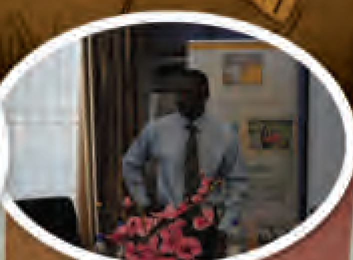
DOMESTIC DEBT MANAGEMENT IN AFRICA THE CASE OF ZAMBIA



AFRICAN FORUM AND NETWORK ON DEBT AND DEVELOPMENT

DOMESTIC DEBT MANAGEMENT IN AFRICA
THE CASE OF **ZAMBIA**

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ABBREVIATIONS & ACRONYMS

AFRODAD	African Forum and Network on Debt and Development
BBC	British Broadcasting Corporation
BoZ	Bank of Zambia
CCS	Commitment Control System
CSO	Civil Society Organisations
FDI	Foreign Direct Investment
FNDP	Fifth National Development Plan
FSP	Fertiliser Support Programme
GDP	Gross Domestic Product
GRZ	Government of the Republic of Zambia
HIPC	Heavily Indebted Poor Countries
IMF	International Monetary Fund
JCTR	Jesuit Centre for Theological Reflection
LICs	Low Income Countries
MDRI	Multilateral Debt Relief Initiative
MOFNP	Ministry of Finance and National Planning
MTEF	Medium Term Expenditure Framework
NAPSA	National Pension Scheme Authority
PDM	Public Debt Management
PEs	Personal Emoluments
PRGF	Poverty Reduction and Growth Facility
RAMCOZ	Roan Antelope Mining Corporation of Zambia
RDC	Recurrent Departmental Charges
TNDP	Transitional National Development Plan
ZANACO	Zambia National Commercial Bank
ZCCM	Zambia Consolidated Copper Mines

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PREFACE

Domestic public debt is not a new phenomenon for developing countries. In the face of budget deficits, against a backdrop of drying up of concessional lending and reduction in development assistance due to the impact of the global financial crisis among others, borrowing from domestic markets becomes a viable option. However far less attention has been given to domestic debt in development policy discussions. The efforts over the years have been centred on external debt where much focus has been on the HIPC and MDRI initiatives. While there has been a remarkable policy shift on external debt following implementation of HIPC and MDRI in a few developing countries, AFRODAD has seen the emergence of a new threat in debt management due to domestic borrowing which is not under the same scrutiny as external borrowing.

Domestic debt has been used to finance primary deficits and implement monetary policies in most African governments, such that in some countries domestic debt now constitutes a large share of the total debt stock. AFRODAD believes that reforms in debt management are critical to avert a vicious cycle of recurring debt burden. If domestic debt is not kept sustainable it will erode the benefits accrued from initiatives like HIPC and MDRI which had improved the fiscal space by freeing resources on the trajectories of pro-poor development policies in most HIPC countries.

Domestic debt can be beneficial if used for the right purposes. However, enormous levels of domestic debt may have a negative effect on financial stability. Arguments against domestic debt include the crowding out effect on private investment and its subsequent effect on economic growth especially in countries with relatively narrow domestic markets. Domestic debts also affect the level of interest rates as they make borrowing expensive due to the relatively narrow investor base and the monopolistic tendencies of most investor groups in Africa. Furthermore, domestic debt service absorbs a significant amount of government resources which could be used for social services and other pro poor expenditures in the economy.

The report analyses the linkages between domestic debt and economic development in Zambia with regards to the use of domestic debt in the economy. It unpacks the legal framework and institutional structure for domestic debt contraction. It analyses the structure and composition of domestic debt in Zambia, providing an assessment of the nature of the relationships between different policy instruments for domestic debt acquisition and the role of different stakeholders in domestic debt management such as parliament, civil society and international financial institutions. Perhaps more critically the report concludes by giving actionable policy recommendations in improving aspects of domestic debt management in Zambia. AFRODAD hopes that the Zambian government and other stakeholders will take the findings of this report seriously and address the concerns contained there in.

Collins Magalasi
Executive Director
AFRODAD

EXECUTIVE SUMMARY

Not until recently, less attention has been given to the issue of domestic debt in low-income countries (LICs) despite the probable and significant impact on government budgets, macroeconomic stability, private sector lending and, ultimately, growth performance. This is because most discussions in the past decades have mainly focused on the external debt burden and its impact on fiscal sustainability and economic growth in LICs. As a result, these debates culminated in various debt reduction plans, such as the Heavily Indebted Poor Countries (HIPC) Initiative, which sought to reduce the external debt stocks in these LICs and free up resources for pro-poor growth government spending (IMF, 2004: 3).

With the spreading of the global financial crisis, the drying up of concessional lending, and commodity prices falling, there is a likelihood of domestic debt becoming a major source of domestic development financing. It is with this in mind that the African Forum and Network on Debt and Development (AFRODAD) proposed to carry out five country case studies with a view strengthening the domestic debt management aspect of the public debt. The focus of the study was to examine the linkage between domestic debt and development financing through the lenses of economic development, monetary policy stabilization and debt sustainability; the regulatory and institutional framework inherent in the domestic debt management and how they affect national debt strategy; the role of key stakeholders in managing domestic debt; and give recommendations on appropriate measures in addressing domestic debt burden in Zambia.

This study has made a number of pertinent observations. Significant is that domestic debt in Zambia has, in the past five years, been increasing at a high rate in nominal terms but in GDP terms has been on the decline. This is against a background of several commitments by the Government to support the achievement of the overall macroeconomic stabilisation goals. This has resulted in the Zambian economy being well managed and resulting in an increase in the real GDP growth. The study has also noted the need for prudent management of domestic debt since it still constitute a large share of government expenditure. For example, the total domestic debt as a percentage of GDP stood at 9.4 percent as at end 2008.

Of the total domestic debt stock, 94% is in government securities while domestic arrears have generally reduced. This growth in Government Securities as a way of deficit financing however has a risk of exerting inflationary pressures as well as crowding-out of private sector investment.

Zambia's legal and institutional framework for debt contraction, management and monitoring lacks a broad-based consultation and commitment from relevant stakeholders such as parliament and civil society. In addition, the Domestic Debt Management and Reduction Strategy that was developed in 2006 have yet to be implemented.
Like many developing countries, Zambia was also affected by the Global Financial Crisis of 2008/9 has had serious implications on government revenues. The massive decline in commodity prices (including copper) has resulted in the deterioration of fiscal revenues as evidenced by the 2010 National Budget which projected domestic borrowing at 2.5 percent of GDP against the FNDP's target of 1.8 percent.

Based on the above findings AFRODAD makes the following recommendations:

- The Government of Zambia should enhance domestic resource mobilization with a special focus on other alternative sources of financing, such as broadening the tax regime rather than relying on domestic borrowing
- The Government should regard the matter of implementing the National Domestic Debt Management and Reduction Strategy policy as a priority
- Efforts should be directed towards the reform of both the legal and institutional arrangement governing the domestic debt acquisition.

1

DOMESTIC DEBT AND ECONOMIC DEVELOPMENT

Developing countries are confronted by problems which include high inflation rate and financial instability leading to impeded investment. Budget deficits and large current account deficits are common features of developing economies. These deficits have normally been financed by foreign capital inflows from both the public and private sectors (Feltenstein and Iwata, 2002: 3).

The attention placed on external debt over the years has lead to reduced external borrowing by many developing economies, especially those that benefited from the Highly Indebted Poor Countries (HIPC) process. Under these circumstances many developing countries have turned to domestic borrowing as a viable option for budget deficit financing.

Although budget deficits may occur for numerous reasons, the term usually refers to a conscious attempt to stimulate the economy by lowering tax rates or increasing government expenditures. The influence of government deficits upon a national economy may be very great. Deficit financing stimulates the economy for a time but eventually can become a drag on the economy by pushing up interest rates.

Critics of deficit financing through domestic borrowing regularly denounce it as an example of short-sighted government policy. Advocates argue that it can be used successfully in response to a recession or depression, proposing that the idea of an annually balanced budget should give way to that of a budget balanced over the span of a business cycle.

The objective of government financing is to mobilise financial resources, taking into account elements of cost and risk, as well as any macroeconomic and monetary implications. Typically, government officials in charge of debt management aim at primarily minimising the financial burden, that is, the direct cost of government debt. However, choosing between various options to government's borrowing requirements should be based on numerous considerations. In practice, this requires close coordination among departments responsible for macroeconomic management, in particular the Ministry of Finance and National Planning and the Bank of Zambia in this case.

Given the limited options in deficit financing many low income countries face, the approach mainly taken consists of developing alternative short-term financing options. Domestic borrowing through issuance of government securities, either directly by the treasury or through the central bank, is one way to diversify financing sources to cover short-term cash requirements and to minimise direct central bank financing.

This is because in the face of public deficits, governments are confronted by the choices between external and domestic financing. If options are available then the choice boils down to cost and risk. This choice is not straight forward as governments usually pursue various objectives such as low inflation; stable exchange rate; low interest rates and favourable yield curves; an adequate foreign reserve cover; and active domestic capital markets (IMF, 2002: 3). Because of its actual and potential magnitude, meeting government's borrowing requirements has significant effects on the economy. Moreover, public sector financing instruments and mechanisms help to develop financial intermediation and thus foster sustained economic growth.

Zambia, like in many African countries, domestic debt can provide a viable investment opportunity besides lending to the private sector, since stock markets are either absent or highly illiquid (Gelbard and Pereira Leite, 1999). The provision of government longer-term paper is therefore highly important for investors to balance their long-term liabilities with long-term assets and for banks to increase profitability by taking on interest rate risk.

Domestic debt can also be used to achieve monetary policy targets. Christensen (2004: 4) observes that this is particularly the case in countries with large balance of payment surpluses, created by large aid inflows or oil exports. In those situations, he stresses, the inflows of foreign exchange increase liquidity, which can undermine macroeconomic stability and the central banks often decide to intervene by selling government or central bank bills to stem inflationary pressures from excess liquidity.

Furthermore, domestic debt, when well managed, can also reduce the government's exposure to interest rates and currency risks. Arnone and Presbitero (2006: 2) contend that a market for government securities is likely to support the implementation and the transmission of monetary policy, and a liquid and depth market with long term instrument could also help reducing the cost of

government financing. Ultimately, the development of a domestic bond market is essential for strengthening the process of sustained economic growth, since it helps mobilizing domestic savings and, if the market is properly organized, can lead to an efficient and market-based allocation of capital.

Thus, the rationale behind the creation of a domestic market for government securities (for purposes of domestic borrowing) in poor countries is that it could stimulate the development of deep and liquid internal financial markets and protect countries from adverse external shocks (Ibid: 5). However, the achievement of a certain degree of macroeconomic stability, in terms of credible fiscal and monetary policies and financial markets liberalization, is required to reap the benefits of the development of an internal bonds market (Arnone and Ugolini, 2005, Del Valle and Ugolini, 2003). If this is not the case, the advantages are likely to be offset by adverse effects in terms of higher interest rates and crowding out of private investments.

In countries such as India, domestic debt has been considered favourable in sharp contrast to prevailing economic theories and thus deficit financing is incurred to raise investment which is expected to increase productivity or output per worker and raise national income. According to Singh (1999:1445), this is so because in a poor country like India, the private sector may not be able to provide the necessary investment for economic development.

The macroeconomic of government deficits can be analysed in the context of two main views. In the Ricardian view, it has been argued that government deficits have no macroeconomic impact in the long run (Barro, 1974). The budget deficit, in this view, affects neither investment nor the external current account. The Ricardian equivalence theorem stipulates that, in principle, an increase in government expenditure or reduction in taxes results in an identical increase in private saving and consequently has no lasting impact on the real economy. The reason is that an increase in the current public sector debt implies a future increase in the tax burden. Rational and forward-looking economic agents are bound to anticipate increased taxes and therefore raise their current rate of saving.

However, Ricardian equivalence presupposes *inter alia* the absence of constraints on borrowing and the neutrality of the tax system. The theory also assumes an infinite time horizon; certainty as to future tax pressure; perfect capital markets; and rational expectations, situations which are unlikely to be found in practice. A

number of empirical studies have denied the practical relevance of the Ricardian equivalence theorem, especially as regards developing countries (Haque and Montiel, 1989; Veidyanathan, 1993).

In the traditional view, government deficits have a large impact on the economy, especially on private investment and the external current account. For a given overall saving rate, an increase in the government deficit entails a drop in private investment. Likewise, at a given private saving rate, and in a setting in which domestic borrowing are scarce, there is a close relationship between the budget deficit and the external current account. However, this relationship is not always direct, as it depends, in part, on the level and composition of government expenditure; the stance of monetary policy; and related changes in interest rates and the real exchange rate (Fischer and Easterly, 1990). The macroeconomic consequences of the borrowing requirements depend also on the method of financing (Beaugrand, Loko and Mlachila, 2002: 8).

The budget deficit can be covered directly by money creation by the central bank or, more generally, by increased credit of the banking system, in which a rapid increase of money supply is not necessarily indicative of a large budget deficit. Conversely, money creation to finance a budget deficit may not result in macroeconomic imbalances if money supply increases at a fast pace. However, the direct cost of budget deficit can be minimal, or even nil but macroeconomic risks are substantial. Excessive monetary financing results in excessive overall demand, which, in turn, translates into inflation or, under a fixed exchange rate, pressure on the balance of payments.

Nevertheless, Fischer and Easterly (1990) contend that the relationship between monetary financing of the budget deficit and inflation is neither direct nor linear, especially in the short run, explaining that the unstable nature of this link is generally attributed to several factors such as private savings, which may change as a result of changes in inflationary expectations; the composition of budget financing which may change over time; the demand for money which may be sometimes unstable; and expectations which may be shaping future government policy.

In this regard, Sergeant and Wallace (1981) further assert that under certain circumstances, especially when economic agents anticipate the future repercussions of budget policies, deficit financing through monetary creation

may turn out to be less inflationary than non-bank borrowing. Covering the government's borrowing requirements by resorting to domestic debt thus leads to increased interest charges; a larger budget deficit; and a heavier debt burden. Eventually, the difficulty of mobilising domestic funds reaches a point where the authorities are forced to resort to monetary creation. By then, inflationary pressures are stronger than they would have been if monetary creation had been chosen from the outset because of the higher stock of debt.

It is for this reason that Beaugrand, Loko and Mlachila (2002: 9) emphasise that domestic borrowing from the banking system (excluding the central bank) and the private sector requires a relatively well-developed financial intermediation system as it reduces inflationary pressures and the risk of external debt crisis. However, they argue that this tends to have a crowding-out effect on private investment, above all when there are restrictions on capital flows, and thus penalise economic growth. Furthermore, domestic borrowing is viewed as more expensive than external financing due to its high interest burden that can absorb a significant amount of government resources thereby reducing pro-poor and growth enhancing spending.

Consequently, the government recourse to domestic borrowing, excluding from central bank, reduces the supply of loanable funds. In countries where interest rates are relatively flexible, the upward pressure on real interest rates leads to a decline in private investment. If the exchange rate and interest rate are subject to government control, resorting to domestic borrowing has a more direct crowding-out effect on private investment by reducing the amount of credit available to the private sector and translates into credit rationing. Crowding-out may not occur, or may be minimal, when the budget deficit reflects an increase in government investment, insofar as public and private investment complement each other.

Kapil Kapoor[1] contends that access to finance and the cost of finance are two major constraints identified by the private sector, especially micro and small and medium enterprises. He stresses that when Governments borrow in the domestic market and increases the stock of domestic debt outstanding; this reduces the credit available for the private sector (crowding out) and at the same time drives up the cost of borrowing. "In effect, high domestic interest rates drive up the overall cost of doing business and therefore are a constraint on economic development" adds Kapoor.

1 Kapil Kapoor is World Bank's Resident Representative in Zambia. He expressed his views in an e-mail query by the author on 02/09/09

Clearly, the link between domestic debt and economic development cannot be over-emphasised. On the one hand, domestic debt can stimulate economic development if there exists a stable macroeconomic environment; an efficient money market; broad investor participation; the presence of a sound legal, regulatory and supervisory framework; a non distortionary tax system; and an updated settlement infrastructure (Arnone and Presbitero, 2006:3). Once these prerequisites are satisfied, domestic bond markets are expected to provide possible benefits as discussed earlier (IMF and World Bank 2001, and Del Valle and Ugolini 2003).

On the other hand, however, domestic debt leads to increased interest charges; a larger budget deficit; and a heavier debt burden. Eventually, the difficulty of mobilising domestic funds reaches a point where the authorities are forced to resort to monetary creation. By then, inflationary pressures would have set in, a factor that affects interest rates and exchange rates and ultimately destabilising the macroeconomic conditions and affecting real GDP growth rate of any given country.

2

REVIEW OF ZAMBIA'S ECONOMIC PERFORMANCE

The mainstay of Zambia's economy has predominantly been copper before and after independence from Britain. Copper exports accounts for more than 70 percent of export earnings each year. However, the lack of investment and volatile copper prices on the international market largely led to the gradual decline in the production of copper for over four decades in Zambia which culminated in poor economic performance throughout the 1990s.

During the 1990s, at the time of liberalisation, the economy recorded the lowest ever average growth of GDP of 0.3 percent per year. During the same time because of price decontrols and a floating foreign exchange policy, inflation averaged 70.9 percent (JCTR, 2006). Overall, the main cause for Zambia's poor economic performance was attributed to lack of diversification away from the copper industry to other sectors such as agriculture and tourism.

Mphuka (2005) noted further reasons for Zambia's poor economic performance that included the lack of timely structural reforms aimed at reducing the cost of inefficient public enterprise; macroeconomic instability, in particular, high inflation and interest rates which deter private sector investments; adverse effects of terms of trade; rapidly declining public and private investments; and a huge and unsustainable external debt that has especially in the 1990, tied large parts of the country's domestic budget to external debt servicing while key sectors such as health and education remained under-funded.

By the 1980s, restructuring of the economy became inevitable. However, a real commitment to restructuring the economy only emerged with the ushering in of a new government in 1991. In implementing the economic reforms, largely prescribed by the International Monetary Fund (IMF) and the World Bank during the 1990s, the country instituted stringent measures such as exchange rate liberalisation; trade reforms aimed at simplifying the tariff structure, removal of quantitative restrictions and transformation of the trade regime into one of the most open economies in the Southern African region; privatisation of state-owned companies including the copper mining conglomerate the Zambia Consolidated Copper Mines (ZCCM); successive currency devaluations;

agricultural liberalisation; price de-controls; and downsizing the public sector through retrenchments.

It is worth noting that all these measures did not yield a satisfactory path of economic growth nor improved social conditions. The JCTR (2006) observes that on average, the Zambian economy recorded only 0.3 percent growth in the 1990s while inflation remained relatively high, at above 30 percent on average, making the goal of macroeconomic stability elusive.

However, from 2000 to 2008, the economy has shown signs of recovery with economic growth recorded above population growth. Table 1 shows that the minimum growth between 2003 and 2008 has been 5.1 percent and a maximum of 6.2, with an average of 5.6 percent. In 2009 the economic growth further increased to 6.3%. Inflation rate for most part of the period has been on the decline, reaching as low as 8.2 percent in 2006, while domestic borrowing as a percentage of GDP has continued to record a downward trend from 5.1 percent in 2003 to 1.5 percent in 2008, reaching its lowest mark of 0.9 percent in 2007. A combination of reduced fiscal deficits since 2004 and accelerated economic growth enabled the Zambian Government (GRZ) to bring down the domestic debt / GDP ratio.

Table 1: Macroeconomic Performance 2003 - 2008

	2003	2004	2005	2006	2007	2008
Real GDP Growth (%)	5.1	5.4	5.1	6.2	6.2	5.7
Money supply (annual % change)	23.4	30.3	0.4	45.1	26.3	14.9
Inflation rat es %	17.2	17.5	15.9	8.2	8.9	16.6
Interest Rates (Lending rate %)	37.2	29.8	27.4	27.9	24.4	26.9
Domestic borrowing (% of GDP)	5.1	1.9	1.8	1.9	0.9	1.5
Overall Budget Deficit (% of GDP)				18.6	(0.2)	(2.6)
Current account deficit (% of GDP)	(16.2)	(10.7)	(11.9)	(0.6)	(0.3)	(9.1)*
Gross International Reserves (months of import cover)	1.3	1.2	1.8	2.2	3.6	2.1

Source: Ministry of Finance and National Planning

The positive growth experienced in the country has mainly been driven by several factors that include construction, mining, tourism, transport and communications, and community social and personal services. While this has been the case, poverty levels have remained relatively high, especially in the rural areas as a result of the poor performance of the agriculture sector arising from low crop yields due, in part, to unfavourable weather conditions, particularly during 2007 and 2008 (GRZ, 2009: 31).

The performance of the monetary and financial sector during the 2003 to 2008 period was mixed with fluctuations recorded in inflation and exchange and interest rates. Single digit inflation was recorded at 8.2 percent and 8.9 percent in 2006 and 2007, respectively. Despite this development, inflation in 2008 rose to double digit figures ending the year at 16.6 percent, attributed mainly to the very high and rising international oil and food prices.

The reduced government borrowing aided the easing of pressure on interest rates while the general performance of the economy significantly improved. On the other hand, access to financial services within the economy remained poor as interest rates were still high for most borrowers.

Unfortunately, like many other countries, the Zambian economy faced a number of challenges in 2008 arising from both external and domestic sources. Record high international oil and food prices were experienced during the first half of the year, followed by the slump in global commodity prices, including that of copper, which is the country's main export earner. On the domestic front, execution of the budget was difficult arising from unanticipated expenditures necessitated by the need to accommodate unexpected expenditures such as Presidential bye-elections and augmentation of the Fertiliser Support Programme (FSP) to mitigate against the rising fertiliser prices (GRZ, 2009: iii).

As a result of these developments, inflation at end-2008 of 16.6 percent was above the target of 7.0 percent, while international reserves declined to 2.8 months of imports from 3.6 months of imports registered in 2007. The average commercial banks lending rate rose to 26.9 percent at end-December 2008 in line with inflationary pressures, compared with 24.4 percent in 2007. Further, the overall balance of payments position narrowed significantly to US $ 12.7 million in 2008 from US $310.5 million in 2007, although it remained positive (Ibid).

Growth, however, remained relatively stronger at 5.7 percent, but lower than the target (7.0 percent) set for the year. Between 2002 and 2009 Zambia GDP grew by 53%. Similarly the budget outturn was favourable measured by the overall budget deficit, despite challenges faced in budget execution. The budget deficit at 2.6 percent of GDP was lower than the planned 3.2 percent of GDP (Ibid: 5).

Zambia's attainment to the HIPC and MDRI Initiatives in 2005 saw the country's external debt reduced from over US $7.1 billion (86% GDP)at the end of 2005 to almost US $1.6 billion (9% GDP) at the end of 2006 (GRZ, 2008). The stock of domestic debt has increased in nominal terms from ZKW 3,416 billion to ZKW 5,195 billion between 2003 and 2008. However, in real terms (i.e. after adjusting for inflation), this represented a decline of about 18% over the period. While the FNDP target of domestic borrowing was set at 0.5 percent of the GDP, Government over-shot this by 1.5 percent, explained by a number of factors that included a large amount of carryover funds; expansion in the monetary policy; and the introduction of long term government bonds (GRZ, 2009: 33).

Domestic debt has reduced the crowding out of the private sector. Between 2003 and 2008 credit to the private sector increased from 6.8% of GDP to 15.0% in 2008 while total Domestic Credit declined from 16.7% to 9.7% over the same period. It should be noted that Zambia's fiscal position have improved from 2002 to date reducing the fiscal deficits from 5.1% of GDP in 2002 (and 7.9% in 2001) to 2.5% in 2009. This has been due to HIPC / MDRI relief on foreign debt, rapid economic growth reduced the requirements to bring down both the debt / GDP and deficit / GDP ratios. The Zambian tax base has been broadened as evidenced by the mining taxes increase after privatization of the mines; mining taxes recorded 1.4% GDP in 2007 and 2008 from zero. The reduction in domestic debt (and interest rates) has reduced both inflationary pressure and the crowding out of private borrowing, which increased from 6.3% of GDP in 2002 to 14.7% in 2008. These domestic interest savings can be attributed to three quite different factors: (a) lower borrowing, resulting from improved fiscal management from 2004; (b) growth; and (c) falling interest rates.

2.1 Impact of the Global Financial Crisis

Zambia like many other developing countries that depend primarily on exports of commodities was adversely affected by the global financial crisis. The negative impact of the crisis had been manifested through reduced revenue earnings from

mineral resources mainly copper. The result was multifaceted with a number of mines either completely closing or being placed on care and maintenance leading to job losses of up to 12, 000 in the mining sector alone (JCTR, 2009).

The financial crisis led to low international demand for commodity exports resulting into fall of commodity prices especially the copper prices that fell from the world record of US$ 8, 980 per tonne in July, 2008 to as low as US$ 2, 812 per tonne in December, 2008 (www.boz.zm). This dramatic fall in the prices of copper on the international market led to reduced earnings for the government from mineral royalties and corporate taxes as well as falling income taxes from employees in the mining and related sectors. This fall in demand also meant that investors' propensity to invest declined resulting into lower production.

The JCTR (2009) notes that the resulting loss of employment led to reduction on household disposable income which ultimately resulted in an increase in poverty levels especially in the mining regions of the country.

The initial impact of the crisis in Zambia was felt and recorded in the foreign exchange market due to drastic declines in copper prices on the international market. The situation led to a constriction in foreign exchange earnings and negative speculation for the short and medium term. During the fourth quarter of 2008, the domestic economic outlook became weaker and foreign investors began to withdraw their money from the local market (GRZ, 2009).

Withdrawals, especially by foreign portfolio investors, softened demand for government securities particularly from the later part of 2008. Low performance in the external sector coupled with lower than expected build up of international reserves had a negative impact on broad money (inclusive money supply) growth. Broad money slowed down to 22.1 percent in December 2008 from 25.9 percent in December 2007 (Ibid). This situation led to a rise in interest rates on Government securities mainly due to the protracted inflationary environment.

At the end of 2008, the local currency depreciated by 27.3 percent against the US dollar. The situation worsened at the end of first quarter 2009 as the currency was trading at an average of K 5, 680.5 (JCTR, ibid) representing a 32.5 percent depreciation between from December 2007.

In spite of the gradually creeping effects of the crisis, budget performance in 2008 was generally positive. Total revenues, including grants but excluding revenues from the new mining tax regime, amounted to K12, 008.2 billion against the projection of K12, 106.4 billion, representing a shortfall of 0.8 percent. The overall budget deficit for 2008, stood at 2.6 percent of GDP and was lower than the projected 3.2 percent of GDP but higher than 1.2 percent in 2007 (GRZ, 2009).

Another negative aspect experienced in 2008 was on the revenue collection side. The Government projected to collect a total of K2, 641.0 billion from Value Added Tax (VAT). A total of K2, 210.0 billion was collected and was below the target by 16.3 percent (ibid). This reduction is significant if one considers that the government expanded the tax base to include mining companies which did not pay taxes before privatisation.

In 2008 the economy grew in real terms by 5.7 percent as shown in Table 2, while this was a positive development, it was lower than the growth rate of 6.2 percent in 2007 and the end year target of 7.0 percent. This outcome was attributed to a slowdown in the secondary sector (e.g. financial institutions and communication), which outweighed the increased output in the tertiary and primary sectors (e.g. construction and manufacturing).

3

EVOLUTION AND CHARACTERISTICS OF DOMESTIC DEBT IN ZAMBIA

3.1 Composition of Domestic Debt

Domestic public debt in Zambia constitutes total debt the local, provincial, public enterprise and the central Government owes domestically. (GRZ, 2006: 6).

Given the above description of domestic debt, data is thus generally disaggregated into two categories. The first is public domestic debt that comprises government securities such as Treasury Bills and government bonds; and borrowings from the banking system. The second category is that of public liabilities which comprises domestic arrears such as outstanding debt to suppliers of goods, works and services; called up guarantees and parastatal debt; outstanding statutory payments such as pension arrears; awards and compensations. Table 2 shows the profile of Zambia's domestic debt from 2003 to 2008.

Table 2: Domestic Debt Stock (K' Billion), 2003-2008

Debt Category	2003	2004	2005	2006	2007	2008
Government Securities	**2, 261.71**	**2, 522.60**	**5, 336.97**	**6, 706.40**	**7,612.50**	**8,02680**
Treasury Bills	1, 127.60	1, 293.70	2, 088.60	3, 261.90	3,416.40	3,280.40
GRZ Bonds	1, 134.11	1, 228.90	3, 248.30	3, 444.50	4,196.20	4,746.40
Kwacha Bridge Loan*	**261.03**	**248.63**	**288.90**	**-**	**-**	**-**
Consolidated Bond**	**1, 646.74**	**1, 646.74**	**1, 646.74**	**1, 120.90**	**-**	**-**
Domestic Arrears***	**578.93**	**577.36**	**509.30**	**515.30**	**233.70**	**197.90**
Capital	305.00	293.17	335.50	340.40	90.30	23.90
PEs and RDC	274.00	284.19	173.80	4.97	65.90	71.10
Pension Arrears	**322.10**	**429.50**	**414.00**	**386.50**	**302.70**	**149.6**
PSPF	262.70	370.10	414.00	386.50	-	-
NAPSA (RAMCOZ)	32.40	32.27	-	-	-	-
NAPSA (GRZ)	27.00	27.00	-	-	-	-
Contingent Liabilities	**15.00**	**15.00**	**-**	**-**	**-**	**-**
Mkushi - Barclays	14.20	14.20	-	-		
Mkushi - ZANACO	0.80	0.80	-	-		
Awards and Compensation	**100.66**	**58.98**	**87.5**	**92.50**	**158.00**	**143.30**
Others	**15.00**	**15.00**	**-**	**-**	**-**	**-**
Grand Total	**5, 186.17**	**5, 498. 81**	**8, 283.40**	**8, 821.70**	**8,306.90**	**8,517.70**

Source: Compiled from Economic Reports, 2003 - 2009 (MoFNP)

*Notes: * The Kwacha Bridge Loan amounting to K288.9 billion was converted into Government Securities*

***Part of the Consolidated Bond was converted into Treasury Bills at end 2006*

****Values for domestic arrears are up to 30th September from 2006-2008*

Total domestic debt has been steadily increasing from K5, 186.17 billion as at end-2003 to K8, 517.70 billion as at end-2008, representing a 60.9 percentage increase in nominal terms. However in real terms domestic debt declined by about 18% after adjusting for inflation and as a percentage of GDP it decreased from 16.7% in 2003 to 10.6% in 2009.

Domestic arrears declined from K578 billion in 2003 to K197.9 billion in 2008 largely on account of settlements of all principal amounts by government, particularly with respect to money owed to road contractors (GRZ, 2009: 34). However, government's commitment in the FNDP to reduce the arrears to manageable levels (zero at mid-term) still remains a pipedream.

The importance of domestic debt in financing government deficits is manifested in the fact that the Zambian government is resorting more to domestic source rather than external sources. For example, in 2008, the government borrowed domestically approximately K812 billion compared to K583 billion externally to finance a K1, 394 billion total budget deficit (Nanyangwe[2]).

3.2 Characteristics of Players in Domestic Debt

From 2001, government securities auctions have been opened up to the general public where commercial banks, institutional investors, corporate institutions and individuals can bid. The investor base is diverse with 14 commercial banks, 8 pension funds, 4 insurance companies and private companies (GRZ, 2006:7). Foreign investors are allowed to purchase Zambia government securities only through commercial banks registered and operating in the country. In the off-tender auctions, individuals and corporate institutions with the exception of commercial banks are allowed to participate.

The Bank of Zambia charges a handling fee of 2 percent applied on the discount earned and Treasury Bills are subject to income tax of 15 percent for corporate institutions and 25 percent for private individuals. Commercial banks are primary holders of Treasury Bills with 69 percent of the total amount of treasury bills outstanding while other primary institutional investors and non-bank financial institutions purchase 30 percent.

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2 Tina Nanyangwe is the former Coordinator of the Debt, Aid and Trade Project of the JCTR. She expressed her views on 12/08/09

3.3 Structure of Domestic Debt in Zambia

3.3.1 Treasury Bills

Treasury Bills are issued both for the implementation of the country's monetary policy and for the financing of government budget deficit. The Bank of Zambia (BoZ) auctions treasury bills every week on Thursday through a combination of competitive and non-competitive bids (off-tender transactions reserved for small investors) of minimum bids of K30 million and between K1 million and K29 million, respectively (GRZ, 2006: 7).

The amounts on offer at the auction sessions are determined based on BoZ's evaluation of the levels of excess liquidity in the market; the financing requirements of the government; and the maturities needed to be rolled over. The auction technique is multiple-price where treasury bills are allocated starting with the most competitive bids until the entire issue is exhausted. The lowest accepted rate then becomes the cut-off rate. For off-tender auction, securities are offered at a predetermined weighed average price from the previous competitive auction.

Government's indebtedness to the banking and non-banking system through treasury bills has been on the increase between 2003 and 2004 but slightly declined in 2005. However, a sharp increase of 56 percent from K2, 088.60 billion at end 2005 to K3, 261.90 billion at end-2006 is observed. Between 2006 and 2008, the treasury bills stock of domestic debt remains relatives steady with very minor increments (Table 2).

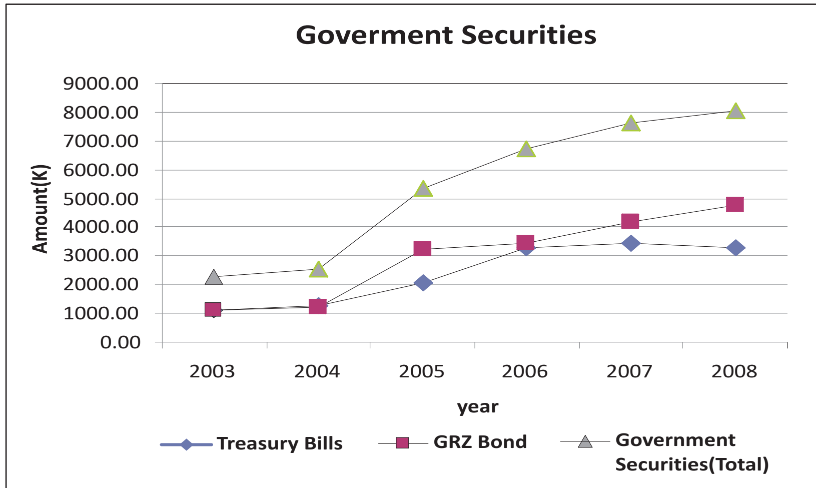
3.3.2 Government Bonds

Government Bonds in Zambia have been issued exclusively for fiscal policy purposes. Auction for Government bonds follow the same guidelines and procedures as treasury bills, though the auctions are held on Fridays every four to six weeks after the latest auction (GRZ, 2006).

Commercial banks are the primary holders of Government bonds with 75 percent while other institutional investors purchase the remaining 25 percent (BoZ, Ibid). According to figures shown in Table 2, between 2003 and 2004, GRZ Bonds recorded a marginal increase of 8.4 percent from K1, 134.11 billion at end-2003 to K1, 228.9 billion at end-2004. However, by the end of 2008, the 2004 figure quadruples to K4, 746.40.

In 2005, BoZ introduced two new instruments in 2005 of 3 and 5 year bonds as part of a new strategy, which by September 2005 had issued a total amount of K25.25 billion and K9 billion, respectively (GRZ, 2006: 8).

Figure 1: Government Securities



Source: Economic Reports, 2003 - 2009 (MoFNP)

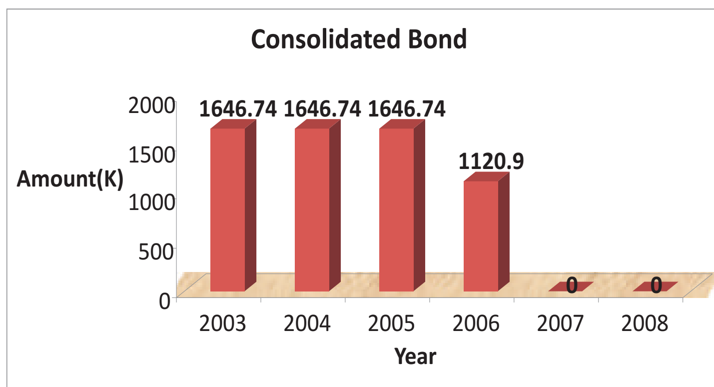
Government Securities (treasury bills and GRZ bonds) constitute a huge portion (K8, 026.80) of Zambia's total domestic debt standing at K8, 517.70 representing 94 percent at end-2008. It is also worth noting that GRZ Bonds have continued to rise while Treasury Bills have somewhat stabilised since 2006. The impact of an increase in government securities has been sustained high interest rates of an average 26.4 percent between 2006 and 2008 (as shown in Table 1).

3.3.3 Consolidated Bond

The Government of the Republic of Zambia (GRZ) and the Bank of Zambia (B0Z) signed an agreement on February 27, 2003 in which all the debts owed by GRZ to BoZ were converted into a consolidated debt. In consideration of such consolidation, GRZ issued a 10 year single repayment long term bond with a face value of K1.6 billion and a coupon rate of 6 percent (BoZ, 2004). This became effective on January 1, 2003 and meant a one cash payment at maturity. The

agreement contemplates that the bond may be rolled over for another ten years on such terms as may be agreed by the parties and that the rate of interest can be reviewed by agreement of these parties. Furthermore, the agreement is non-transferable.

Figure 2: Consolidated Bond



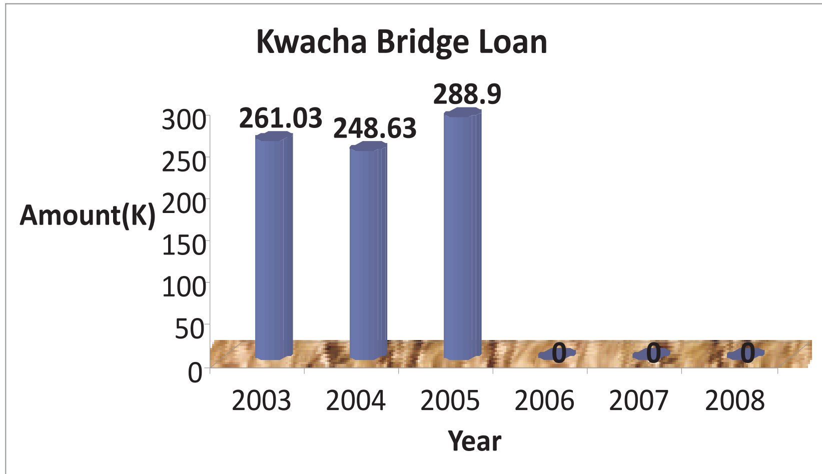
Source: Generated by author from figures in Table 2

The bond consolidated GRZ securities held by BoZ of K1, 646.74 billion remained stable between 2003 and 2005 and then drops to K1, 120.90 billion at end-2006. However, part of the Consolidated Bond was converted into Treasury Bills at end-2006 and thus disappears from the domestic debt composition for 2007 and 2008.

3.3.4 Kwacha Bridge Loan

The Kwacha bridge loan was obtained by GRZ from Bank of Zambia in order to meet extra budgetary expenditures. When the Government requests for a Bridge loan from the central bank, the Ministry of Finance and National Planning makes specification on how much and when the loan is to be paid back in the letter to the Governor of Bank of Zambia. When the payment of principal and interest fall due, BoZ directly debits the government account (control 99) according to the debt specification.

Figure 3: Kwacha Bridge Loan



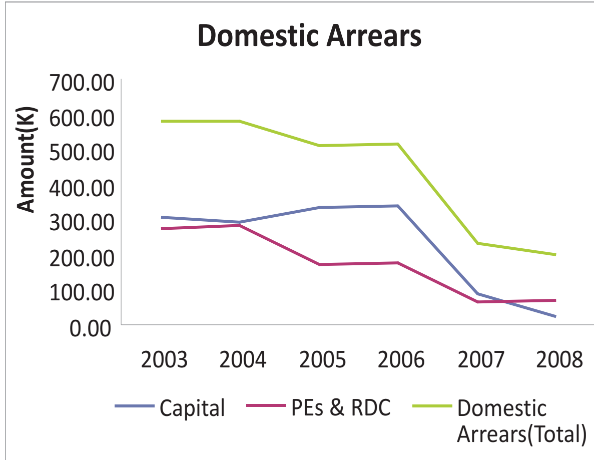
Source: Generated by author from figures in Table 2

At end 2005, the amount outstanding on the Kwacha Bridge Loan was K288.90 billion or about 3.5 percent of the country's public liability and domestic debt portfolio. This instrument carried a zero percent interest rate and no longer appears as part of the domestic debt stock in the period 2006 to 2008 as it was converted into treasury bills. The decreasing or completely wiping out of this component was largely attributed to Government's strict monetary policy of 2004 (GRZ, 2005: 13).

3.3.5 Domestic Arrears

Domestic arrears are divided into two main categories of suppliers and contractors arrears. Supplier arrears represent the arrears on the supplies of goods and services related to recurrent departmental charges that are contracted by the technical ministries. Various reasons are attributed to the reasons why line ministries end up contracting this type of liabilities. However, the main underlying reason from the historical point of view has been due to underfunding of the operations of the line ministries (GRZ, 2006).

Figure 4: Domestic Arrears



Source: Generated by author from figures in Table 2

Contractor arrears arise mainly from contractual obligations for services rendered by contractors under various construction projects that were not met by the Ministry of Works and Supply. The reasons that explain origin and existence of this kind of debt are similar to those for arrears on suppliers of goods and services.

Domestic arrears declined by 0.3 percent between 2003 and 2004 and then steadily between 2005 and 2008 largely due to government payments to local contractors and suppliers of goods and services. However, between 2003 and 2004, the personal emoluments and recurrent departmental charges components of domestic arrears marginally increased by 3.7 percent largely due to government implementation of the Commitment Control System (CCS).

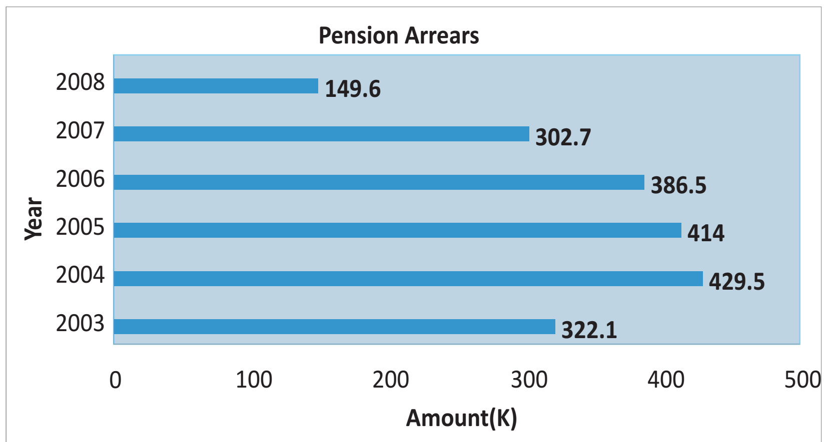
From 2004, domestic arrears continued to record a decline as government had started implementing a programme of dismantling the huge domestic debt over the medium term. In this regard, negotiations with some of the largest creditors, particularly road contractors, were initiated while the contracting of new suppliers' credit was curtailed through the strict implementation of the CCS (GRZ, 2004: 20).

In 2006, domestic arrears recorded a decline of 3.4 percent while the overall decline is from 11.2 percent of the total domestic debt stock at end-2003 to 2.3 percent at end-2008. The implication of dismantling this component of domestic debt has been a steady growth of the construction sector that has contributed significantly to the overall growth of Zambia's GDP in the last few years.

3.3.6 Pension Arrears or Un-remitted GRZ Statutory Contributions

Pension arrears largely constitute employers and employees share of the contribution to the National Pensions Scheme Authority (NAPSA) and the Public Service Pensions Fund (PSPF). Lack of remittances on the part of Government has led to the accumulation of areas on statutory contributions. The Government has not fully committed to honouring statutory obligations despite the Accountant General providing the schedule payment on time (GRZ, 2006: 8).

Figure 5: Pension Arrears



Source: Generated by author from figures in Table 2

Pension Arrears increased from K322.10 billion at end-2003 to K429.50 billion at end 2004. From then onwards, a decline is recorded up to 2008 where Pension Arrears represent a paltry 1.76 percent of Zambia's total domestic debt. This decline is largely attributed to Government's commitment in reducing payments against the PSPF arrears (Opcit). This fact is observed in the continued increases

in the Social Sector allocations of the National Budgets in the years running from 2005 to 2008. This means that resources that would have otherwise been used for dismantling huge pension arrears are increasingly being channelled to needy social sectors of health and education.

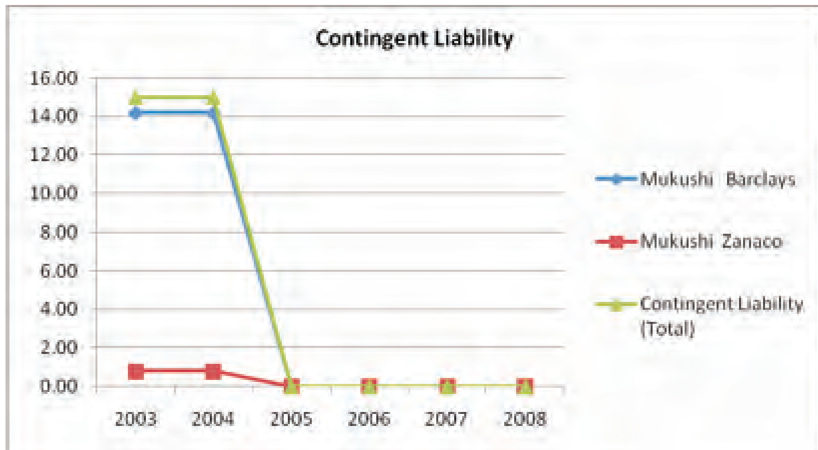
The other contributing factor is that by end 2005, the government had liquidated the arrears owed to the defunct Roan Antelope Mining Cooperation of Zambia (RAMCOZ) and NAPSA. However, there is no disaggregated data on the composition of Pension Arrears between 2007 and 2008, thereby making it difficult to validate Government's commitment to honouring statutory obligations on time.

3.3.7 Guarantees and Contingent Liabilities

Government guarantees to a number of parastatal institutions, mainly those that have failed to redeem their loan repayment obligations constitute a major part of this category of domestic debt. On the other hand, contingent liabilities comprise obligations arising from, i) government guarantees for non-sovereign borrowings and liabilities of regional and local governments, and public and private sector enterprises; ii) government insurance schemes and pension funds; iii) court cases awaiting judgements; and iv) Bank failures and other financial sector bailouts

The Domestic Debt Policy and Reduction Strategy (2006: 10) indicate that as end 2004, the call up of former contingent liabilities amounted to 0.3% of the portfolio. This debt stock was mainly attributed to the Mkushi Arrears whose call on Government guarantees added an additional stock of arrears of K15 billion of the domestic debt stock outstanding. These arrears were due to Barclays Bank (K 14.2 billion) or 95% of the total amount of arrears and to ZANACO amounting to K800 million (GRZ, 2005: 12).

Figure 6: Contingent Liabilities



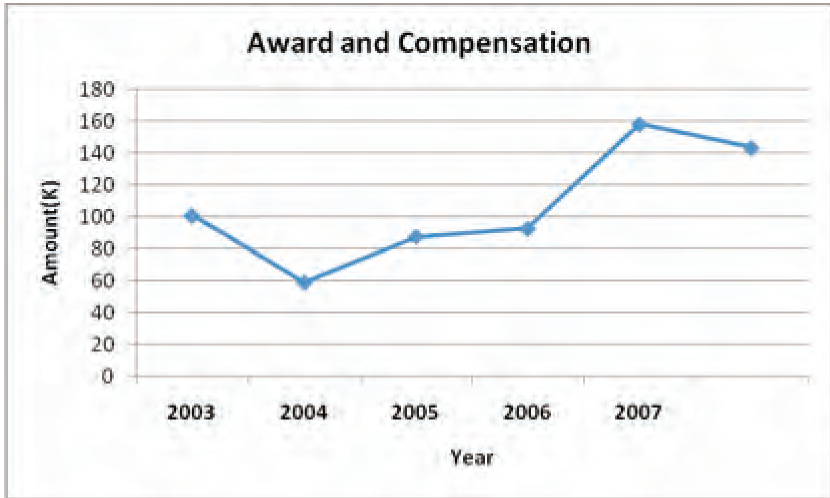
Source: Generated by author from figures in Table 2

Although contingent liabilities appear to have been completely settled, this category of domestic debt has had a negative effect on Zambia's public debt sustainability and budget due to poor recording, monitoring and analysis to determine their budgetary implication. These problems were further compounded by a lack of an elaborate early warning system (Opcit).

3.3.8 Awards and Compensations

This category of liabilities arises out of litigation against Government in courts of law. Table 2 indicates that as of end 2003, Awards and Compensations stood at K100.66 billion. This amount then dropped in 2004, with Government owing K58.4 billion representing 1.1% of its total public liabilities and domestic debt stock.

Figure 7:Awards and Compensation



Source: Generated by author from figures in Table 2

From 2005 to 2007, Figure 7 shows that this category of domestic debt has been increasing to as high as K158 billion and then dropping to K143.3 billion at end-2008, representing a 9.3 percent decline. This figure has remained relatively high due to Government's continuous losses of cases in courts of law. Zambia's debt situation has improved quite a lot not because of good debt management but because of the growth in the economy.

4

LEGAL FRAMEWORK FOR DEBT MANAGEMENT IN ZAMBIA

A strong legal and institutional framework is an essential component of an efficient debt management, particularly if a country wants to implement successfully its public debt strategy (both external and domestic). In Zambia, debt management is governed by several legislation and regulations. There are several principal laws and regulations that constitute the legal frameworks for public debt management.

4.1 The Loans and Guarantees (Authorization) Act- Chapter 366 of the Laws of Zambia

The Loans and Guarantees (Authorisation) Act authorizes the Government to raise and guarantee loans. It gives the Minister of Finance the sole authority to rise in the Republic or elsewhere short and long term financing within certain limits as s/he shall from time to time be authorized by resolution of the National Assembly prescribed by statutory instrument (Part 11 –Section 3). The Law requires that debt service payments be charged from the general revenue (Part 11 Section 5). Loans that can be issued under the legislation may take the form or by agreement in writing (Part 111- Section 6).

The Act (Part 111-Section 8) also defines the responsibility of the Bank of Zambia and assigns functions such as i) to undertake and perform such functions in connections therewith; and ii) to perform such function 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.

In addition, the Act requires the creation of a sinking fund if the financial instrument has an original maturity of more than 20 years to redeem such loans contracted outside or inside Zambia to anybody specified or belonging to a class specified in the schedule; any person for or in connection with the purchase or provision of housing under any housing scheme approved by the Minister; and person ordinarily resident outside Zambia.

However, Section 15 of the law provides limits on the total amount of contingent liabilities based on authorization of the National Assembly.

4.2 The Loans and Guarantees (Maximum Amounts) Order

This Order provides the limits for domestic and external borrowings as well as guarantees. Specifically, the order stipulates that i) the amount outstanding at any one time on loans raised within the Republic payable over a period of not more than one year shall not exceed 20 000 million Kwacha; ii) the amount outstanding at any one time on loans raised within the Republic payable over a period of more than one year shall not exceed 20 000 million Kwacha; iii) and the amount outstanding at any one time raised in the Republic shall not exceed K600 000 million.

In addition, the Order specifies that the total contingent liabilities at any one time in respect of guarantees given in terms of sub-section fourteen of the Act to person resident of Zambia shall not exceed K8000 000 million; and the total contingent liabilities at any one time in respect of guarantees given in terms of subsection fourteen of the Act to a person outside of Zambia shall not exceed K30 000 million.

4.3 Local Loans (Registered Stock and Securities) - Chapter 353 of the Laws of Zambia.

The Act authorizes the president or the minister of Finance to borrow in the domestic capital market (a) by the creation and issue of registered stock and b) by the issue of securities in the form of bonds and debenture (Part 11, Section 4). The law specifies the conditions of issuing various financial instruments and limits the maturity of these instruments to sixty years (Part 11- Section 6). The law specifies the types of securities that can be issued, such as registered debentures, debentures payable to bearer, registered bonds, and bonds payable to bearer (Part IV- Section 17). The Act also stipulates that every registered security shall, before being issued be registered by the secretary for that purpose, and the name and address of the holder of each registered security and all transfers of registered shall be noted on that register (part IV-Section 19).

4.4 The Loan (Stock, Bonds and Treasury bills) Regulations

The regulation defines, among other things, the functions of Bank of Zambia in the issuance of stock, bonds and treasury bills. In particular, it stipulates that the Bank of Zambia is the agent of the Minister to undertake and perform such functions as must be necessary in connection with the issue and subsequent administration of treasury bills, stocks and bonds (Part 11- Section 4). It is further the responsibility of Bank of Zambia to keep a register in respect of each issue of stock or bonds (Part 11- Section5). It also requires the Government to pay interest and principal of registered stock and bonds (Part IV – Section 6)

4.5 The Public Finance Act of 2004

The law defines the function of the Minister of Finance and gives him/her the responsibility to manage, supervise, control and direct all matters relating to financial planning and the economic management of the Republic (Part 11- Section 3 (1)) and to present annually to the National Assembly the estimates of revenue and expenditure and supplementary estimates (Part 11-Section 3 (2)). The Act also creates the office of the Treasury headed by the minister, composed of the Ministry of Finance and National Planning, and whose powers are exercised by the Secretary to the Treasury (Part 11- Section 4).

Section 5 of the Act specifies the functions of the Treasury such as to promote the Government's National Fiscal Policy; to co-ordinate the macro-economic policy; to manage the National Budget; to exercise control over the implementation of the annual national budget, including any supplementary budgets; and to facilitate the implementation of the transparency and effective management in respect of revenue, expenditure, assets and liabilities of ministries, government departments, and statutory corporations.

Among the functions attributed to the Secretary to the Treasury, the law gives him/her the responsibility to manage and administer the consolidated fund and other funds established under this Act (Part 11- Section 6 (3 j)). The Act also allows the secretary of the Treasury to designate controlling officer whose one of its main functions is to not commit government to excess of money appropriated by parliament (Part 11- Section 7 (1) and (3 g)). It also creates the consolidated fund into which all general revenues and other public moneys accruing to the Treasury shall be credited (Part 111- section 13) as well as moneys received from loans, grants and donations (Part 111- Section 28).

4.6 The Bank of Zambia Act of 1996 – Chapter 360 of the Laws of Zambia

The Act provides the functions and responsibilities of the Bank of Zambia. The main objective of BoZ is to formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial systems stability so as to promote balanced macro- economic development (Part 11, Section 4(1)). Additionally, Bank of Zambia shall among other functions; acts as banker and fiscal agent of the Republic (Part 11, Section 4 (2 d) as well as acts as adviser to the government on matters relating to economic and monetary management.

The relation between the Government and the Bank of Zambia is defined in Part VII of the Act. Specifically the Act provides in Section 45 that the Bank shall be the banker to and fiscal agent of the government and, through the minister, act as financial adviser to the government and render advice and furnish reports on matters relating to the functions of the Bank and on other matters likely to affect such functions.

The Act further authorizes the BoZ to issue and manage government loans and loans guaranteed by the government as the Minister (of Finance) may determine (Part VII- Section 47) and to act as agent of the government for such purposes and on such terms and conditions as the minister may determine.

Section 50 of Part VII of the authorizes the Bank to give credits to the government by way of short-term advances, purchases or securities in a primary issue, or any other form or extension of credit up to fifteen percent of the ordinary revenues of government in the previous financial year. Lastly, Bank of Zambia may underwrite, purchase, sell or deal in securities issued or guaranteed by the government which form part of a public issue.

A review of the legal framework above shows that the country has a tradition in legislating and regulations that define certain functions and responsibilities of the Ministry of Finance and National Planning and the Bank of Zambia. The legislation specifically determines the limits of indebtedness and guarantees that the country can undertake. However, it is important to note that the law clearly assigns the responsibility of approving all contractual obligations of the Republic of Zambia to the Minister of Finance and National Planning, implying that the MOFNP is responsible for managing public debt.

In addition, the Loans and Guarantees Act and the Local loan Act clearly give the sole authority to raise funds in and outside of Zambia to the Minister of Finance while the loan (stock and treasury bills) regulations and the Bank of Zambia Act gives power to the central bank to undertake and manage government securities that are publicly issued. The law also assigns the responsibility of registering securities to the Ministry of Finance and National Planning, a function currently undertaken by Bank of Zambia through the Book Entry System (BES) as per the regulation.

Clearly, the current legal framework is weak as it does not allow for broad participation in the contraction of domestic loans. This is further worsened by lack of parliamentary oversight, hence accountability to the Zambian people is lacking. Given that the governance of fiscal management in addressing the domestic debt burden is critical, Kapoor[3] observes that "a key problem in fiscal management in most economies is holding the system accountable for delivering results. It is imperative that, especially when contracting debt, the system is held accountable so that the returns from investment are sufficient to service the debt so that over time the debt remains sustainable."

Furthermore, a strong observation made here is that the legal framework of debt management is not exhaustive and does not encompass all types of financing such as direct and guaranteed debt of central government, public enterprises, sub-national governments, private external debt, external and domestic public debt, and grants. For example, the legislation is silent on who is responsible for negotiating and monitoring grants and private external debt, a function usually reserved to the Central Bank in most countries.

3 Kapil Kapoor in a response to the Author's query

5

INSTITUTIONAL FRAMEWORK FOR DEBT MANAGEMENT IN ZAMBIA

The macroeconomic policies of the Fifth National Development Plan (FNDP) builds upon the successes of both the Transitional National Development Plan (TNDP) as well as the Poverty Reduction Strategy Paper (PRSP) of 'sustaining and securing fiscal and financial stability, and deepening structural reforms to achieve economic growth' (GRZ, 2006: 26). The Government has recognised the fact that one of the potential impediments to the attainment of this macroeconomic goal is the level of domestic debt that has been increasing at a high rate in the past five years and is becoming unsustainable. It is in this regard that the government set out the macroeconomic objectives in the Medium-Term Expenditure Framework (MTEF) for the period 2005 to 2007 that specifically addresses the problem of domestic debt so as to support the achievement of the overall macroeconomic goal.

The specific macroeconomic objectives that are directed at public debt management include i) restoring a sustainable debt position both domestically and externally; ii) strengthening public expenditure management and reducing domestic borrowing; iii) improving of government operations; and iv) developing well functioning financial systems (GRZ, 2005).

It should be noted, though, that the specific objects for public debt management in Zambia have not been elaborated upon. Given the level of development of the Zambian economy, it is important that the primary focus of the debt management objectives aim at the development of the market for debt instruments. In this regard, the proposed debt management objectives were aimed at i) controlling the quantum of the stocks of borrowing; ii) managing the cost of borrowing; and iii) optimising the returns on surplus funds.

5.1 Co-ordination Mechanisms (MOFNP and BoZ) in Domestic Debt Management

One objective of debt management is to enable the public sector entities to dispose of sufficient resources to finance the development and poverty reduction

programmes of a country, without impacting negatively on the medium and long term financial stability of the country. This is because inappropriate macroeconomic policies can lead to over-indebtedness.

The Zambian law clearly mandates the ministry of Finance and National Planning to manage Zambia's public debt (external and domestic). MOFNP plays a leading role in defining the borrowing strategy (mix between external and domestic debt) and the type of instrument it wants to issue with Bank of Zambia acting as technical advisor on the offering of domestic financial instruments. The management of both domestic and external debt falls under the ambit of the Investment and Debt Management Department and is in charge of the database. The BoZ continues to be the agent of government as it is assigned the responsibility to issue government securities and also provides advice on the sequencing. As mandated by the Bank of Zambia Act, BoZ continues to be responsible for conducting and implementing the country's monetary policy.

Currently in Zambia, there is no formal co-ordination mechanism that design and implement debt strategy for government new financing. The situation still lingers on where the Ministry of Finance and National Planning has the sole responsibility to contract external and internal debt. The Bank of Zambia, on the other hand, effects payments of external debt and manages domestic debt through its open market operations where it sells and buys government securities on behalf of government (Mphuka, 2004: 37).

What is missing from the relationship between MOFNP and BoZ is a clear coordinating mechanism of recording and managing both domestic and external debt as the two institutions appear to generate different figures. This problem also appears to extend to various reports generated within MOFNP that give different figures. For example, the Medium-Term Expenditure Framework (MTEF) 2010 – 2012 (2009) puts the real GDP growth at 6 percent while the Mid-term Review of the FNDP (2009) puts the figure at 5.7 percent. Two documents from the same Ministry and published in the same year.

5.2 Debt Management Policy and Strategy

Over the years various domestic debt restructuring techniques have been elaborated to attempt to reduce the debt burden on the country's budget. Over the past couple of years the Government of Zambia has prepared public debt

sustainability analyses that have analyzed various domestic debt strategies. In addition, in an effort to reduce the debt stock, the Government in the MTEF 2009 – 2011 targeted at settling arrears to suppliers (accumulated prior to December 2002) and pension arrears in the 2009 budget. Furthermore, the Government committed to reducing the stock of government securities and its interest cost by re-financing short term instruments using longer dated instruments and reducing the tender sizes as a way of reducing the rollover cost (GRZ, 2008: 11). The various options proposed and highlighted in the 2003 domestic debt strategy to restructure the country's public liabilities included the allocation of budget resources over a three-year specifically,

i. To repurchase domestic arrears in the amount of K189 billion in 2005; K100 billion in 2006; K114 billion in 2007; and K250 billion in 2008.
ii. To buy back at par pension funds arrears of K100 billion (as well as grants K154 billion for its contribution) in 2006 and budget K166 billion both to provide its contribution to the Pension Fund and liquidate arrears in 2007 as well as in 2008 with an amount of K174 billion, of which K142 billion was been allocated for that purpose in 2005.
iii. To liquidate Mkushi liabilities by the end of the year. Government of Zambia hopes to complete negotiation with Barclays by the end of November 2005, while ZANACO had agreed in principle that Government will purchase only the principle arrears outstanding.
iv. To budget K50 billion for awards and compensation arrears in 2005 and K60 billion each year between 2006 and 2008.
v. To liquidate the Bank of Zambia advances (Kwacha bridge loans).

An analysis of Zambia's domestic debt stock and its composition reveal that the above measure appear to have been implemented by the government owing to significant reductions in respective portfolios (see Table 2).

Moreover, the Bank of Zambia has adopted the strategy of introducing new financial instruments in the market. In August 2005, the central bank issued 364 Treasury bills that replaced the one year government note and the three year and five year bonds. The strategy also includes the redemption of the 18 month government bond to streamline the instruments also available in the local market. This strategy would help develop Zambia's capital market, provide benchmarks, and build a yield curve from which the market could refer to price private sector borrowing (GRZ, 2006: 21).

As observed already in this paper, in most developing countries, issuance of treasury bills is widely used to finance budget deficits due to market constraints (the uncertainties of appropriate long-term yields, nascent local capital markets and the lack of confidence caused by the existence of domestic arrears in certain cases). One manager risk of this strategy is the roll over risk characterised by increased interest rates and the possibility that the country might be able to roll over an ever increasing amount of debt (spiralling effect). Higher interest payments would further reduce the utilization of resources for development (for social expenditures for instance).

In the case of Zambia, the Bank of Zambia has followed a strategy of rolling over existing principal (defined as cost or actual disbursement) and paying interest (defined as face value minus cost) from government budget, so as to reduce the risks described above and lower future interest payments. Bank of Zambia also issues new debt for fiscal and monetary purposes that will be needed to be rolled over subsequently in the same manner (Ibid, 23).

In order to achieve Zambia's debt management objectives, the Domestic Debt Policy and Reduction Strategy of 2006 further proposes a number of things, among them, the need to create and formalize debt co-coordinating committees. These will be the Debt Co-ordination Committee (political level) and the Debt Co-ordination Technical Committee (technical level). These committees would be created and formalized through appropriate regulations and be given detailed terms of reference (GRZ, 2006: 42).

Other proposals included the role of Parliament in debt contracting, management and monitoring. However, the implementation of the Strategy still remains uncertain as most of the proposals have not been effected. "All these measures will only take effect once relevant issues are straightened out. I can assure you that Cabinet has already approved the document (Domestic Debt Policy and Reduction Strategy)."[4]

This situation, by no means, has attracted a lot of concerns from various stakeholders, with Kapoor strongly emphasising the need for the implementation of a domestic debt strategy in Zambia. He strongly recommends the need for "having in place a debt strategy, both domestic and external debt strategy and making sure that there is a strong review process that governs the contracting of debt, both domestic and external". Furthermore, the unavailability and

4 An MOFNP Official speaking on condition of anonymity in an interview on 02/07/09

inconsistency in information makes it difficult to determine the resources available to the domestic debt management team including the quantity of staff, their skills levels and technological resources for managing the debt stock and new debt issuance on a professional basis.

5.3 The Role of Parliament in Domestic Debt Management and Monitoring

Both the legal and institutional framework does not specify the role of parliament in domestic debt management and monitoring in Zambia. The discussions come up only at the point of debating the national budget. Parliament can neither approve nor disapprove of any loans, domestic or external. The other way in which Parliament comes close to engaging in the debate on debt is through sittings of specialized committees such as the Public Account, Labour and Economic Affairs, and the Expanded Committee of National Assembly. Here, parliamentarians receive submissions from different stakeholders, including government institutions and civil society organisations after which a report is compiled and presented to the main house through the speaker and the story end there. Therefore, the oversight role of Parliament on debt issues is conspicuously missing raising questions of transparency and accountability in debt contraction, management and monitoring.

5.4 The Role of Civil Society in Domestic Debt Management and Monitoring

The Civil Society has long been a partner with government over the debt issue, both domestic and external. In Zambia, the main actor has been Jubilee Zambia, hosted by the Debt, Aid and Trade Project of Jesuit Centre for Theological Reflection (JCTR). The Jubilee Platform brings together various actors and has been at the centre of the Debt Cancellation Campaign from the late 90s. The JCTR (2007) proposed various changes to the current debt regime and its management. Salient are the proposals aimed at sealing loopholes in loan contraction, with an emphasis on parliamentary oversight; and the establishing of a central depository account for all the borrowed money to enhance easy monitoring.

Although the role of civil society in domestic debt is limited only to that of advocacy, the JCTR has thus far made presentations of their proposed debt

restructuring to the Public Accounts Committee of the National Assembly as well as to the Public Finance Committee of the National Constitution Conference (NCC). Both committees adopted the recommendations made by JCTR. However, the plenary session of the NCC was divided over the issue and deferred the matter to a referendum. "This is sad in that a clear issue emerging out of a clear diagnosis can be treated in this manner. We have lost an opportunity to correct things. It is difficult to have a referendum over an issue such as this one. Domestic debt and external debt are not political issues" lamented Privilege Hang'andu[5], Programme Officer for Debt and Public Resource Monitoring at JCTR.

The Civil society in most cases wants to ensure that government borrows for capital expenditure and that these debts are settled as per agreement. Civil society's role is also to write up on other countries' experiences to show government that high levels of domestic borrowing can compromise economic development. "Many private firms are usually willing to lend government because of the high expectation that the debt would be settled. But the civil society should work with the private sector to study the danger of lending to the government as opposed to putting resources in large domestic investment," adds Nanyangwe.

The biggest obstacle to civil society's involvement in domestic debt monitoring is the lack of access to information. Hang'andu further bemoans the secretive nature of government offices "even when the information is erroneous and when given, information differs from one office to another".

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5 Interview conducted on 17/01/10

6

CONCLUSION AND RECOMMENDATIONS

6.1 Conclusion

This study has made a number of pertinent observations. First is that domestic debt in Zambia has, in the past five years, been increasing at a high rate and is slowly becoming unsustainable. This is against a background of commitments made in the Medium-Term Expenditure Framework (MTEF) for the period 2005 to 2007 and subsequently 2010 to 2012 that specifically seek to addresses the problem of high domestic debt so as to support the achievement of the overall macroeconomic stabilisation goal. For example, the total domestic debt as a percentage of GDP stood at 1.5 percent as at end 2008. For instance, it is noted that in 2006, the projected overall deficit stood at 2.4 percent of GDP, rising to 3.7 percent in 2007 and projected at 3.0 percent and 2.5 percent in 2008 and 2009 respectively (GRZ, 2009: 19).

Although the total domestic debt has been on the increase, this study has revealed that a huge portion (94%) of it constitute Government Securities while domestic arrears have generally reduced. The implication here is that reducing domestic arrears is good as it favours local citizens since it comprises money owed to them. The growth in Government Securities as a way of deficit financing, however, may lead to inflationary pressures as well as crowding-out of private sector investment.

Second, this study has shown that Zambia's legal and institutional framework for debt contraction, management and monitoring lacks a broad-based consultation of relevant stakeholders such as parliament and civil society. Further, the study has shown that the Domestic Debt Management and Reduction Strategy that was developed in 2006, including many other commitments made by the Government, have not been implemented.

Third, it is clear that the Global Financial Crisis of 2008/9 has had serious implications on government revenues in many LICs. The massive decline in commodity prices over the last six months of 2008 and their weak prospects in 2009 further contributed to additional pressure on export sectors and deterioration of fiscal revenues. On the fiscal front, less buoyant tax revenues,

combined with pressing expenditure needs opened up higher financing gaps in many LICs, a trend that continued in 2010 and the near foreseeable future, confirmed by Zambia's 2010 National Budget that has projected domestic borrowing at 2.5 percent of GDP as opposed to the targeted 1.8 percent (GRZ, 2009).

These factors therefore necessitate the need for comprehensive reforms in the whole debt contraction, management and monitoring regime.

6.2 Recommendations

- Government should exhibit exemplary political will in avoiding the accrual of unsustainable domestic debt. Bearing in mind that more sections of society pay the highest price for unsustainable debts accrued, there is need for Government to enhance domestic resource mobilization strategy that focuses on other sources, such as broadening the tax regime.
- A debt policy in still at large, Government should regard the matter of implementing the National Domestic Debt Management and Reduction Strategy policy an urgent one. Without a debt policy, it is difficult for interested groups in society to hold government accountable for not upholding good morals in debt acquisition and servicing.
- There is also urgent need to reform both the legal and institutional arrangement governing the current debt acquisition. This must allow for a broader participation of critical stakeholders such as parliament and civil society.
- The civil society, in collaboration with the private sector from which most of domestic debt is sourced, must ensure that government borrows for capital expenditure and that these debts are settled on as per agreements.
- Civil society must also write up on other countries' experiences to show government that high levels of domestic borrowing can compromise economic development.
- Many private firms are usually willing to lend government because of the high expectation that the debt would be settled. But the civil society must also work with the private sector to study the danger of lending government as opposed to putting resources in large domestic investment.

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ANNEX A

BACKGROUND

Since the mid-Nineties there have been increasing efforts by international financial institutions and governments efforts towards the development of domestic markets for government securities. The rationale of these efforts lie is the advantages that an internal credit markets could provide to the governments and their economies. As an alternative source of financing with respect to external borrowing and banking credit, domestic markets have been seen as likely to reduce the vulnerability of a country to reversal in capital flows and external shocks. In some quarters domestic securities have been seen as a substitute for external financing, thus avoiding the build-up of foreign-currency denominated debt (with all the risks related to exchange rate devaluations) and the monetary financing of government deficits. Most importantly however is its potential to spur growth and economic development in developing countries.

In spite of the importance domestic markets play in the economy and especially to the government as a source of development finance, there is evidence to show that resources from these markets are increasingly consuming huge chunks of the national budget in the form of debt servicing. Domestic debt even though has been rising over the years, policy makers and international institutions have given it far less attention. Over the period 1991-2006, the domestic debt stock almost doubled. While on average the value is around 18% of GDP among sub Saharan Africa, there are countries in which this ratio is substantially higher. Arnone and Presbitero (2006) observe that HIPC countries have moved from a situation in which external debt service is largest part of interest payments, to an opposite situation, in which the expenditure on domestic interests has become the greatest share of overall interest expenditure.

Domestic debt is already more expensive than external debt, in terms of a larger share of GDP that is destined to interest repayments. From 1991 to in 2003, while interests on external debt were slightly higher than 1% of GDP, domestic

interests soaked up, on average, more than two percentage points of GDP. In particular, in some countries this percentage in the last years were much higher, up to 6% in Ghana, around 4% in Gambia, and Malawi, and 3% in Sierra Leone. The situation is further compounded by the huge external indebtedness that these countries still continue to experience in the light of the absence of permanent exit solution to the debt problem. Increasingly the cost of domestic borrowing is likely to absorb resources freed with debt relief; and the subsequent increase in interest rates could have dramatic effect on economic growth, because of reduced investments and pressures on the exchange rate. The unfavourable evolution of domestic debt could further be worsened by a reduction in aid resources, given the proposed move from loans to grants.

For HIPC countries in sub Saharan Africa, matters are further complicated by the fact that the HIPC Initiative and the Debt Sustainability Analysis implemented in the multilateral programs ignore the role played by domestic debt in poor countries. While participation in the HIPC Initiative forbids borrowing on commercial terms in the international capital markets, and monetary financing of the deficit is normally prohibited in IMF programs, internal financing has become more and more important in many countries and this trend is not likely to be reverted any time soon. Furthermore countries under HIPC and MDRI have had to cope with the slow fiscal adjustment, together with the lack of access to adequate inflows of concessional lending, thus forcing the governments to recur to domestic markets to finance their primary deficits.

As a consequence, internal debt service is already absorbing more resources than external debt, undermining pro-poor investment and social expenditures. Moreover, the rising cost of internal financing could undermine the overall debt sustainability and make the whole HIPC program irrelevant. Therefore, to assess external debt sustainability and the impact of the HIPC Initiative it is necessary to look at the fully fledged budget constraint, without ignoring the relevant role played by domestic debt dynamics.

Given the important of domestic financing through domestic in many countries and reasons to believe that this trend will not revert anytime soon given the spreading of global financial crisis, the drying up of concessional lending, and commodity prices falling, there is a need to manage domestic debt to avoid problems of default and promote domestic development financing. It is with this in mind that AFRODAD proposes to carry out five country case studies with a

view strengthening the domestic debt management aspect of the public debt. The focus of the study is to examine the linkage between domestic debt and development financing, regulatory and institutional framework and the role of key stakeholders in managing the domestic debt. The countries identified for the studies include; Ghana, Kenya, Malawi, Senegal and Zambia.

Objectives

1. To carry out an in-depth analysis of country cases' domestic debt through the lenses of economic development, monetary policy stabilization and debt sustainability
2. To expose the regulatory and institutional framework inherent in the domestic debt management and how they affect national debt strategy
3. To give recommendations on appropriate measures in addressing domestic debt burden in the countries under study.

To constitute a national multi stakeholder conference on the impact of domestic debt in national development : Prospects and challenges

Methodology

This study took a qualitative approach by reviewing debt management practices of the Government of the Republic of Zambia (GRZ) through the review of various documents and reports, Cooperating Partners, CSOs' (Jubilee Zambia) reports and academic literature.

The research also involved interviewing some debt management officers in the Government who are involved with the day to day management of the debt and the contraction of debt and other interest groups such as the civil society and individuals with an interest in the subject matter. However, for purposes of this report, some of these interviews are anonymous as respondents did not wish to have their names published. The research also reviewed some country case studies of debt management practices particularly those in the African region which have had similar backgrounds in terms of debt problems to those of Zambia. Furthermore, the research made extensive use of various websites that host relevant information on the topic under study.

Limitations

There were two major limitations to the study as follows,

- Unavailability of major stakeholders to interview and validate secondary information. Most Government Officers are not willing to give out information, especially when the study is sponsored by civil society for fear of retribution. It was also difficult to get hold of a Parliamentarian for a scheduled interview.
- Conflicting data between various government institutions made the timely completion of this report difficult. This was worsened by the unwillingness of government officials to give out information.

About AFRODAD

AFRODAD Vision

AFRODAD aspires for an equitable and sustainable development process leading to a prosperous Africa.

AFRODAD Mission

To secure policies that will redress the African debt crisis based on a human rights value system.

AFRODAD Objectives include the following:

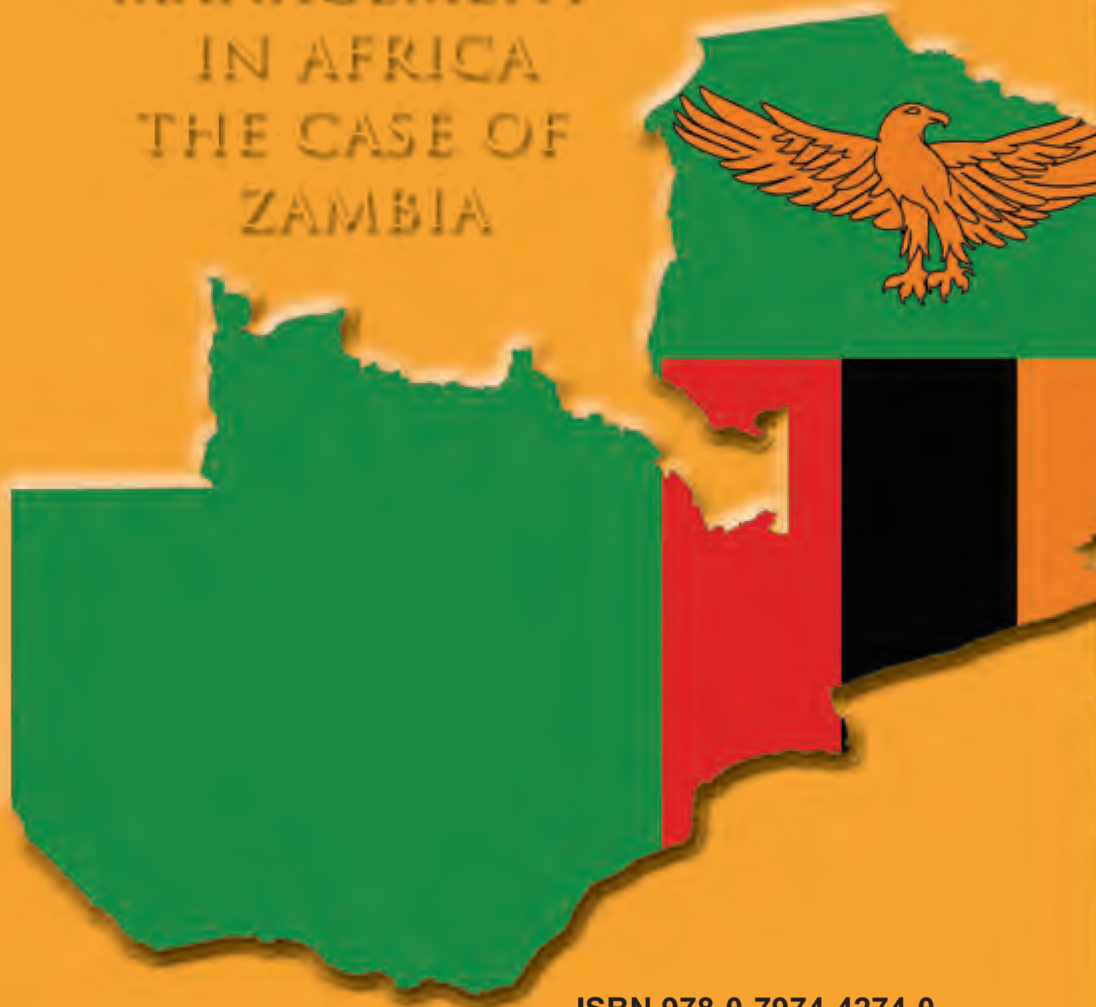
1 To enhance efficient and effective management and use of resources by African governments;
2 To secure a paradigm shift in the international socio-economic and political world order to a development processthat addresses the needs and aspirations of the majority of the people in the world.
3 To facilitate dialogue between civil society and governments on issues related to Debt and development in Africa and elsewhere.

From the vision and the mission statements and from our objectives, it is clear that the Debt crisis, apart from being apolitical, economic and structural issue, has an intrinsic link to human rights. This forms the guiding philosophy for ourwork on Debt and the need to have African external debts cancelled for poverty eradication and attainment of social andeconomic justice. Furthermore, the principle of equity must of necessity apply and in this regard, responsibility ofcreditors and debtors in the debt crisis should be acknowledged and assumed by the parties. When this is not done, it isa reflection of failure of governance mechanisms at the global level that protect the interests of the weaker nations. TheTransparent Arbitration mechanism proposed by AFRODAD as one way of dealing with the debt crisis finds a fundamen-tal basis in this respect.

AFRODAD aspires for an African and global society that is just (equal access to and fair distribution of resources),respects human rights and promotes popular participation as a fundamental right of citizens (Arusha Declaration of1980). In this light,African society should have the space in the global development arena to generate its own solutions,uphold good values that ensure that its development process is owned and driven by its people and not dominated bymarkets/profits and international financial institutions.

AFRODAD is governed by a Board of seven people from the five regions of Africa, namely East, Central, West, Southernand the North. The Board meets twice a year. The Secretariat, based in Harare, Zimbabwe, has a staff compliment of Seven programme and five support staff.

DOMESTIC DEBT MANAGEMENT IN AFRICA THE CASE OF ZAMBIA



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