to 23% of domestic revenues in 2017 (nearly K10 billion).

The 2017 International Monetary Fund (IMF) Debt Sustainability Analysis (DSA) indicated that Zambia was at high risk of debt distress (IMF, 2017a). Sustainability

indicators on both total debt and external debt are expected to breach their respective thresholds as determined by the Joint IMF/World Bank's Debt Sustainability Framework (DSF) for Low Income Countries³. The projected disbursements of about \$4 billion in external loans contracted in 2016 and 2017 and the borrowing plans of an additional \$5 billion mostly on non-concessional terms over the next five years will raise the total debt burden to over 60% of GDP and the present value of external debt to over 40% of GDP by 2019 (IMF, 2017b.). The debt-service-to-revenue ratio will also temporarily defy its 20% threshold in 2022 and 2024 when Eurobond payments fall due (IMF, 2017c.).

A debt to GDP ratio of 59% was attained in 2017, way earlier than predicted by the IMF. And in 2018 Zambia is part of 25 low income countries that are considered to be at high risk of debt distress. Other countries include Cameroon, Cape Verde, Central African Republic and Ghana (IMF, 2018). Distress may ultimately lead to default if Zambia is unable to meet interest payments on time, or may require debt relief (for non-commercial debt) when the principal falls due, as was the case during the Highly Indebted Poor Countries (HIPC) era. If that happens, Zambia would join countries such as Chad, Grenada, Mozambique, Sudan,

1 The number of districts increased from 72 in 2011 to about 115 in 2018.

2 This assumes GDP of K245.7 billion (2017 Economic Report) and an exchange rate of K9.55/US\$ (Bank of Zambia Fortnightly Statistics)

3 While Zambia is classified as a lower middle income country, it still uses the DSF for low income countries due to a significant concessional debt portfolio and limited market access

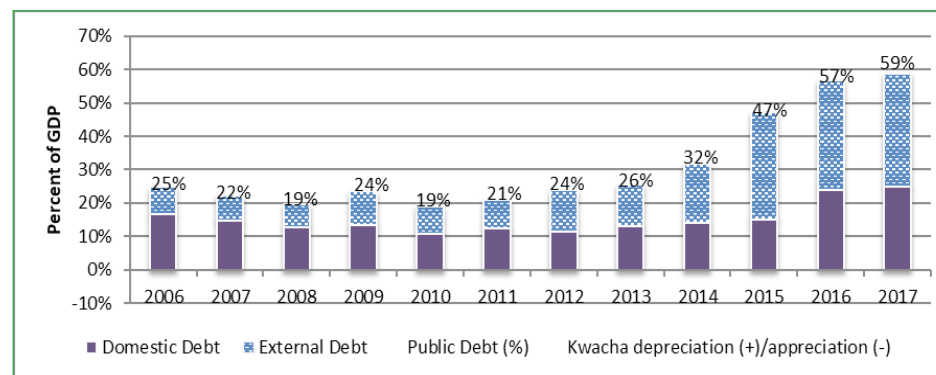
South Sudan and Zimbabwe who are already in debt distress. Figure 1-1 shows the rising trend of Zambia's external and domestic debt during the period 2006-2017.

Given that the stock of public debt is skewed more towards external debt, this exposes the debt portfolio to external vulnerabilities and fluctuations in foreign exchange rates. This is typified by the surge in the stock of public debt from 32% of GDP in 2014 to 47% of GDP in 2015 due to a 44% depreciation of the Kwacha in 2015.

Despite the changes in the level, composition and heightened risks of Zambia's public debt and its implications on public finances and the economy, there have been no clear guidelines and requirements for public debt management (PDM) – until 2017. Inadequate regulations exist on issuing, utilisation and payment plans of debt as well as on monitoring and publicising debt information. Nalishebo & Halwampa (2015) find that mechanisms to achieve debt objectives in consistency with fiscal and monetary policy through appropriate coordination and oversight are inadequate.

To improve debt management while awaiting the revised Loans and Guarantees Act, the Zambian Government devised and published the 2017-2019 Medium Term Debt Strategy (MTDS) in September 2017. It serves as a guiding tool for debt decision-making, and sets up objectives to manage the country's public debt prudently. The strategy intends to reduce the rate of debt accumulation and attain a cheaper and longer debt maturity profile so as to

Figure 11: Zambia's growing Public Debt to GDP ratios, 2006-2017



Source: Ministry of Finance, annual economic reports

reduce debt distress. Tactically, the MTDS embraces a gradual increase in domestic and concessional financing to achieve the debt objective of meeting Government's financing needs and payment obligations at the lowest possible cost, consistent with a prudent degree of risk. The main aim of altering the debt portfolio structure is to reduce associated exchange rate risks of large proportions of foreign currency denominated debt (Ministry of Finance, 2017). Consequentially, Government aims to deepen the domestic debt market.

With about a year into implementation of the 2017 to 2019 MTDS, this paper gives a synopsis of the strategy. It delves into each of the pillars of the strategy and analyses the pros and cons of each and assesses whether the pillars will achieve the intended results. Particularly we ask: i) whether the increase in

the share of domestic debt to 60% is tenable; ii) the challenges Government may face to reduce the share of external debt to 40%; iii) how to strengthen debt management capacity and improve institutional capability to ensure debt sustainability.

To do this, the paper firstly gives some background on why debt matters for Zambia and how it has been previously managed. Thereafter, the paper analyses the pillars within which the MTDS is set and showcases the strengths and weaknesses of the pillars of the Strategy. In doing this, we try to understand whether the choice of strategy will help return Zambia to a trajectory of lower debt distress. Lastly, the paper concludes and presents recommendations that will help to mitigate the risks embedded in the debt strategy and help reverse Zambia's high risk of debt distress.

2 Why Debt Matters for Zambia

Debt is an important source of development finance for Zambia and has been seen as a key tool for poverty eradication. For several years, Zambia's recurrent expenditures have exceeded revenues and as such, the financing of capital projects cannot be met entirely from domestic resource mobilisation. Therefore, debt financing has helped Government deliver infrastructure and other long term projects as they have been needed and has increased the capacity for further investment. However, debt has become a problem because it has grown to levels that cannot be sustained by the economy, and this has been worsened by the lack of financial discipline in public investments. The rapidly increasing debt levels are like cancerous body cells that grow out of control and crowd out normal cells.

For most ordinary Zambians, the matter of public debt seems far removed from their everyday realities. In a study conducted by the Zambia Institute for Policy Analysis and Research (ZIPAR) in 2016⁴, debt did not feature in the top five reasons for the 2015 economic downturn. Rightly so, because the ordinary person only feels the secondary effects of debt and may only realise the impacts of debt should a default happen. As such, the public ranked it lower than issues such as the high cost of living, the volatile exchange rate and the limited job opportunities because it is not evident to the general public that government debt could have been the reason behind the very things that they are more worried about. Yet debt

matters in Zambia for a number of reasons.

Increased domestic debt impacts on economic growth, as Government competes with the productive sector for credit. If a government borrows excessively from the domestic markets it results in increased commercial bank interest rates and what is known as the "crowding out" effect for private investment. This means that due to increased domestic borrowing by Government, there are fewer domestic resources for the private sector to invest (Blanchard & Johnson, 2013). Interest rates in Zambia have remained persistently high with government securities attracting high yields and commercial banks finding it more attractive to lend to the Government than to the riskier private sector. However, Government borrowing from banks has not been the sole reason behind the crowding out effect.

Accumulation of Government arrears limits economic activity. In Zambia, a good number of businesses are dependent on government contracts. Therefore, Government's delayed payment arrears have a huge impact on economic activities, as funds that could be used for business are locked up. Payment delays mean that local businesses are unable to meet their loan repayment obligations with banks, hence the rise in non-performing loans (NPLs) which have left banks reluctant or unable to extend credit to new customers from 2016. Credit growth to the private sector has contracted in real terms because of tightened credit conditions arising from

the rise in NPLs. To offset the risks of non-recovery, banks pass the cost of arrears onto other private borrowers by adding a premium to their lending rate, hence the high interest rates. Further, as suppliers to government suffer from liquidity shortages, there are knock-on effects from lower profits. Suppliers may reduce or withhold payments of taxes and other statutory obligations to offset the delayed amounts owed by Government.

Not enough resources are being channelled to poverty alleviation programmes. Zambia risks sabotaging its poverty reduction programmes continue to receive less resources. Presently, recurrent expenditures are not being entirely met by domestic revenues. As a percentage of domestic revenues, recurrent expenditures have increased from 92% in 2011 to 110% in 2017 as shown in Table 2.1. While the wage bill has been contained at around 47-48% of domestic revenues and spending on subsidies has declined, clearly the rise of interest payments on public debt continues to crowd out other Government expenditures including social protection, health and education.

Spending on social benefits, for example, accounted for 5% of domestic revenues in 2011 as shown in Table 2.1. This steadily declined and reached 1% of domestic revenues in 2016, before rebounding to 4% of domestic revenues in 2017. In per capita terms this translated into a social benefit

4 In a paper entitled "In the Eye of the storm: the impact of the economic slowdown on the labour market in Zambia"

Table 2.1: Recurrent expenditures exceed domestic revenues

	2011	2012	2013	2014	2015	2016	2017
Recurrent expenditure, % of domestic revenue	92%	94%	97%	103%	112%	111%	110%
Personal emoluments	38%	42%	45%	52%	47%	48%	47%
Interest payments	6%	9%	7%	12%	15%	19%	23%
Other recurrent, including subsidies	49%	43%	45%	39%	49%	44%	40%
o/w Social Benefits	5%	4%	3%	2%	2%	1%	4%
Capital expenditure, % of domestic revenue	20%	19%	29%	20%	38%	21%	20%
Social Benefits per capita (Kwacha)	70.1	58.4	48.3	48.9	53.5	33.4	115.0

Source: Ministry of Finance and ZIPAR's own calculations

allocation of K70.1 in 2011, which declined to K33.4 in 2016, before increasing to K115 in 2017. The small amounts of revenue being channeled into social benefits cannot meaningfully tackle social development challenges and entail that the pace of reducing poverty will be slower.

Higher debt leads to increased debt servicing costs and more borrowing, creating a vicious cycle. The higher the debt servicing component required from revenues in Zambia, the more borrowing is required to undertake various other expenditures. This is because debt servicing consumes more from revenue and leaves less for all other expenditure. As shown by Table 2-1, interest payments have grown from a low of 6% of revenue to 23% and in 2017, 10% of

recurrent expenditure had to be borrowed as recurrent expenditure could not be completely covered from domestic revenues. By implication all capital expenditure was undertaken using borrowed money.

Imprudent use of debt results in delayed future economic benefits thereby raising the risk of failing to pay back. According to Nalishebo & Halwampa (2015), though most of the capital projects financed by the Eurobonds were of high-value and could potentially boost economic growth, the funds were not disbursed in a timely manner, nor were they efficiently used, resulting in scattered investment, waste, and loss of investment capital. This is aptly stated and is exemplified by the 2013 Auditor General's report which highlighted fund misapplication, lack of

receipt and disposal details, delayed and irregular disbursements of the Eurobond funds.

The current debt stock levels and their repayments may affect future borrowing. Current borrowing habits such utilising debt for recurrent expenses may hamper future financing needs for Zambia as credit risk ratings may deteriorate further. If this be the case, then Zambia will only be able to obtain debt at very high costs. Moreover, Zambia is already at a high risk of debt distress. Should Zambia continue on a path of excessive borrowing, it may lead the country to fail to fulfil its debt obligations as it chokes on its own debt, especially if it were to face risks of unfavourable economic conditions that could hinder debt repayment.

3 Zambia's New Blue Print for Public Debt Management

After years of groping in the dark with regard to debt management, Zambia now has an MTDS covering the period 2017-2019. The MTDS is the new blue print for debt management. Outlined in it are plans, programmes and procedures as well as guidelines and predetermined options of amounts, type, how, when and from whom debt is to be obtained. Also, maturity profiles and a currency mix of external debt are delineated in the policy document. As an integral part of the Economic Stabilisation and Growth Programme, the MTDS is being implemented to achieve Government's objective of managing the country's debt portfolio. The MTDS was devised after undertaking a Debt Sustainability Analysis (DSA) in early 2017. The DSA statistically and analytically informed the quantitative benchmarks or targets and initiatives for new borrowing in the medium term.

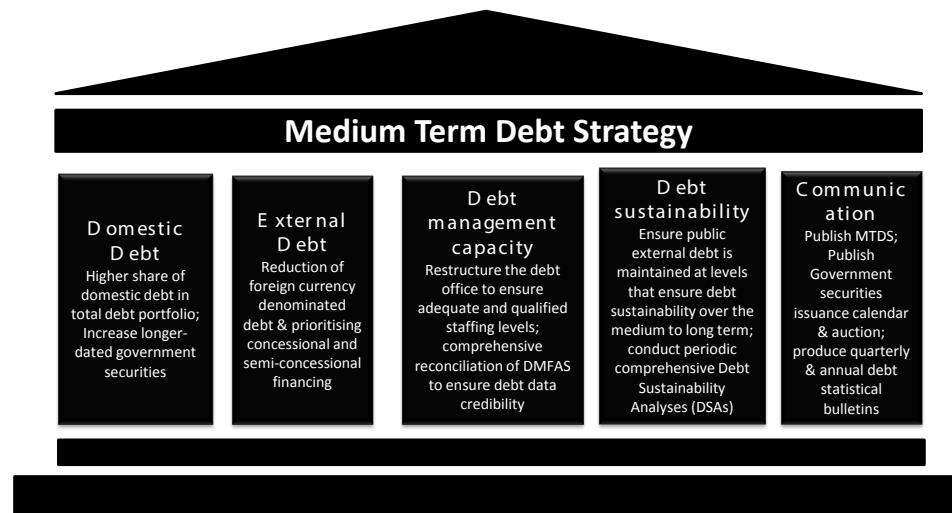
Through the MTDS, Zambia is going to embrace a gradual increase in domestic financing and concessional external financing which has been modelled to have the cheapest costs and risks for the nation to meet its debt objectives. The target is to change the structure of the debt portfolio by lowering the proportion of external debt from 55% to 40% while increasing domestic debt levels from 45% to 60%. In doing so, longer tenor domestic securities will be preferred to minimise the risk of refinancing domestic debt. Further, concessional

external debt will be maximised over commercial external borrowing.

Essentially, the strategy addresses balance of payment requirements and the foreign exchange risk exposure associated with the depreciation of the Kwacha in relation to large foreign currency-denominated debt. Equally, the strategy aims at improving debt management capacity in the Investment

and Debt Management Department of the Ministry of Finance to ensure adequate and qualified staff as well as carrying out comprehensive reconciliations of debt data to enhance reliability and credibility. Furthermore, Government also intends to keep the general public informed on the debt dynamics. The summarised strategy is shown in Figure 3-1.

Figure 3.1: Pillars of the 2017-2019 Medium Term Debt Strategy



Source: Ministry of Finance 2017

While the intermediate goal of the MTDS is to provide a basis on which to resolve debt challenges, which include a burgeoning debt, refinancing risks arising from the sizeable portion of short-term treasury bills in government securities, maturing Eurobonds in 2022, 2024 and during 2025-2027, and the exchange rate risk arising from the domination of foreign currency debt in the portfolio, the ultimate goal is efficient and effective debt management. The question then is: will this medium term strategy be able to achieve its intentions?

3.1 Increasing the share of Domestic Debt: Is this tenable?

A higher share of domestic debt will be pursued within the strategy, with the bulk of contracted domestic debt in form of longer-dated Government Securities. Consequently, costs and risks encountered with increased external debt as informed by the sustainability analysis have triggered a conviction that increasing domestic debt, while bringing down external debt, would be the optimal debt choice in the next three years.

3.1.1 The evolution of domestic debt

Historically, three mediums have been used to contract domestic debt in Zambia. These are:

- i) Treasury-bills (T-bills), which are short term borrowings of less than a year and are issued at a discount;
- ii) Government bonds that span from 2 years to 15 years with semi-annual coupon payments; and
- iii) domestic arrears of Government which relate to amounts owed to suppliers of goods and services, unremitted pension contributions,

and payments towards litigations and compensations.

From 2007 to 2010, Government bonds were the major domestic debt instrument averaging 51% of the total domestic debt portfolio – T-bills accounted for 41%. Starting in 2012, the frequency of issuing T-bills was reduced from weekly to fortnightly and Government bond issues from monthly to quarterly. Refinancing of maturing government securities was also undertaken. However, this resulted in an increase in the share of T-bills to an average of 51% during 2011-2013; Government Bonds, on the other hand, declined to an average of 43% of the total domestic debt portfolio.

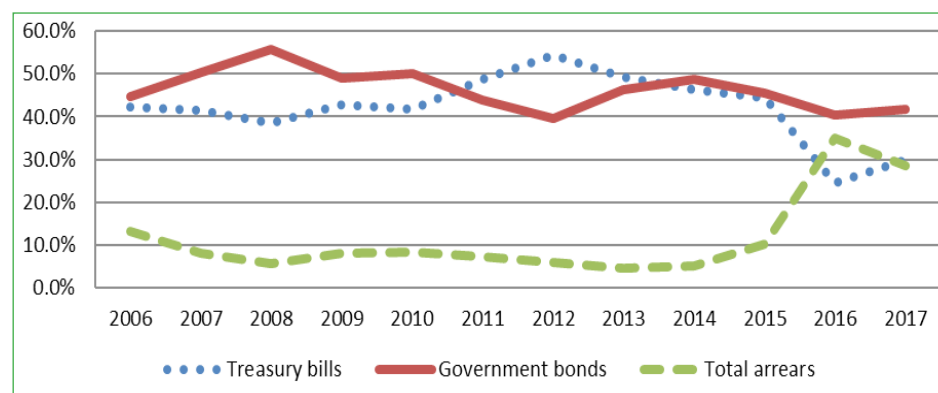
Poor commitment controls and tough liquidity conditions led to significant accumulation of payment arrears which, in 2016, surpassed the T-bills portfolio and were almost at par in 2017. Arrears increased significantly as a share of domestic debt from 10% in 2015 to 35% in 2016 before reducing to 28% of the debt portfolio in

2017. Government bonds also declined from 49% in 2014 to 42% in 2017. This is shown in Figure 3-2.

Because Government accessed lower than planned foreign loans and did not go into the international capital markets in 2016, it increased the issuance of government securities by increasing the size of T-bills, and the size and frequency of auctions for Government Bonds from quarterly to every two months.

Going into 2017, the policy stance was that Government would limit domestic borrowing to 2% of GDP or 19% of total deficit financing requirements while 5% of GDP or 81% of Government debt would be contracted from external sources. However, most of the external financing in 2017, mainly premised on an IMF bailout package and increased project grants, did not materialise. Government revised its deficit financing policy and switched from external to more domestic borrowing. Figure 3-3

Figure 3.2: Debt instruments as a percentage of total domestic debt, 2006-2017



Source: Ministry of Finance and Bank of Zambia

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demonstrates that 79% of the total financing requirements were met through domestic borrowing, a complete turnaround from the originally

3.1.2 Strengths of the domestic pillar

The strategic debt choice to gradually increase domestic debt is especially useful for Government's investment needs and should help achieve medium and long-term financing through:

a) **Reduced risk of financial contagion:**

The existence of a well-functioning domestic securities market reduces the need to borrow abroad, avoids the build-up of foreign currency denominated debt and lessens potential currency mismatches (Herring & Chatusripitak, 2000). When well utilised, local bond markets reduce the exposure to foreign currency issues and the dependence on international bond markets (Jiang, Tang, & Law, 2001). This diversification in the financial system insulates the economy from a credit crunch and reduces vulnerability to financial crises by absorbing volatility of capital flows through cross sectional

risk sharing – risk dispersion contributes to financial stability. With this in mind the target should be to introduce tenors longer than 15 years and introduce financial products, such as derivatives including forwards, futures, swaps and options that will help manage risks and improve financial stability to achieve the objective of deepening the local currency bond market.

b) **Widen creditor sources:** Non-resident investors' holding of Government securities increased to K8.4 billion in December 2017 from K6.6 billion in December 2016, representing 17.4% of the total stock of Government securities. Inflows from non-residents, who mainly preferred high-yielding Government bonds, also helped to stabilise the exchange rate.

c) **Achieve additional objective of developing bond markets and improve efficiency:** Bond markets remain the backbone of fixed income security markets and have wide macro and micro-economic benefits. Jiang, et al. (2001), state that it is desirable

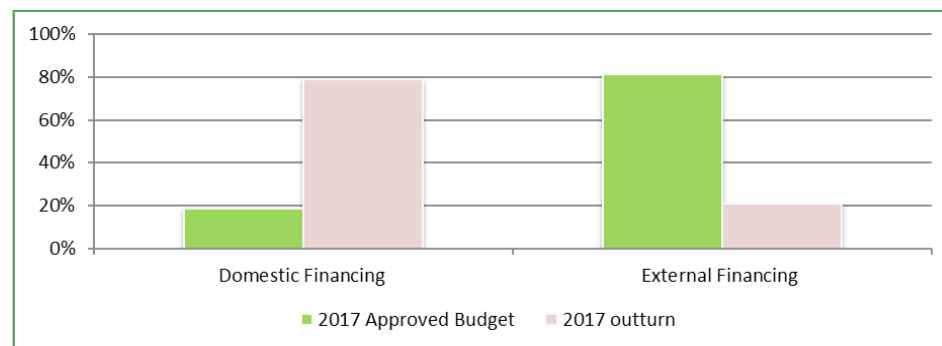
to have direct financing from bond markets dominating indirect financing which is intermediated by commercial banks. Similarly, Herring & Chatusripitak (2000) find that the absence of a well-functioning local bond market renders an economy less efficient and significantly more vulnerable to financial crises.

d) **Diversification and control of credit and liquidity risks:**

Alternative financing provided by local bond markets creates a competitive environment for bank financing and helps build long-term financial sustainability. It may also lead to the development of a legal, institutional and information infrastructure that benefit the financial system (Harwood, 2015). Where a liquidity crunch may threaten to disrupt normal credit flows, the availability of multiple avenues of financial intermediation serves the economy well. Besides, the competition from debt financing forces banks to provide more attractive terms and conditions.

e) **Activation of saving surpluses and additional financing:** Growing the government securities markets, by among other things, developing a secondary market, will allow other players to participate in providing long-term finance. Currently, banks are the major bond holders due to regulations that incentivise banks to invest in highly-rated liquid instruments. Encouraging other participants will activate savings and enhance competition with bank-based finance. As secondary markets develop, transaction costs are lowered and liquidity increases, so investors gain the confidence needed to invest

Figure 3.3: The switch in deficit financing, 2017, percentage shares



Source: Ministry of Finance 2017

in long-term government securities. Additional capital from local saving will be unlocked and create stable funding that can be targeted to finance projects with longer payback periods such as infrastructure. Debt markets provide mature and liquid funding for long term capital investments at higher yields and spur investment and higher economic growth.

However, it should be made clear that gains from a gradual increase in domestic borrowing in the bond market can only be maximised if the bond market is efficient, otherwise the real interest rate on the bonds will be higher than those bonds denominated in foreign currency and the markets will soon be illiquid as happened in 2015 and 2016. There should therefore be sufficient scale and a large enough demand and supply with no or limited distortions in the Government securities market.

3.1.3 Weaknesses of the domestic pillar

(a) Lack of control on fiscal deficit: The Zambian Government has run large fiscal deficits, usually much higher than the set limits in the annual budgets showing a lack of control over expenditures and general fiscal indiscipline. For instance in 2016, Government targeted a fiscal deficit of 3.8% to GDP but the outturn was 6.8%, almost twice the set target. Large financing needs in form of high fiscal deficits add financial pressure in the domestic debt market and increase the need to roll-over large amounts of domestic debt. This can make a country vulnerable to investor sentiments and contribute to capital outflows. Further, should the Central Bank finance the deficit through

monetary issues, it generates inflation. Inflationary expectations discourage investors to allocate resources on government bonds, increase the cost of funds and shorten the maturity of the issues (Valle C. d., 2002). Without rationalising expenditures, increasing revenues and targeting debt for capital projects, Zambia risks obtaining debt for recurrent expenditures, thereby widening the fiscal deficits.

(b) Crowding out of private sector investment can subdue growth.

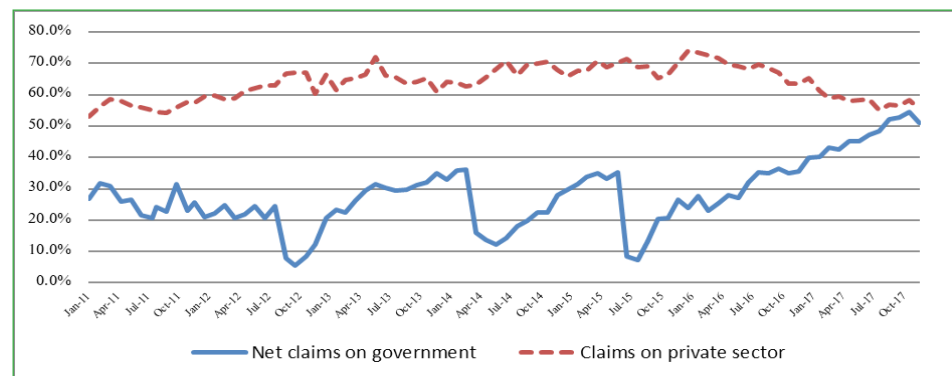
According to Valle (2002), high real interest rates are one of the common effects of an economy with a government incapable of implementing discipline on its expenditure. Despite the reduction in the Bank of Zambia policy rate from a high of 18.5% to 9.75% in 2018, the average lending margin stands at 14% and nominal interest rates still hover above 24% while real interest rates are around 17%. This poses a risk to the rest of the economy, as firms and households are secluded

from the credit markets by virtue of the high interest rates.

Figure 3-4 shows data on depository corporations' credit to the private sector and net claims on central government, both expressed as a percentage of broad money. The data suggest that there is an inverse relationship between net claims on central government and claims on the private sector. Indeed, if Government borrows one Kwacha more from the banking sector, the banks are left with one Kwacha less for the private sector. From mid-2015, net claims on central government started to increase, with a corresponding decrease in claims on the private sector.

(c) Increased private external debt can lead to a debt trap. As Government utilised more domestic debt, the mirror effect was increased private external debt. In the period of increased Government domestic borrowing, private external debt increased at alarming rates from 19.9% of GDP in 2011 to 66.4% of GDP in 2016, double

Figure 3.4: Net claims on central government and private sector as % of broad money, Jan 2011-Dec 2017



Source: Bank of Zambia

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the external public debt of 33% of GDP in 2016.

This is a risk worth watching out for. For instance, the Asian crisis in the 1990s, affecting Malaysia, Indonesia, Philippines, Thailand and South Korea, arose from a debt trap whose major source was a large private external debt that was not adequately monitored by debt managers as described in Text Box 1. Most importantly, increased private external debt hints towards the crowding out effect which is high when Government utilises the securities market to cover its deficit.

Limited investor base: According to the 2017-2019 MTDS, the investor base for Government securities is concentrated in a few big investors and is homogeneous. The largest investors in Government securities are financial institutions (mainly banks) and pension houses like the National Pension Scheme Authority (NAPSA). With bank lending dominating corporate and debt financing, savings are mostly channeled

through the banking system. Should the investor base continue to be restricted and undifferentiated, there is a possibility that a high proportion of the debt will continue to be concentrated in the banking system. This poses a risk to Government in mobilising adequate resources from the domestic market in the form of auction failures. Worsening sovereign debt positions have contributed to destabilising domestic banking systems and vice versa. If bonds are mostly held by banks, they can trigger a full-blown banking crisis.

(d) Contagion from increased foreign participation: While foreign investments can help to increase liquidity, lengthen maturities, develop secondary markets and create a more diversified investor base, they can however, also increase financial vulnerability as markets become more exposed to risks of international financial contagion and sudden outflows of capital. Countries with large holdings

of non-resident bonds are more exposed to a financial crisis than those that are more diversified. For instance, the World Bank (2017) show that the drive by non-resident investors behind the increased issuance of securities is likely to reverse if domestic conditions deteriorate (as happened in 2015) or if global interest rates increase as this has substantial impact on emerging market inflows. This creates vulnerabilities that require debt managers to carefully monitor the debt position, manage roll-over risk, and carefully track the proportion of non-resident purchases.

(e) Shortened average time to maturity: The strategy aims at lengthening maturities and ensuring that redemptions are evenly spread over time. It is anticipated that the average time to maturity will be maintained at a minimum of 3 years. However, the auctions of 2017 do not show any intent by Government to reverse the "sins" of the past where domestic debt was dominated by short term T-bills. Though the percentage of debt maturing in a year declined throughout 2012-16 as longer tenor paper replaced short-term T-bills, the proportion increased in 2017 from 41% of outstanding securities in 2016 to 47% thereby increasing refinancing and rollover risks. This is shown in Table 3-2.

Given the strengths and weaknesses of increasing the share of domestic debt in the debt portfolio, the strengths seem to be highly dependent on external factors while the risks for Zambia's domestic debt pillar are almost certain. Going by the government securities auctions of the first half of 2018,

Table 3.1: Public and private external debt, US\$ million, 2009-2016

	Private external debt	% of GDP	Public external debt	% of GDP
2009	5,018	32.7%	1,545	10.1%
2010	4,810	23.7%	1,766	8.7%
2011	4,668	19.9%	1,956	8.3%
2012	7,518	29.5%	3,474	13.6%
2013	9,708	34.6%	3,513	12.5%
2014	12,506	46.1%	4,807	17.7%
2015	13,422	63.4%	6,704	31.7%
2016	13,991	66.4%	6,947	33.0%

Source: Ministry of Finance

Text Box 1: Asian crisis: causes and developments

The debt crisis in East Asia stemmed from inappropriate borrowing by the private sector. The macroeconomic shocks astounded many people, more so that government budgets were in good shape - in surplus, and the Asian economies had experienced fast growth during the period 1990-97. Growth coincided with expansion of global capital markets and the preferred destination of these increased capital flows were the "emerging markets" – countries that have some characteristics of a developed market but do not meet the standards to be developed markets. Foreign capital, in particular bank debt, was an important source of finance to the Asian economies and was primarily invested in private financial and corporate sectors. Private firms and corporations looked to finance speculative investment projects. However, firms overstretched themselves.

Corporate borrowings were mostly foreign and short term commercial bank debts. The high weighting of short-term foreign bank debt within the capital inflows rendered the economies vulnerable to any sudden reversal. Vulnerability showed in the ratio of short-term foreign debt to foreign-currency reserves which were high. For instance, foreign liabilities as a percentage of foreign assets of the banking sector alone (not including Non-Bank Financial Institutions) had expanded to: close to 700% in Thailand, to about 200% in Malaysia, and to over 100% in Korea and Indonesia.

When banks and corporations started to fail, the abrupt change in investor and lender sentiments reduced stakes in these Asian economies destabilising the financial markets, which caused rapid depreciation of the currencies and further loss of confidence. At the onset of the crisis and in response to currency depreciations, foreign capital was withdrawn and a major reversal of capital flows and triggered financial and economic crisis throughout the region. According to the IMF (1999), private capital recorded a total net inflow of US\$62.93 billion for the Asia-5 countries (Thailand, Korea, Indonesia, Malaysia, and the Philippines) in 1996, but reversed into a total net outflow of US\$22.13 billion in 1997 and US\$29.61 billion in 1998. The magnitude of the outflow was most evident in the commercial-bank sector.

The outflows rocked the Asian economies with instability, interest rates soared and currency depreciations made foreign debt more expensive and heightened the mismatches on maturity. The financial sectors could not withstand this pressure and defaults began. Since an increasing portion of the credit expansion was directed towards non-traded sectors, the countries' ability to service their foreign debt weakened.

Corporate profitability had been trending downwards during the period leading to the crisis and the deteriorated investments reduced earnings available to service the borrowings with a larger share of profits covering interest costs. By 1995, the share of firms whose interest expenses exceeded their profits had risen, electronics registered the lowest profitability in 1996, and in Korea, the industry also had the highest share of firms unable to cover interest on loans. Declining profitability and rising interest costs generally reflected past overinvestment in production capacity.

Though the Governments tried to bail out the private sector, it was difficult to remedy the situation since the bulk of the country's foreign debt was in the private nonbank sectors. It was more difficult for the Government's to co-ordinate any debt restructuring repayment of corporate debt. Attempts at negotiating rescheduling remained piecemeal and often inconclusive and generally fell into partial suspension. Therefore, debt payments were largely suspended and sorted out on a case-by-case basis. Attempts at recovering the economy using IMF bailouts did not remedy the situation as quickly as anticipated because the issues were not at a macro but at a micro level. The effects of the crisis were far reaching, though the crisis eventually waned toward end 1998, major contagion developed in global capital markets, particularly in Russia and Latin America, which saw the weakening of the positions of hedge funds and investment banks.

Source: Adapted from the Hong Kong Institute of Economics and Business Strategy (2000)

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performance has been below expectation with Government raising less funds than anticipated. Thus, unless the risks faced are mitigated, Government may be forced to obtain debt from external sources and thus not achieve the intended objective of increasing the share of domestic debt to 60% of the debt portfolio.

3.2 External debt strategy: Maximise concessional and semi-concessional borrowing

The Strategy sets out to maximise concessional and semi-concessional debt as an alternative to riskier and more expensive non-concessional loans. Within the MTDS, it is not clear how Government intends to maximise concessional and semi-concessional borrowing. Though well intended, the pillar faces major risks and as the next section shows, the ease with which Zambia managed to obtain commercial external debt remains a serious temptation to return to the commercial markets especially in hard times. The pillar therefore lacks hard line rules on when to obtain debt from certain sources and within what sequence.

3.2.1 The evolution of external debt

Before 2011, the largest share of Government's external loans was contracted from multilateral creditors, including the World Bank, European Investment Bank (EIB), African Development Bank (AfDB) and the International Fund for Agricultural

Table 3.2: Government securities outstanding

Year	Outstanding T-bills		Outstanding Bonds		Domestic Debt Maturing in a Year
	K (Million)	% GDP	K (Million)	% GDP	
2012	6,597	3.9%	3,691	2.2%	64%
2013	8,526	5.7%	7,818	4.7%	55%
2014	10,809	6.5%	10,264	6.1%	51%
2015	12,290	6.7%	11,362	6.2%	52%
2016	13,174	6.1%	18,730	8.6%	41%
2017	20,416	8.4%	23,339	11.1%	47%

Source: Bank of Zambia, Statistics Fortnightly 2017

Development (IFAD). This was followed by bilateral credit. Collectively, multilateral and bilateral debt accounted for an average of 88% of the total external debt during 2006-2011. However, the reclassification of Zambia as a lower middle income country in 2011 subsequently reduced the country's access to the traditional concessional borrowing from multilateral and bilateral partners.

As a consequence, Government expanded its sources of external financing into the international capital markets with commercial sources taking a prominent share. Commercial debt thus became the principal financing mechanism of external debt, moving from 0% in 2011 to 48% in 2016. With less concessional and more commercial debt, interest costs

increased and access to long-term funding reduced. The main reason for the increased commercial debt was the issuing of Eurobonds in 2012, 2014 and 2015.

When considered from the perspective of the nominal interest rates, Eurobonds may seem to be low cost. However, when the exchange rate risk is considered, the effective borrowing cost is three to four times the nominal interest rate as shown in Table 3-3. While the average interest rates on Eurobonds seem low at around 8%, the effective borrowing costs (interest rate *plus* average annual rate of depreciation) averaged 26% in 2016.

This shows that commercial external debt is just as, if not more, costly as domestic debt.

Table 3.3: Government borrowing costs on the 2012, 2014, and 2015 Eurobonds

	2012	2014	2015
Amount issued (million U.S. dollar)	750	1,000	1,250
Amount issued (million kwacha) ⁵	3,770	6,127	9,591
Nominal interest rate (coupon, %)	5.375	8.5	8.97
Yield at Issuance (%)	5.625	8.625	9.375
Yield as at July 5, 2017 (%)	6.971	7.868	8.21
Issue Price (%)	98.108	99.174	97.257
Maturity	22-Sep 22	24-Apr 24	Jul - 25, 26, 27
Interest payments			
U.S. dollar, million	40	85	112
In kwacha, million, estimated at issuance ⁶	203	521	860
In kwacha, million, effective payment in 2016 ⁷	431	812	1,206
Effective Interest payments in 2016	11.4	13.3	12.6
Exchange rate depreciation effect (%) ⁸	112.8	55.9	40.1
Average annual rate of depreciation (%) ⁹	17.1	19.4	19.4
Effective borrowing cost in Kwacha (%) ¹⁰	22.5	27.9	28.4

Source: The International Monetary Fund, 2017

Semi-concessional borrowing has also taken a prominent share of the debt portfolio. Faced with dwindling financing from Paris Club countries, which is generally contingent on meeting the conditions similar to that of the IMF bailout package, Government has been increasingly looking more to Asia, and particularly China, to access semi-concessional financing. Export credit facilities offer semi-concessional

terms which are much more favourable compared to commercial instruments. Their maturities profile generally range between 20 - 25 years with interest rates between 2.0-4.0%. The bulk of Chinese financing, which now accounts for about 30% of total external debt, goes through Chinese financial intermediaries to largely Chinese contractors.

Against this background, interest payments

have grown significantly since 2011, rising from less than 1% of GDP in 2011 to 4% of GDP in 2017 reflecting the rapid accumulation of debt, rising borrowing cost, and the impact of exchange rate depreciation. It is therefore understandable why the focus of the MTDS is to reduce foreign currency denominated bonds and prioritise concessional over commercial debt.

3.2.2 Strengths of the external strategy

- a) **Provides an alternative to riskier and more expensive commercial loans:** Concessional loans offer more favourable terms than commercial borrowing. Concessional loans which

5 The prevailing exchange rates on issuance dates were K5.026/US\$1 (2012), 6.1267/US\$1 (2014) and 7.673/US\$1 (2015).

6 Fixed annual amount in dollar terms.

7 The prevailing exchange rate on due date for interest payments in 2016 [K 11.25/US\$1 (Jan 30), 11.36(Mar 20), 9.18(Apr 14), 10.25(Jul 30), 10.03(Sep 20) and 9.92(Oct 14).

8 Additional effective interest payment in % of the estimated cost at issuance.

9 K/USD, from issue date to December 30, 2016.

10 Coupon rate plus K/USD average annual rate of depreciation

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Zambia has had access to have an average interest rate of 1% per annum, average repayment period of 30 years and average grace period of 10 years. Further, export credit facilities particularly from China offer semi-concessional terms which are much more favourable compared to commercial instruments. Their maturities profile generally range between 20 - 25 years with interest rates between 2% and 4%. But non-concessional loans have maturity profiles of 8-10 years, a shorter average grace period of 3 years (or no grace period at all as is the case with Eurobonds), and interest rates ranging from 7-10% with significant exchange rate risks.

- b) Catalyst for improving fiscal and economic governance:** Accessing concessional financing is mostly contingent on the country meeting certain conditionalities imposed by creditors. The underlying principle behind most cooperating partners is that financing for development must reconcile the objective of meeting the large developmental needs with that of maintaining public debt at sustainable levels. Zambia's failure to access about US\$1.3 billion interest-free bailout package from the IMF in 2017 – funds required to support the balance of payments and create fiscal space for social and economic infrastructure development – was mainly due to the failure to reassure the IMF regarding sustainability of external debt servicing over time.

The IMF had concerns on the aggregate borrowing plan of the Zambian Government. The key message from the IMF was that

Zambia was at high risk of debt distress. So, in order for the Zambian Government to access the bailout package, a number of actions had to be undertaken by Government including “a slow down on the contraction of new debt, especially non-concessional loans, strengthen debt management capacity, and improve project appraisal and selection processes” (IMF, 2017d.). Implementing these measures would help improve fiscal governance, which currently stands as the weakest link on the CPIA rating.

3.2.3 Risks of the external strategy

- a) Access to concessional borrowing is increasingly limited:** Since Zambia's classification as a lower middle income country in 2011, Official Development Assistance (ODA), given in form of grants and highly concessional loans, has decreased as aid preferences shift towards low income countries and countries in post-conflict situations.
- b) Concessional borrowing comes with conditionalities:** Zambia has been negotiating for a zero interest rate concessional loan from the IMF over the last few years, but with little success, due to the Zambian Government's failure to meet the IMF conditions. IMF places particular emphasis on debt sustainability. For a country like Zambia that still relies on official external financing on concessional terms, public debt sustainability analysis is typically undertaken using the Low Income Country Debt Sustainability Framework (LIC-DSF), conducted jointly by World Bank and Fund staff.

The assessment of public debt vulnerabilities is informed by the risk of external debt distress and, where relevant, the overall risk

of debt distress. For countries assessed to be at low risk of external debt distress, limits on external public debt would typically not be required as part of programme conditionality. For countries assessed to be at moderate or higher risk of external debt distress, debt limits would be required as part of programme conditionality, with the specification of debt conditionality appropriately reflecting country circumstances (IMF, 2015).

Going forward, the risks to obtain external financing are heightened, given the poor performance of government securities and subdued economic growth which has frustrated efforts for domestic resource mobilisation. It is unlikely that Government will increase domestic borrowing to the desired 60% of the debt portfolio within the Strategy period as external debt remains the most viable option for financing the deficit. But, Zambia is unlikely to access more concessional and semi-concessional external financing as compared to the more available yet expensive commercial debt.

4 Strengthening Zambia's Debt Management Capacity

Debt management has increasingly become more sophisticated with Government increasing the debt sources as well as anticipating the use of debt transactions such as exchanges, debt buy-backs, and hedging through derivatives such as currency and interest rate swaps. Government may also become increasingly involved in transactions of on-lending to subnational entities and extending guarantees of various types to other government entities and/or the private sector. Therefore, the legal and institutional frameworks need to reflect these changes.

The current debate and mistrust regarding the scope of the existing public debt inherently reflects weaknesses in the debt management structures and capacity to record debt, as well as the past legacy of increased borrowing. For example, the recording, analysis and management of non-securitised debts (on-lending, Government guaranteed debt, domestic arrears, etc.) have been problematic because of inadequacies in the legal framework and institutional linkages (weak reporting system between departments within the Ministry of Finance and also between the Ministry and outside organisations). Strengthening the debt management capacity would ensure that mistrust is reduced and confidence is restored.

4.1 Legal framework

The legal framework for debt clearly defines the authority to borrow both domestically and externally but there are still some issues

that need to be addressed.

The Minister of Finance is given the power by the Constitution of the Republic of Zambia (Amendment) Act No. 2 of 2016, under Part XVI – Public Finance and Budget – Articles. 198 – 212, to commit the country to any kind of borrowings, that is, external or internal borrowings. It also provides for Parliamentary oversight of the Executive in matters relating to public debt (National Assembly of Zambia, 2017). Loans to be contracted by the State and guarantees on loans contracted by State institutions or other institutions are to be submitted by Cabinet to the National Assembly for approval.

Further, there are a number of other pieces of legislations that empower the Minister of Finance to borrow on behalf of Government through different instruments, issue guarantees, lend and to set the limits of the proposed borrowing (Text Box 2). The primary legislation is the Loans and Guarantees (Authorisation) Act No 13 of 1994. This Act is primarily intended to give blanket authority to Government to borrow.

There are also a number of Acts that authorise the application of international law in Zambia. These are the: International Development Association, Cap. 361; Bretton Woods Agreements Act, Cap. 367; and International Finance Corporation, Cap. 368. These Acts enable Zambia to be a member of, and therefore eligible to borrow from, the respective institutions.

Text Box 2: Main legislation governing Public Debt Management in Zambia

- The Amended Constitution Act No. 2 of 2016;
- The Loans and Guarantees (Authorisation) Act – No 13 of 1994;
- The Loans and Guarantees (Maximum Amounts) Order No 25 of 2014;
- Local Loans (Registered Stock and Securities) Act No 161 of 1967;
- The Loan (Stock, Bonds and Treasury Bills) Regulations;
- The Public Finance Act No 1 of 2018;
- The Bank of Zambia Act No 43 of 1996;
- The Finance (Control and Management) Act No 31 of 1996;
- Development Bond Act No 13 of 1994;
- The Treasury Bills Act No 159 of 1965;
- The National Planning and Budgeting Bill of 2015

The key provisions of the Loans and Guarantees (Authorisation) Act are as follows:

- **General borrowing powers:** Part II of the Act gives the Minister of Finance general powers to borrow both within and outside Zambia, as she or he may deem desirable. However, this gives the

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Minister of finance too much discretion to commit the country to debt and within the new Act, Parliament has been given an oversight role.

- **Methods of raising loans:** Loans may be raised through the issue of bonds or stock, issue of treasury bills and by agreement in writing. The Minister of Finance determines the terms and conditions applicable. The expectation that the Minister should negotiate terms that are favourable to Zambia is unrealistic as, in most cases, the lenders have the upper hand and set the terms and conditions of the loan(s). However, it may by implication mean that loans should be obtained from the cheapest or most favourable terms for Zambia.
- **Setting up of a sinking fund:** Part IV Section 9 of the Act provides for the Minister of Finance to establish a sinking fund whenever any bonds or stock are issued in respect of a loan raised under this Act for a period of more than ten years for the purpose of redeeming such bonds or stock. This is optional in the case of a loan raised for a period not exceeding ten years. Therefore, in the case of the Eurobonds which do not exceed 10 years, the Minister is not obliged to set up a sinking fund. This is a missed opportunity as the amounts involved are large. The legislation should also take the amount of the loan into consideration.
- **Annual contribution to sinking fund:** Part IV Section 11 stipulates that whenever a sinking fund is established under Section 9 or 10 in respect of any loan, the annual rate of contribution to such sinking fund shall be sufficient

to provide for the redemption, upon the expiry of the period of such loan, of not less than 75% of the principal of such loan. This provision commits Government to unnecessary burden as there are other financing options that can be used, in addition to the sinking fund, to redeem such a loan.

- **Power of Minister when the National Assembly is not sitting:** When the National Assembly is not sitting, the Minister is authorised in the public interest and with the approval of the President, under section 26, to vary the ceiling on borrowing to the extent necessary to raise an urgent loan or guarantee. This creates a loophole which can be exploited.
- **Debt Ceilings:** The subsidiary legislation Loans and Guarantees (Maximum Amount) Order No. 25 of 2014 specifies the debt ceilings. The present borrowing ceiling for external loans is K160 billion. Other borrowing limits are as follows: i) Treasury Bills: K30 billion; ii) Government Bonds: K40 billion; iii) Contingent Liabilities to non-residents: K50 billion; iv) Contingent Liabilities to residents: K30 billion. It is not clear whether these figures are determined on the basis of the country's ability to absorb and service such debt or simply to accommodate the existing debt obligations and their multiplication if Government fails to pay back or service them adequately. Further, the debt ceiling is not tied to the size of the economy which would act as a binding constraint - a recipe for fiscal and debt unsustainability.

The on-going revision of the Loans and Guarantees (Authorisation) Act No 13 of

1994 should address these short-comings in the legal framework as well as to make it conform to the 2016 Constitution especially concerning parliamentary oversight.

Further, Section 55 Clause (3) of the draft National Planning and Budgeting Bill of 2015, if enacted, will compel Government to invest in high-return projects. It states "Any resources proposed to be raised through domestic or external borrowing shall relate and be tied to appraised projects and programmes. This is to ensure that debt is invested in high return projects at cheaper rates and with longer times to maturity". 'High return' means the costs and interest on debt will be recovered from the projects undertaken.

Some countries in Sub-Saharan Africa have actively used the proceeds from local bond markets on high return capital projects. For example, the financing of the *Gautrain* project, an 80 km commuter rail system in Gauteng, South Africa built to relieve traffic congestion in the Johannesburg-Pretoria traffic corridor and offer commuters a viable alternative to road transportation during the 2010 World Cup and beyond. With 63,000 people using the train every weekday, it sustains about 6,000 jobs and contributes significantly to the GDP of Gauteng Province¹¹. Further, all tollable road networks in South Africa are funded using bonds. This is to ensure that financing obtained is paid back using funds collected from tolls. In 2017, the Kenyan Government successfully raised a 7 year bond worth US\$300 million financed through mobile money for various road projects.

11 http://www.engineeringnews.co.za/article/gautrain-2015-07-24/rep_id:4136

4.2 Institutional framework

The 2017-2019 MTDS states that to complement the implementation of the debt management strategy, a strengthened institutional arrangement for debt management will be pursued to reinforce the delegated authority of the Minister of Finance as a duly authorised official to commit Government to liabilities and the Ministry of Finance's centrality in debt contraction and debt management processes.

There are a number of institutions involved in the management of debt in Zambia. Key among them is the Ministry of Finance (MOF) and the Bank of Zambia (BOZ). Within the Ministry of Finance, the department responsible for management of debt is the Department of Investment and Debt Management (IDM); the Accountant General's Office is involved in recording some components of domestic debt such as the domestic arrears; and Budget Office records the debt serving payments. Better reporting and monitoring is required of the size of various domestic debt components that are variously handled between Budget Office, Accountant General's Office and IDM.

BOZ is involved in the management of debt as the fiscal agent of government as stipulated in the Bank of Zambia Act no. 43 of 1996. BOZ is mainly directly involved through the Financial Markets Department that conducts the auctions of Government securities on behalf of the Ministry of Finance. Further, BOZ also plays a role of financial adviser to Government on both domestic and external debt. The central bank also performs functions relating to the investment and management of any sinking fund established in respect of the loan as the Minister may from time to time direct.

4.2.1 Functions of the debt office

Nalishebo & Halwampa (2015) analyse the functions of the debt office and show that IDM department is presently organised along lines based on the source of debt, i.e. external and domestic debt unlike best practice as suggested by the World bank in Text Box 3.

The External Debt unit is responsible for multilateral, bilateral and commercial

Text Box 3: Sound practice for institutional framework for debt management

To achieve sound debt management and reduce operational risks, the World Bank recommends that the institutional set up of the debt office ought to be organised by functions (front, middle and back offices) rather than products (external, domestic debt) or lenders (multilateral, bilateral, etc.). The Front Office is 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 is 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 is operational, involving transaction confirmation, settlements, reconciliation and payments, as well as maintaining records of new contracts, disbursements, payments, debt restructuring and on lending. (World Bank, 2011)

debt. The unit's tasks include back office functions of recording new debt, grants and disbursements in the Data Management and Financial Analysis System (DMFAS), a system developed by UNCTAD; data validation and reconciliation, and initiation of debt service payments. Front office responsibilities include monitoring the outstanding stock of debt, and calculating the grant element for external loans. The Domestic Debt unit is responsible for the management of products such as traditional (Government securities) and non-traditional (arrears, awards and compensation) debt. The unit coordinates with the Bank of Zambia to auction government securities. Both the external and domestic debt units perform limited middle office functions of analysing the debt portfolio and monitoring risk indicators.

With such a structure, there are operational risks that include inadequate debt data recording systems and poor information flow across the departments involved within the Ministry of Finance, consequently leading to inaccurate and/or incomplete debt records. It also makes it difficult to verify creditor claims due to conflicting figures from the various bodies handling the debt management function. And, as suggested in the fourth pillar of the MTDS, there is need for a comprehensive reconciliation of the DMFAS.

To ensure that the MTDS is an effective tool of debt management it should be prepared by IDM in coordination with all relevant departments in a rolling fashion (yearly). Additionally, a middle office should be set up. Scaling up the middle office functions would require a critical mix of skills including finance and risk analysis, public policy skills to understand the role of debt management within the context of overall macroeconomic policies, and strong mathematical and

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modelling skills to assess the financial implications of the various clauses and conditions in the loan agreements to avoid committing the country to impossible or unsustainable obligations.

Additionally, the critical debt data unit requires staff with specialisations that will reflect the environment in which they work, including economics, basic finance and financial markets, and statistics.

To allow for effective functioning in the debt office, Government has taken steps to improve debt management capacity. Efforts include the restructuring of the Investment and Debt Management Department with a focus to engage qualified and adequate staffing at all levels. The staff recruited are being trained in debt management skills in collaboration with capacity building institutions such as the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), International Monetary Fund (IMF), United Nations Conference on Trade and Development (UNCTAD) and the World Bank.

5 Conclusion and recommendations

Unguided debt contraction and inadequate management of public debt have been a major cause of increased debt accumulation. The absence of an MTDS made it relatively easy to contract debt in fertile grounds of an expansionary fiscal policy. Unfortunately, limited financial discipline in public investment and improper usage of public debts in Zambia has resulted in scattered investment, waste, and loss of investment capital. Though the funds have helped the country increase its road, rail, and bridge infrastructure, Zambia may delay to see the results of these investments. The 2013 Auditor General's report highlights misapplication of funds, lack of receipt and disposal details, delayed and irregular disbursements of funds as some of the reasons that will hamper the benefits of these investments.

A number of economic effects have resulted from the increased public debt. Government debt obtained from the domestic markets has resulted in increased commercial bank interest rates with Government "crowding out" the productive sectors from the local credit markets. This has had an effect of dampening economic growth. Further, increased payments on interests have relegated social benefit expenditure to less than 1% of GDP as interest obligations moved from just under 2% of GDP in 2012 to 4% in 2017 affecting public service delivery. Moreover this has introduced a vicious cycle requiring more borrowing to cover other expenditures since about 70% of revenues are used for personal emoluments and interest payments.

Debt remains essential to the Zambian economy, but proper management is a must. Usage of debt financing is still with us as Government revenues remain stagnated. Debt should therefore be obtained strictly for capital expenditure and not to fund recurrent expenditures. Moreover, project appraisals should be undertaken to ensure that good returns are obtainable from the projects to ensure smooth repayments. Going forward, Zambia should target low risk debt with higher returns. That is why the MTDS is a step in the right direction as its objectives are to obtain debt at the lowest cost within reasonable risk to meet Government's financing needs. But more needs to be done to ensure that the MTDS achieves its objectives.

More weaknesses than strengths in the domestic debt pillar. Though aiming to increase the share of domestic debt in the debt portfolio, the local currency bond markets are still shallow. Thus the strengths of this pillar are highly dependent on external factors while the risks for Zambia's domestic debt pillar are almost certain. Going by the below par government securities auctions of the first half of 2018, unless the risks faced are mitigated, Government may be forced to obtain debt from other sources, mostly external, and thus not achieve the intended objective of increasing the share of domestic debt to 60% of the debt portfolio.

The external debt strategy of prioritising concessional and semi-concessional financing is unlikely to be met in

the Strategy period. Given the poor performance of government securities and subdued economic growth which has frustrated efforts for domestic resource mobilisation, external financing may remain the most viable option for financing the deficit. However, Zambia is unlikely to access more concessional and semi-concessional external financing as compared to the expensive commercial debt financing. It is therefore unlikely that Government will reduce external borrowing to the desired 40% of the debt portfolio within the Strategy period.

Zambia's new blue print for debt management is a good start but requires more. It offers an opportunity for Zambia to deepen its domestic markets, reduce contagion that arises with huge foreign debt portfolios, and enable the country raise the required domestic financing. However, the plan does not spell out measures to ease debt distress and return Zambia to low levels of risk. Therefore the adopted plan is unlikely to reduce the risk of debt distress.

5.1 Recommendations

To help Zambia reverse the high risk of debt distress, we propose the following:

- **Managing Zambia's debt requires a return to fiscal sustainability.** The fundamental question is: "what is the impact of the adopted strategy on medium and long term public debt sustainability?". In its current form, the MTDS as published by the Ministry of Finance does not answer this

question. The answer to this question is beyond the MTDS and hinges on fiscal sustainability. Though many definitions of fiscal sustainability abound, a simple and practical indicator for fiscal sustainability is where and at what point in time will the country be able to cover its recurrent expenditures from domestic revenues. In thinking about this, Government ultimately has to put in place policies that grow the economy and improve revenue collection.

- **With a track record of half-hearted implementation of reforms, public debt management needs to be backed by legislation.** Government should use legal tools to support debt management – this should include a mandate to review the MTDS on a rolling basis. These measures could be combined with the periodic setting of the Medium Term Expenditure Framework (MTEF) to create a coherent fiscal strategy for Zambia. Institutional arrangements for debt management may be strengthened by including debt management objectives in the legislation, as well as requirements to publish information on public debt periodically and on a timely basis with explicit mention of the debt management strategy. The law should also be clear that all public debt-related activities should be carried out in compliance with the Strategy, with legal consequences of non-compliance enforced. The revised Loans and Guarantees (Authorisation) Act, which is yet to be tabled before the National Assembly, would be a good vehicle for the bulk of these measures.
- **Clarify scope of debt within the law to avoid different debt estimates.** Essentially, this will clarify the definition

of debt in the Zambian law and will support the publishing of a single debt figure. The scope should include all types of public debt and consider including contingent liabilities of the country so as to cover all debt instruments that could be considered as hidden obligations of Government. This will encompass the main financial obligations over which the central government exercises control, including both marketable and non-marketable debt. Moreover, the concept of debt should clarify circumstances under which implicit hidden obligations may become actual obligations so as to ensure that they are subject to the same safeguards. This will ensure that public debt is calculated accurately, adequately and will be consistent for Zambia, international organisations, and foreign countries.

- **Periodically set fiscal rules.** Government needs to set legally binding rules or provide long-standing quantitative restrictions on budgetary or fiscal aggregates, particularly on expenditure, deficit financing and overall debt contraction are essential to significantly strengthen fiscal and debt management. Fiscal restrictions on Government budgetary allocations influence political decisions of the executive and the legislature and are essential in the management of fiscal affairs.

There are basically four broad and distinct sets of rules:

- a) Expenditure rules (or ceilings) impose a ceiling on the amount of government spending, either in nominal or real terms, or using nominal or real growth rates, or using

a specific government expenditure-to-GDP ratio.

- b) Budget balance rules impose a ceiling on government spending vis-à-vis revenues, using either cyclically adjusted/structural or nominal measures, or using percentage of GDP measures.
 - c) Debt rules set limits on the amount of government debt, either in nominal terms, as a ratio to GDP, or even an explicit reduction of debt in terms of the debt-to-GDP ratio.
- Revenue rules impose constraints on the allocation of higher-than-expected revenues in good times, and can impose constraints on expansion of the tax-to-GDP ratio. **Reduce the crowding out effect.** With Government aiming at larger domestic debt proportions, Government has to be weary of the fact that borrowing from commercial banks has been the main reason behind crowding out of private credit and increased interest rates. Additionally, Government's rapid accumulation of arrears make it difficult for illiquid suppliers to make repayments on lending – they may try to bridge the delay in payment by borrowing from banks and other financial institutions, adding pressure to credit markets and driving up interest rates. Government's increased spending to clear arrears is a welcome move as this is likely to mitigate the crowding-out effect. Government should also seek to address information asymmetries that lead to low private sector lending by, among other things, considering credit guarantee schemes designed to diminish the risk associated with lending to SMEs (Government has since incorporated a

credit guarantee scheme as explained in Text Box 4).

Text Box 4: Government sets up credit guarantee scheme

Following Government's plan to establish an agricultural and industrial credit guarantee fund for small and medium enterprises as reported in the 2017 Budget Speech, the Zambia Credit Guarantee Scheme Limited (ZCGS) was incorporated in September 2017 and is expected to be fully operational by September 2018. It aims to promote affordable SME financing in Zambia. The ZCGS will act as an interlocutory agency in providing credit guarantees to SMEs, thus reducing perceived risk profile to financing institutions. The guarantees will facilitate financial institutions to provide affordable financing to SMEs. ZCGS will support all productive sectors of the economy except for highly speculative activities such as gambling, real estate investment, mergers and acquisitions and refinancing. The Guarantee will offer and support three tiers of customer segments with loans of up to K5 million. Tier 1 customer segments are well-established and functional businesses; Tier 2 businesses are less structured with bank accounts and proven business records; while the Tier 3 segment focuses on the unstructured and unbanked segment with no proven business record.

Source: Zambia Credit Guarantee Scheme Limited, 2008

- **To support this, there is need to widen the investor base.** Government securities market is understandably dominated by commercial banks and a few pension houses such as NAPSA. For the debt market footprint to expand, Government should put in place the necessary institutions and infrastructure to open up the market to other financial investors and the wider populace. Retail (individuals) and corporate bond participation in the debt market is almost non-existent. Encouraging participation of retail investors (such as retirees, small and medium enterprises, schools, churches, workers and traders), primarily through mutual funds that pool money from many investors to purchase securities. Further selling securities in easily accessible environments such as over the Post Office counters and through mobile money would be a good start as currently secondary market agents are few and only located in cities. It is imperative that more companies issue corporate bonds as an alternative to expensive bank loans. Setting up of a dedicated team of experts within the Ministry of Finance to facilitate development of the retail and corporate bond markets and following up on relevant implementation initiatives will help.

Reducing the risk of debt distress requires strong and sustained fiscal consolidation: limiting spending overruns, improving domestic resource mobilisation (by removing hurdles to growth mostly faced by the private sector), and exercising restraint on concessional and semi-concessional

borrowing. Implementation of the above measures could be achieved if the consolidation announced by the Minister of Finance in mid June 2018 were to be adhered to in earnest as they are essential to ensure that debt accumulation does not happen at a fast pace as it did in previous years.

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