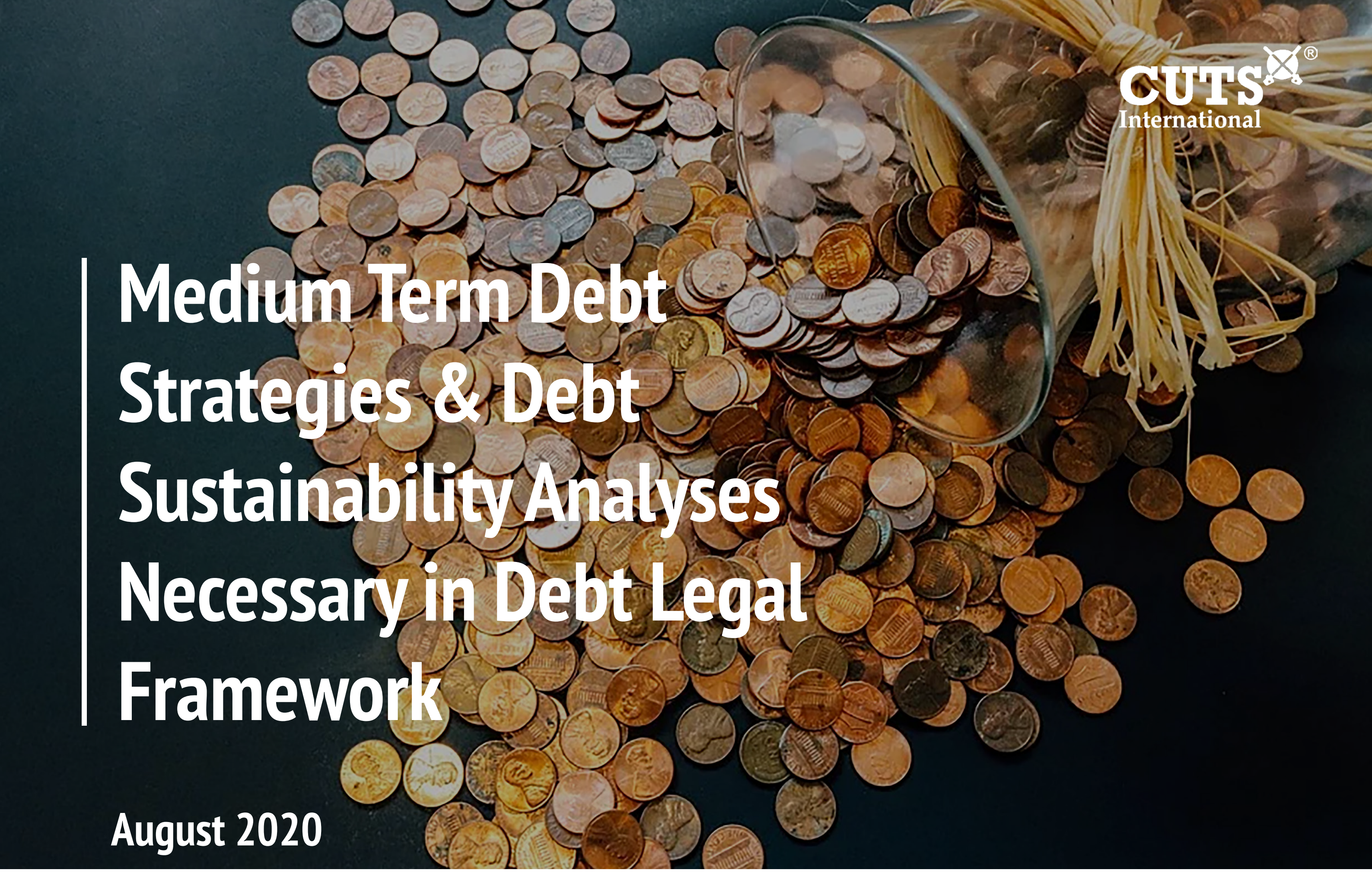

Medium Term Debt Strategies & Debt Sustainability Analyses Necessary in Debt Legal Framework

August 2020

1. Introduction

Zambia's current legal framework for public debt management is inadequate. The high levels of external debt standing at US$11.2 billion and domestic debt at K80.2 billion, have heightened risk of debt distress. A major contribution to this risk was the shift from concessional to non-concessional borrowing. Concessional loans are granted to low-income countries and have interest rates below those available on the market while non-concessional loans are provided with a market-based interest rates. Zambia relied on concessional external financing for infrastructure development and budget support. However, in 2011 when the country was reclassified to a lower middle-income category there was a significant reduction in concessional financing available to Zambia. The Government, therefore, resorted to non-concessional borrowing which is generally more expensive. According to the international Monetary Fund (IMF) debt sustainability analysis conducted in 2017, the share of debt from multilaterals had fallen sharply from about 60 percent in 2011 to 20.5 percent, while the share of private banks and investors has risen to almost 50 percent in 2017.

The gap between revenues raised and government spending has been widening for the past ten years inadvertently resulting in high fiscal deficits. According to the Bank of Zambia, the deficit outturn in 2018 was recorded at 7.6% of Gross Domestic Product (GDP) higher than the 6.1% target. This trajectory continued in 2019, where the deficit was recorded at 8.2% of GDP on a cash basis against a set target of 6.5% of GDP. Elevated deficits have mainly been attributed to higher than programmed capital. High debt servicing costs have left the Government unable to pay its domestic obligations to companies and contractors leading to the high accumulation of payment arrears. As at December 2019, the Government owed K26.2 billion to domestic contractors. These payment arrears have hit many businesses' cash flows and reduced liquidity in the market as evidenced by the undersubscription of Government securities which means that there is less appetite for the financial securities from investors. High levels of domestic borrowing by the Government have also made it harder for businesses to access finance to make investments, thereby crowding out the private sector and stunting the sectors growth.

The country's debt situation may also limit the Government's capability to finance development projects such as the Seventh National Development plan (7NDP) and Sustainable Development Goals (SDGs). This has subsequently made it difficult for the country to achieve its development plans. Further, the country's high debt levels have also led to a depreciating kwacha as money is increasingly being externalized due to high external debt servicing costs. This has lowered international investor confidence and credit rating agencies have downgraded Zambia's sovereign credit rating. High debt levels have also had an impact on inflation resulting in goods and services becoming more expensive therefore, increasing the cost of living and doing business for Zambians. Empirical evidence shows that, with a net debtor country, increases in government debt tend to increase inflation.

As such, Zambians are feeling the implications of high debt levels as increased debt servicing costs have left less funds for public service delivery needed mostly by low income consumers of public goods and services. Also, almost every year new taxes and fees (e.g. turnover tax, base tax, presumptive

tax, withholding tax on rental income and borehole fees) are introduced to help facilitate domestic resource mobilization and help pay back the increasing debt. Cognizant of the importance of taxes needed to domestically finance different projects, high taxes and fees are squeezing consumers' disposable income.

There is need to ensure prudent debt management to avoid the adverse effects of high public debt. Legislating policy action such as a Medium-Term Debt Strategy (MTDS) and a Debt Sustainability Analyses (DSA) would help improve debt management in the long run. The weak implementation of the 2017-2019 MTDS and lack of frequent DSAs raises questions on the adequacy of the laws that govern public debt management. Now more than ever, with Zambia quickly headed to its first bullet repayment on its Eurobond debt in 2022, the country needs to enhance its legal framework on Public Debt Management (PDM).

Requirements for a Medium-Term Debt Management Strategy

An MTDS is important because it provides the policy framework in which managerial decisions about recurrent or programmable debts are to be facilitated. While this is done as part of the intermediary resolve to address debt challenges, the ultimate goal is efficient and effective debt management. A good MTDS is more or less a start off point that must be coupled with sound macroeconomic and regulatory policies that are essential for containing the welfare and output costs associated with external and financial shocks. The MTDS may support secondary objectives such as development of the domestic debt market.

Zambia faces a series of simultaneous development constraints that would make good use of the additional capital provided by debt to overcome these challenges but the absence of a strategic plan in form of an MTDS has led to an indeterminate kind of debt management. Absence of the provision of an MTDS in the legal framework underestimates the fact that the Government manages a huge foreign exchange reserve portfolio, a fiscal position which is subject to real and monetary shocks. It also fails to appreciate the effects that a large exposure to contingent liabilities and the consequences of poorly managed balance sheets in the private sector can have on the whole economy.

A well thought out MTDS should be considered within the broader context of the general factors and forces affecting the management of the Government's balance sheet. This would ensure prudent PDM policies irrespective of shocks within the domestic financial banking sector or from the global financial contagion. Lack of legal frameworks specifying the inclusion of an MTDS to be periodically established made Zambia only publish its first MTDS in September 2017 after several underlying attempts. However, despite the excellent effort at an MTDS, the aims were abrogated sooner than anticipated. The strengths of the espoused domestic debt pillar were highly dependent on external factors while the risks were almost certain. If the performance of Government security auctions in the first half of 2018 was anything to go by, Government's expectation on domestic debt was too optimistic that they ended up raising less funds than anticipated from the domestic markets. It was unlikely that Government would increase domestic borrowing to the desired proportion of 60% within the debt portfolio as purported in the MTDS period, especially that external debt remained the most viable option for financing the deficit.

Additionally, it was also on the horizon at the mid-point implementation of the strategy in 2018, that Zambia was unlikely to access more concessional and semi-concessional external financing as compared to the more available yet expensive commercial debt because of the reclassification to a lower middle-income country. Thus, with unmitigated risks to the adopted pillars and strategies, the maiden MTDS was not meant to be. Silently, the Government abandoned the strategy they themselves had mapped out. Showing that even if an MTDS was to be adopted, on its own it lacks the power to be effective in Zambia because it is not mandated in the PDM laws.

PUBLISHED BY
CUTS International, Lusaka
Zambia

Email: lusaka@cuts.org
Web: www.cuts-lusaka.org

First Published: August 2020

This paper was authored by Kangwa Muyunda, CUTS Lusaka, Programmes Officer.

The design and layout was done by CUTS Communications & Advocacy Officer, Mr. Njavwa W Simukoko.

Citation: Consumer Unity & Trust Society, (2020), 'Medium Term Debt Strategies & Debt Sustainability Analyses Necessary in Debt Legal Framework', CUTS International, Lusaka.

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Debt Sustainability Analyses

In addition to the MTDS, Debt Sustainability Analyses (DSAs) should be a part of the overall fiscal risk management framework and help to assess the sustainability of debt given macroeconomic and institutional variables. DSA's help identify and prudently manage fiscal risks from debt, and they provide guidance for sound debt management strategies. They have become a common feature in several jurisdictions even though they are strictly speaking not a core PFM function. The lack of frequent undertakings of DSA may be part of the reason why Zambia has been unable to draft frequent debt strategies and it could also be because there is little or no capacity within the MOF to undertake these exercises.

The first MTDS was devised after undertaking a DSA in early 2017. The DSA statistically and analytically informed the quantitative benchmarks or targets and initiatives for new borrowing in the medium term. It was through the DSA conducted by the IMF in 2017 that Zambia's risk of debt distress was elevated from medium to high implying that the probability of breaching the debt sustainability thresholds was high and a default on debt servicing was more than likely. However, DSAs have not been frequently undertaken partly because they are not a requirement of the law and in part because the country still has to develop capability to conduct them. If Zambia had the capacity to undertake these DSAs annually, the risks of debt distress would have been pinpointed and dealt with quite quickly.

Thus, providing a statutory basis for the undertaking of DSAs could help to formalize and entrench the practice. If this were to be provided for in the law, there would be need to clarify the responsibility for their preparation and approval and the periodic frequency of preparation, such as on an annual basis or on a mid-term basis, if domestic capacity makes this feasible.
Annual Borrowing Plans

Ideally, the legal framework should also mandate the preparation by debt managers of annual borrowing plans to help with implementation of the MTDS over a given fiscal year. Although, like the MTDS, approval by the legislature is typically not required. Borrowing plans should work to predictably achieve the objectives of PDM. While the Zambian Government has had annual borrowing plans, they have been declared ambitious by the IMF. In 2017 and 2018, the IMF reiterated a few times that: "[the] borrowing plans provided by the Zambian Government continued to compromise the country's debt sustainability and risked undermining the country's macroeconomic stability and, ultimately, living standards of its people". In tandem with these warnings, Zambia's debt stock grew by 21.6% and 16.2%, respectively, in 2017 and 2018, showing that the country was unwilling or unable to adjust its borrowing plans despite the need for austerity during the period. This shows that without the objectives of reduced cost and risk, borrowing plans may actually jeopardise the aims of PDM.

With the burgeoned public debt stock in Zambia, the need for prudent PDM has become very critical. The existing legal frameworks for PDM in Zambia were appropriate for a time when the country borrowed almost entirely from bilateral and multilateral lenders such as the World Bank, and as a result, have served their purpose. The ushering in of commercial borrowing since 2012, the hardly implemented 2017 – 2019 MTDS and the surpassing of the debt ceiling in 2019 call for updating of the legal framework to mandate certain actions and adapt to changed circumstances.

Conclusion and Recommendations

Zambia's debt has increased greatly following Zambia's participation in the Highly Indebted Poor Countries (HIPC) Initiative. However, there is a lack of transparency, accountability and participation in the management of debt which needs to be addressed. The law should require that the Government undertake prudent debt management which is so critical for risk management given that debt default can lead to severe macroeconomic consequences.

Clear debt management objectives to give a general policy direction are missing in the pieces of legislation. There is no guidance on the procedures of debt management including requirements for DSA, MTDS regarding when, and for what debt should be obtained, debt has served budget support and to a larger extent road infrastructure projects.

On Debt Sustainability Analysis (DSA), the Ministry of Finance website has information on debt for 2012 which is outdated. Information on Zambia's Debt Sustainability Analysis of 2017 is on the IMF website, which indicates that Zambia is at high risk of debt distress. The Government in 2018 indicated that as a practical step towards ensuring debt sustainability, it would carry out a DSA exercise to analyse the capacity to accumulate debt as it relates to economic parameters, such as the GDP growth, reserves and debt servicing capacity. This however, has not been done. Furthermore, the first MTDS was crafted in 2017 and was hardly implemented. The country is expected to develop another one this year, in 2020, but the first half of the year has already passed without any medium-term guidance. In light of the current corona virus pandemic and funds expected to be borrowed to fight the pandemic these medium term debt management strategies are pertinent.

The legal framework should explicitly provide for the preparation of the MTDS and DSA with the Minister of Finance requiring its preparation in a rolling fashion and in coordination with all other relevant departments and the medium-term expenditure framework. Moreover, the legal framework should explicitly provide for the MTDS to be approved by cabinet as is with the Medium Term Expenditure Framework (MTEF). As a policy document, the law will empower it and give it authority so that all public debt-related activities be carried out in compliance with it. Should non-compliance occur, legal consequences should be spelled out, borrowing plans should be anchored within the MTDS and prudent PDM objectives and rationalised as such. The legal framework should not only require the borrowing plans but should enforce restraint within the PDM objectives without which the borrowing plans may actually worsen PDM as has been the case in Zambia.

Endnotes

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