

A Cautionary Tale of Zambia's International Sovereign Bond Issuances



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“There are no easy, risk-free paths to development and prosperity. But borrowing money from international financial markets is a strategy with enormous downside risks, and only limited upside potential – except for the banks, which take their fees up front. Sub-Saharan Africa’s economies, one hopes, will not have to repeat the costly lessons that other developing countries have learned over the past three decades”

- Joseph E. Stiglitz and Hamid Rashid, 2013

Executive Summary

In recent years, Zambia has been faced with the increased need to plug huge infrastructural gaps. However, the slowing down of bilateral and multilateral financing due to austerity measures in developed economies has made the country diversify its budget and project financing options by issuing Eurobonds. Eurobonds are commercial borrowings by governments in currencies other than their own - in Zambia's case, the borrowing is denominated in US dollars. Since 2012, the Zambian Government has issued two ten-year sovereign bonds collectively worth US\$1.75 billion mainly to finance infrastructure projects.

Eurobonds bring with them opportunities for economic development, but there are risks. This report assesses the current legal and institutional frameworks governing borrowing from international capital markets in Zambia, including the role of credit rating agencies. It also examines the benefits, costs and risks associated with the issuance of sovereign bonds, including the cost and risk of sovereign defaults. It also proposes the mitigation of these costs and risks.

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

However, by issuing Eurobonds, African economies have been exposed to "hot money" that seeks to take advantage of relatively high interest rates in Africa. The Eurobonds issued so far in Zambia have an average coupon rate of 6.9%. Comparatively, most bonds in the developed countries have interest rates of less than 2%. With bullet repayment structures, the lump sum principal payments on the two bonds will be paid at the end of the respective ten-year periods. Notwithstanding the high interest payments of over US\$125 million annually, the bullet structure of the bonds pose significant repayment risks as the country is expected to repay the US\$1.75 billion within a two-year period (in 2022 and 2024). Zambia may experience difficulty in repaying or refinancing the face value at maturity if the money is not spent in activities with high economic returns and if there are adverse changes in its exchange rate or international market conditions.

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

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

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

All these challenges for managing Zambia’s debt must also be seen against the backdrop of the challenging domestic and external macroeconomic conditions. Zambia is currently running high fiscal deficits averaging about 5% in the last three years. It has also been dogged by exchange rate depreciation and high currency volatility. Interest rate payments have been on the increase and the dependence on copper, which accounts for about 70% of the total exports, makes the country vulnerable to falling copper prices.

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

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

Recommendations and Policy Options

Zambia is currently on a learning curve from concessional and non-concessional borrowing to more market-based financing, both domestic and external. To mitigate the likely liquidity issues that may arise due to the bullet structures of the two bonds, Government should:

1. Address fiscal performance challenges through fiscal consolidation

Improving revenue mobilisation measures: This is by prioritising the broadening the tax base through streamlining incentives, reducing exemptions and enhancing SME and informal sector taxation; strengthening tax administration through modernisation and continuous enhancement of the technical capacity of the Zambia Revenue Authority, tax-payer education, curbing of tax evasion and redesigning of the mining fiscal regime. These measures will improve efficiency in tax administration and thereby increase compliance by the tax payers. There is also need to improve poorly performing tax types such as corporate income tax and domestic VAT.

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

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

Short term measures include the finalisation of the draft Medium Term Debt Management Strategy and mechanisms for periodic reviews of the strategy. Medium to long term measures include the reorganisation of the debt office by functional lines to enhance its risk portfolio monitoring and analysis and enhancing Parliament's oversight role over loan contraction and holding the executive accountable for debt management (or mismanagement).

3. Consider various available financing options

This includes either setting up a joint sinking fund for the two Eurobonds to insulate against future adverse macroeconomic conditions; or refinancing the second bond, which was obtained on relatively less favourable terms, by obtaining another bond with lower coupon rates and longer maturities; and widening creditor sources to reduce the appetite for Eurobonds.

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Acronyms

BOZ	Bank of Zambia
CSOs	Civil Society Organisations
DMFAS	Data Management and Financial Analysis System
EMD	Economic Management Department
GDP	Gross Domestic Product
IDM	Investment and Debt Management
IMF	International Monetary Fund
MOF	Ministry of Finance
MTDS	Medium Term Debt Management Strategy
QE	Quantitative Easing
RTI	Right to Information
ZIPAR	Zambia Institute for Policy Analysis and Research

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1 Introduction

Until recently, the Zambian Government has been relying on concessional and non-concessional loans¹ from multilateral and bilateral institutions such as the World Bank, the International Monetary Fund (IMF) and donor countries for budget and project financing. The World Bank's reclassification of Zambia to a lower Middle Income Country implies that Zambia has now become richer than before. As a consequence, bilateral and multilateral financiers reduced concessional loans from Zambia to other needy countries in the lower income bracket hence the country becoming a victim of its own success. As a matter of policy, the Zambian Government still prefers the use of concessional resources where available (Ministry of Finance, 2014). With the unpredictability and dwindling of traditional sources of income over the years, coupled with the severity of the global economic crisis in advanced economies, Government has had to diversify its financing sources by resorting to commercial borrowing from external markets – hence the issuance of sovereign bonds in 2012 and 2014.

Zambia's entry onto the sovereign bond market was through the issuance of a ten-year US\$750 million Eurobond at a coupon rate of 5.375%. The coupon rate is the amount of interest the bond pays when it is first issued. The issuance of the sovereign bond was meant to finance several infrastructure projects in energy, transport, rehabilitation of tertiary hospitals and access to finance to sustain growth (Ministry of Finance, 2012). In order to augment funding to the selected investment projects under the first Eurobond, Government successfully issued a second Eurobond amounting to US\$1 billion in 2014 at a coupon rate of 8.5%.

Zambia joins a growing list of African countries that have entered the international sovereign bonds market. Before 2006, only South Africa had issued a sovereign bond in Sub-Saharan Africa. Since 2009, 14 other countries have issued a total of US\$17 billion in sovereign bonds. These include Angola, the Democratic Republic of the Congo, Côte d'Ivoire, Gabon, Ghana, Kenya, Namibia, Nigeria, Rwanda, Seychelles, Senegal and Tanzania. Excluding South Africa, Sub-Saharan sovereigns issued US\$6.3 billion of foreign-currency denominated bonds in 2014 alone. These findings are shown in Table 1.

Table 1: Bond issuances in Sub-Saharan Africa (excluding South Africa), 2009-2014, US\$ Millions

	2009	2010	2011	2012	2013	2014	Total
Angola				1,000			1,000
Cote d'Ivoire		2,330				750	3,080
Ethiopia						1,000	1,000
Gabon					1,500		1,500
Ghana					750	1,000	1,750
Kenya						2,000	2,000
Mozambique					850		850
Namibia			500				500
Nigeria			500		1,000		1,500
Rwanda					400		400
Senegal	200		500			500	1,200
Seychelles		168					168
Tanzania					600		600
Zambia				750		1,000	1,750
TOTAL	200	2,498	1,500	1,750	5,100	6,250	17,298

Source: Overseas Development Institute, 2015⁶

¹ Concessional loans are loans extended on terms substantially more generous than market loans with typically lower interest rates and/or long grace periods.

Sovereign bonds carry significantly higher borrowing costs than concessional debt does. Stiglitz and Rashid (2013) have shown that the 10 African economies that had collectively raised US\$8.1 billion from their maiden sovereign-bond issues by February 2013 had an average maturity of 11.2 years and an average coupon rate of 6.2%. These countries' existing foreign debt, by contrast, carried an average interest rate of 1.6% with an average maturity of 28.7 years (Stiglitz, 2013). Zambia's non-concessional debt has an initial coupon rate of 5.5% and a maturity of 10 years (International Monetary Fund, 2013). By contrast, the average maturity on new external debt commitments in Zambia was 23.48 years with an average interest rate of 1.72% in 2010 (Trading Economics, 2013).

Despite the benefits of concessional borrowing, African sovereigns are increasingly tapping into the international capital markets mainly as a result of dwindling concessional resources. Another reason is the low returns on investments in Europe and the United States which appear to be pushing international investors away from the developed world and towards emerging markets such as Africa. This strong investor demand, alongside higher funding rates in the developed countries, currently makes it convenient for many African countries to issue debt on the international markets than domestically (Standard and Poor's, 2013). Other reasons include the exceptionally high liquidity and lack of conditionalities.

This study assesses the opportunities and challenges of Zambia's entry onto the sovereign bond market by exploring exactly what the country is getting itself into. In pursuing this key objective, the study seeks to understand the definitional and conceptual issues surrounding sovereign bonds and the national legal and institutional frameworks in place for borrowing from international capital markets, including the role of credit rating agencies. It also examines the benefits, costs and risks associated with the issuance of sovereign bonds, including the cost and risk of sovereign defaults. Lastly, it proposes the mitigation of vulnerabilities associated with sovereign bond issuance.

2 The Basics of Bonds and Zambia's Sovereign Bonds

2.1 Bond Basics

Bonds are a type of debt instrument in which the purchaser of a bond – the investor or creditor – is essentially loaning money to the issuer – the debtor – for a fixed period of time. Sovereign bonds are a form of debt security issued by a national Government within a given country. Often referred to as Eurobonds, they are denominated in a foreign currency (usually the United States dollar, rather than, as its name would suggest, the Euro).

The name 'Eurobond' is a misnomer and can be confusing. Although the euro is the currency used by participating European Union countries, Eurobonds refer neither to the European currency nor to a European bond market. It instead refers to any bond that is denominated in a currency other than that of the country in which it is issued. Bonds in the Eurobond market are categorised according to the currency in which they are denominated. For example, a Eurobond denominated in Japanese yen but issued in the U.S. would be classified as a Euroyen bond. In terms of origin of the term, Eurobonds refer to the first securities market where these bonds were sold².

The Zambian Government has so far issued two ten-year sovereign bonds. The first was issued on 13th September 2012, while the second was issued on 14th April 2014. In return for their purchase, investors receive a guarantee that they will have the principal amount repaid by a certain future date, and that they will receive interest payments at certain intervals. The date when the principal is due for payment is referred to as the date of maturity. The first bond is due for payment on 20th September, 2022, while the second bond is due on 14th April, 2024. (Financial CBonds Information, 2015).

Coupon rates for sovereign bonds vary according to the credit rating of the issuing country and the maturity of the bond (Tyson, 2015). The US\$750 million Eurobond in 2012 was at a coupon rate of 5.375%, while the US\$1 billion in 2014 was at a coupon rate of 8.5%. Interest payments on each bond are made semi-annually. For 2015, the interest payments on the US\$750 million bond are due on 20th March 2015 and 20th September 2015, while the interest payments for the US\$1 billion bond are due on 14th April 2015 and 14th October 2015 (Financial CBonds Information, 2015). There are therefore steep humps in the semi-annual interest payment schedule for the two bonds (March, April and September, October).

The two bonds have bullet repayment structures. This means that a lump sum principal payment will be paid at the end of the ten-year period. The bullet structure of the two bonds may have significant repayment risks as the country is expected to repay US\$750 million in 2022 and another US\$1 billion barely two years later to repay the bonds. The country may experience difficulty in repaying or refinancing the face value at maturity if there are adverse changes in its exchange rate given the country's heavy reliance on copper exports or international market conditions.

The risk that a debtor may default on its bonds is assessed by sovereign credit rating agencies – the main ones being Standard & Poor's, Moody's and Fitch. These agencies rate a sovereign's ability to repay its obligations.

² It is generally accepted that the first Eurobonds were traded in 1963 and were originally issued by Autostrade, an Italian motorway construction company, in conjunction with SG Warburg and Co; Autostrade issued US\$15 million in Eurobonds with a 15 year final maturity and an annual coupon of 5½% (Source: <http://www.mysmp.com/bonds/eurobonds.html>; <http://www.icmagroup.org/About-ICMA/Organisation/history/50th-anniversary-of-the-euro-bond-market>).

Ratings range from 'AAA' to 'Aaa' for "high grade" issues that are very likely to be repaid to 'D' for issues that are currently in default. Bonds rated 'Baa' to 'BBB' or above are called "investment grade"; this means that they are unlikely to default and tend to remain stable investments. Bonds rated 'Ba' to 'BB' or below are called "junk bonds", which means that default is more likely, and they are thus more speculative and subject to price volatility. Table 2 shows the grading of sovereign credit ratings as used by the three main rating agencies.

Table 2: Rating symbols for investment and speculative grades

Category		Moody's	Standard & Poor's	Fitch
Investment grade	Highest grade credit	Aaa	AAA	AAA
	Very high grade credit	Aa1, Aa2, Aa3	AA+, AA, AA-	AA+, AA, AA-
	High grade credit	A1, A2, A3	A+, A, A-	A+, A, A-
	Good credit grade	Baa1, Baa2, Baa3, Baa4	BBB+, BBB, BBB-	BBB+, BBB, BBB-
Speculative ("junk") grade	Speculative grade credit	Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-
	Very speculative credit	B1, B2, B3	B+, B, B-	B+, B, B-
	Substantial risks – In default	Caa1, Caa2, Caa3, Ca	CCC+, CCC, CCC-, CC, C, D	CCC, CC, C, RD, D

Source: Moody's, Standard & Poor's, Fitch

At the time of issuance of the first Eurobond, both Standard and Poor's and Fitch rated Zambia at B+. For the second issuance, Standard and Poor's rated Zambia at B+, Fitch at B, while Moody's rated it at B1. Contrary to the popular view that these ratings are 'favourable', the ratings signify the existence of considerable credit risk as they are below investment grade⁷.

Table 3: Zambia's sovereign bond issues, 2022 and 2024

	2022	2024
Amount (million)	750	1,000
Currency	USD	USD
Payment structure	Bullet	Bullet
Coupon rate	5.375%	8.5%
Issue date	13 September 2012	14 April 2014
Coupon frequency	Two times per year	Two times per year
Tenor	10 years	10 years
Date of maturity	20 September 2022	14 April 2024
Sovereign rating on issue date	B+ (S&P); B+(Fitch);	B+ (S&P); B (Fitch); B1 (Moody's)

Source: Ministry of Finance

2.2 The Timing of the Sovereign Bond Issues

Timing is everything. The impeccable timing of the 2012 Eurobond at a yield of 5.375% made it cheaper for the country than many pundits would have expected. It was issued at a time when investors were looking out for countries that could offer high yields along with growth to offset the falling yields and economic slowdowns in developed and emerging markets. There was also excess liquidity in the market, due to quantitative easing in the United States.

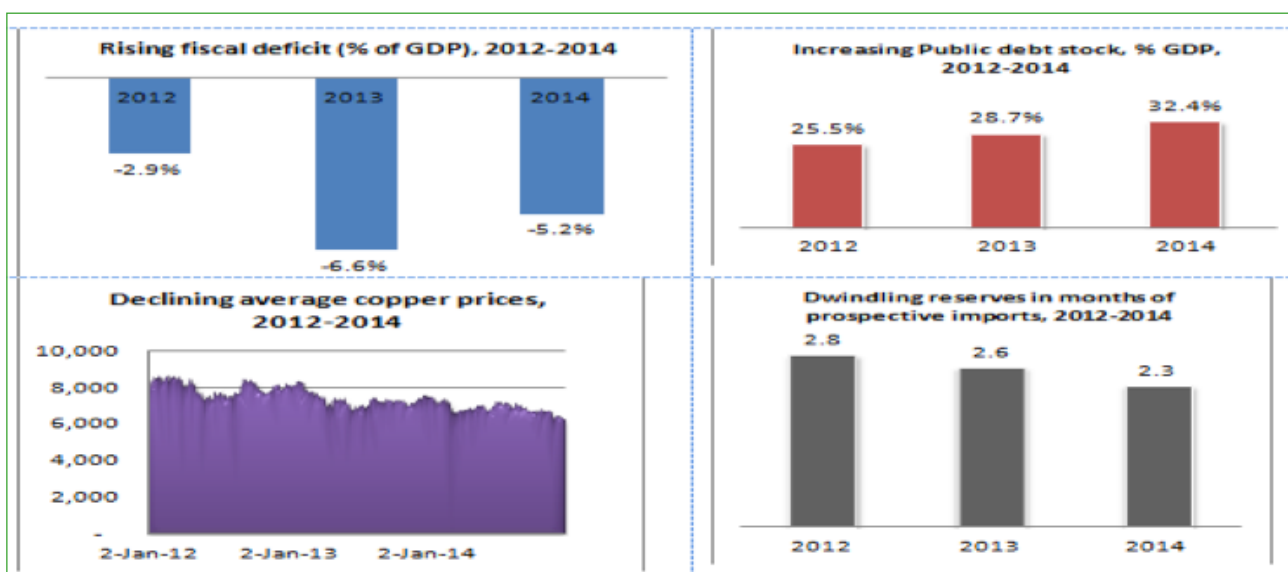
Additionally, Zambia had better macroeconomic fundamentals in 2012 than it has had since: its fiscal deficit was low at 2.9% of GDP; public debt levels were 25.5% of GDP; the stock of domestic debt at 12.0% of GDP and the stock of external debt at 13.5% of GDP was relatively lower; copper export prices were high, at US\$7,959 per tonne; and gross international reserves were higher, at US\$3.044 billion or 2.8 months of prospective imports.

³ This is dealt with in more detail in Section 4 on understanding the role of credit rating agencies.

The second bond issue was somewhat ill-timed and the country paid a higher price as investors demanded a relatively high interest rate of 8.5%. International conditions no doubt had an impact – following increased economic growth, the US started the “tapering” of the Quantitative Easing programme which meant that investors began to face up to a future without the Federal Reserve dumping liquidity in the financial markets.

However, in addition, Zambia’s domestic macroeconomic fundamentals deteriorated compared to 2012. By April 2014, the country had just come out of a challenging year [2013] with regard to fiscal policy – it experienced the highest fiscal deficit in recent years – 6.6% of GDP compared to a target of 4.3% of GDP in 2013. This was mainly caused by higher than planned expenditures, including personal emoluments and public infrastructure. Personal emoluments as a share of GDP breached the 8% barrier in 2013 and reached 8.2% of GDP following the unprecedented wage adjustments for public sector workers. Government’s spending on non-financial assets – mainly investments in road infrastructure - doubled to 6.7% of GDP in 2013 from 3.4% of GDP in 2011.

Figure 1: Selected macroeconomic indicators, 2012-2014



Source: Ministry of Finance, www.investing.com (copper prices)

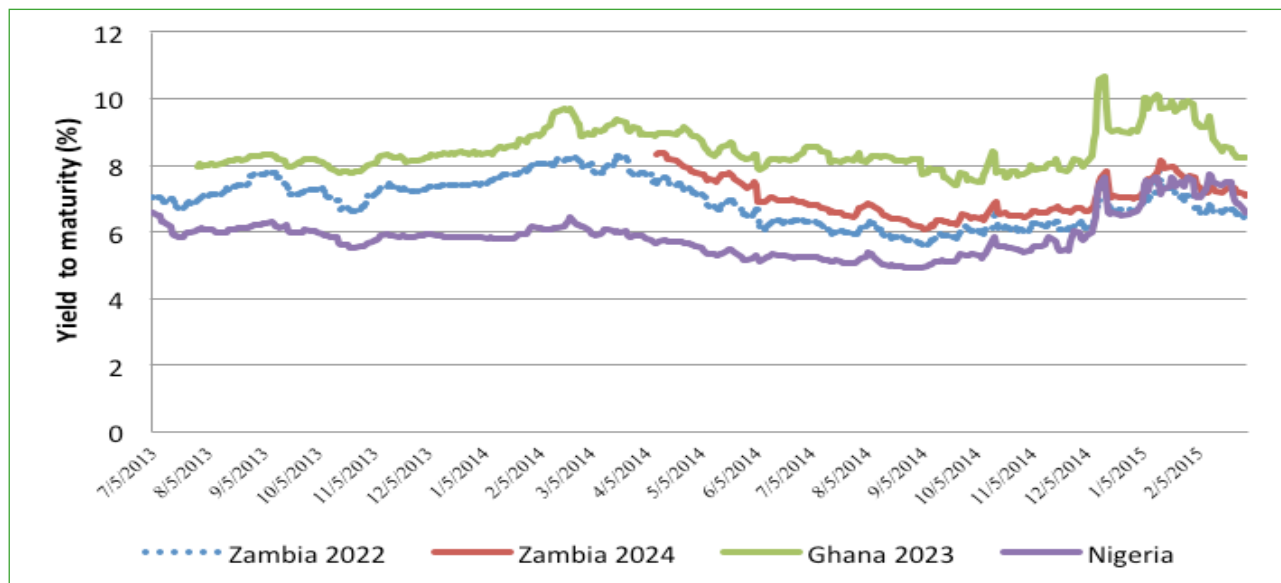
Additionally, public debt levels increased from 25.5% in 2012 to just below 30% of GDP at the beginning of 2014. There were also concerns about the country’s vulnerability to declining copper prices, as copper constitutes about 70% of the total exports. The price of copper plunged to US\$6,400 per metric tonne in early 2014 from about US\$8,000 per metric tonne in October 2012.

2.3 Trading in the Secondary Market

Like other African sovereigns, Zambia’s two Eurobonds are traded in the secondary bond market. Comparing the yield performance of Zambia’s bonds with two other African countries – Nigeria and Ghana – shows notable variations and similarities among the three countries due to different market conditions at different times and differences in credit ratings.

With a B+ rating (based on Standard and Poor’s), Zambia’s credit rating is sandwiched between the two countries – Ghana’s B rating is a notch below Zambia, while Nigeria’s BB- rating is a notch above Zambia. Yields on Zambia’s debt in the last two years have consistently been between the yields of Ghana and Nigeria (with Ghana being the higher) until mid-December 2014 when yields on securities in Nigeria and Ghana, which are oil producers, spiked to record highs as dollar inflows from oil dwindled, implying that these countries would find it increasingly difficult to service their debt. This is shown in Figure 2.

Figure 2: Mid Yield-To-Maturity of Zambia’s 2022 and 2024 Eurobonds in Relation to Ghana and Nigeria



Source: Bloomberg, 2015

Market perceptions are often thought to be country-specific. However, the picture revealed through the comparison with Nigeria and Ghana suggests that market perceptions towards Zambia are generally similar to the dynamics of other African sovereigns. The chart shows Zambia’s bond yields following a similar trend to those of Nigeria and Ghana. Zambia’s bonds trading on the secondary market experienced similar spikes in mid-December 2014 as Ghana and Nigeria.

2.4 Conclusion

Zambia’s two sovereign bonds have the same ten-year maturity period and bullet payment structure. This comes with significant repayment risks. Despite similar credit ratings, the second sovereign bond was issued with much higher interest rates than the first one, primarily due to deteriorating conditions both domestically and internationally.

Interest payments are made semi-annually for each bond in March and September for the first bond and in April and October for the second bond. The timing of the interest payments of the second bond in relation to the first bond has resulted in interest payment “humps” in March-April and September-October.

The trading of the bonds on the secondary market shows that the Zambian bonds are performing similarly to other African bonds – particularly, Ghana and Nigeria, suggesting that international market conditions play a big role in the pricing and yields of the bonds.

3 Legal and Institutional Frameworks for Managing Public Debt

With the recent issuance of sovereign bonds, Zambia is currently on a learning curve from concessional and non-concessional borrowing to more market-based financing, both domestic and external. Debt management will increasingly become more sophisticated as the Government starts using debt transactions such as exchanges and debt buy-backs, as well as hedging transactions including through derivatives such as currency and interest rate swaps. The Central Government may also be increasingly involved in transactions of on-lending to sub-national entities and extending guarantees of various types to other government entities and/or the private sector. This will also entail the periodic design of a public debt management strategy which will involve the modelling of costs and risks and an analysis of macroeconomic and market constraints.

We assess the current legal and institutional frameworks for managing public debt to determine our preparedness for the increased sophistication and challenges ahead. Strong and clearly-thought-out legal and institutional frameworks are cardinal for efficient debt management and the implementation of a public debt management strategy.

3.1 Legal Framework on Loan Contraction and Management

3.1.1 Current Legal Framework

In Zambia, debt management is governed by several pieces of legislation and a number of accompanying regulations. The Loans and Guarantees (Authorisation) Act Cap. 366 of the Laws of Zambia provides for the raising of loans, the establishment of sinking funds, the giving of guarantees and indemnities and the granting of loans by or on behalf of the Government.

Other pieces of legislation relevant to debt management include:

- The Bank of Zambia (BoZ) Act Cap 360 that gives the bank the mandate to act as fiscal agent of Government;
- The Finance (Control and Management) Act Cap 347 that stipulates that all the moneys received by way of loans, grants and donations shall constitute public moneys and shall be deposited in the Treasury Account for the credit of the Consolidated Fund;
- Development Bond Act Cap 379;
- The Treasury Bills Act Cap 348; and
- Local Loans (Registered Stock and Securities) Act, among others.

We focus on the Loans and Guarantees (Authorisation) Act Cap 366 which is the primary legislation that deals with public debt management in Zambia. This has the following key elements:

- **General borrowing powers:** The Act in Part II Section 3 vests on the Minister of Finance the powers to raise loans from time to time within the country and elsewhere on behalf of the Government as he may

deem desirable for a period not exceeding one year. In the case of loans exceeding one year, the Minister of Finance requires approval from the National Assembly to borrow. In addition to the legal requirement, a new procedure was put in place in 2014 that requires Cabinet approval for any loan proposed to be contracted by the Minister of Finance.

- **Methods of raising loans:** Part III Section 6 of the Act provides for the Minister of Finance to raise loans through issuance of bonds and stocks, treasury bills, or by agreement in writing. The Minister of Finance determines the terms and conditions upon which the loan is raised. Further in Section 8, loans raised through issuance of bonds and treasury bills are managed by the Bank of Zambia as Government Agent. The Central Bank also is responsible for investment and management of the sinking funds that may be established in respect of the loans.
- **Establishment of a Sinking Fund:** Part IV Section 9 of the Act provides for the Minister of Finance to establish a sinking fund whenever any bonds or stock are issued in respect of a loan raised under this Act for a period of more than ten years for the purpose of redeeming such bonds or stock. This is optional in the case of a loan raised for a period not exceeding ten years. The Minister may give directions in respect of the establishment, management and control of any sinking fund required or permitted to be established under this Act.
- **Maximum borrowing amounts:** Further, the Act under subsidiary legislation - Loans and Guarantees Act (authorisation, maximum amounts) and Statutory Instrument No.25 of 2014 - provides for limits of amounts of loans raised both within and outside the country under sections 3 and 5. Currently the maximum amount borrowed within the Republic of Zambia (domestic) for a period not exceeding one year is K13 billion while the maximum amount for the period exceeding one year is K20 billion. The maximum ceiling for external borrowing is now at K35 billion.
- **Institutional structures:** The Act provides for the establishment of institutional structures to carry out the day to day functions of borrowing and repayment of loans thereafter contracted. Under this provision, debt management is conducted by the Ministry of Finance which manages public and publicly guaranteed debt and the Bank of Zambia which monitors private sector external debt.

Box I: Sound practice for the legal framework for debt management

This box sets out what is, according to the World Bank, sound practice in debt management. In the following section we use this as the basis for an assessment of the current arrangements in Zambia.

Authority to borrow: The primary legislation should set out the authority to borrow in both domestic and foreign markets. Parliament will usually have the ultimate power to borrow on behalf of central government; in some cases this power flows from the constitution. However, parliament should not be involved in individual debt management operations. The first level of delegation of the borrowing power therefore comes from the parliament down to the executive branch (whether to the president, cabinet or directly to the minister of finance). There may be further delegation (possibly in secondary legislation) within the executive branch of government to one or more debt management entities. These powers should be exclusive: there should be a single borrowing authority not multiple authorities.

Specify borrowing purposes. To guard against the risk of abuse, the delegation of the borrowing power is often restricted by a statement of the purposes for which the executive can borrow or by a limit on the annual net borrowing or the outstanding debt (or both).

Set clear debt management objectives. For accountability purposes, it is important to ensure that there is a formal objective against which the government's performance can be assessed. This serves as an anchor for the debt management strategy development, and supports its implementation.

Preparation of a debt management strategy. Another key feature to include in the primary legislation is a requirement for the preparation and periodic update of the debt management strategy. This highlights the importance of the strategy for sound public management in addition to assuring steady planning and monitoring of the government's portfolio. Additionally, reporting of the implementation results to Parliament and Government should be included in the law in order to strengthen the governance structure and empower the debt management function.

Specify mandatory (at least annual) reporting to the parliament on debt management activities, including an evaluation of outcomes against stated objectives and the determined strategy.

Determine audit requirements. An external audit will usually be the responsibility of the country's supreme audit institution.

Subnational financing. With regard to subnational financing, in most countries the legal framework regulates the borrowing of local governments and their subsidiaries in addition to imposing some limits on their financing. In these countries, governments can regulate and manage, to an extent, the risks stemming from the contingent liabilities related to sub-national entities.

3.1.2 Issues for Consideration

Debt management objectives. While the Act clearly states the authority to borrow, purposes for borrowing domestically and externally and sets borrowing limits, the legislation excludes clear objectives for public debt management to serve as an anchor for the development and implementation of a debt management strategy.

Medium term debt management strategy. To avoid or mitigate future financing challenges, Government has put in place a rolling Medium Term Debt Management Strategy (MTDS). This is currently in draft form. It is intended to provide a framework under which Government plans to address the potential liquidity challenge that may arise in servicing the two bonds by putting in place a robust debt redemption and refinancing strategy underpinned by a prudent macroeconomic environment that fosters fiscal sustainability and supports growth. Government's commitment to servicing the obligations of the two outstanding bonds is a key ingredient for enhancing the country's credibility, creditworthiness, and asset values (Ministry of Finance, 2014). However, the primary legislation has no requirement for the preparation and periodic update of the medium term debt management strategy.

Regulations for subnational borrowing. The primary legislation has no regulations on sub-national (corporations, local government and their subsidiaries) borrowing. Following the 2012 sovereign bond issuance, there were media reports that the Zambia Railways, ZESCO, the Road Development Agency, and the Lusaka City Council intended to raise additional funds via bond issuances. Collectively, they intended to raise as much as US\$7.25 billion if and when they issue the bonds. Additionally, the 2013 Foreign Private Investment and Investor Perceptions in Zambia report revealed that the stock of private sector foreign liabilities was in excess of US\$15 billion by mid-2013 (Bank of Zambia, Central Statistical Office, Zambia Development Agency, 2013). Such legislation would enable the government to regulate and manage, to an extent, the risks stemming from the contingent liabilities related to sub-national entities.

Parliament's oversight role. The Act does not explicitly provide for Parliament to play its oversight role in the debt management process except for approving debt ceilings; the Executive solely executes this function. Parliament's involvement is limited to scrutinising and passing annual appropriation Acts (as a House) and scrutinising the Auditor General's reports particularly in line with the role of the Public Accounts Committee included in the legislature's standing rules and orders. Another concern is that reports to Parliament are mostly general and not disaggregated.

Establishment of a sinking fund. While the law provides for the establishment of sinking funds for loans with maturity exceeding ten years, the Minister has the discretion of setting up sinking funds for the two sovereign bonds. The absence of sinking funds for the two bonds exposes the country to a likelihood of default in the event of macroeconomic shocks since they both have bullet payment structures.

Public involvement and right to information. The legal framework does not provide for the involvement of the general public and civil society in terms of access to public debt information in order to enhance transparency and accountability, save for the gazette notices issued periodically by Government on various issues for the information of the general public. The Third World Debt Crisis has been a major arena for reflection and debate on the issue of citizen participation and inclusivity in public affairs within civil society. As testimony to the importance of this issue, the IMF and World Bank, in their 'Guidelines for Public Debt Management' now declare that "public participation in general, and public access to debt information in particular, is central." (IMF, World Bank in the Fall, 2003).

3.2 Institutional Framework for Debt Management

3.2.1 Current Organisational Structure

The Ministry of Finance, and specifically the Investment and Debt Management (IDM) department, is responsible for managing Zambia's public debt, while the Bank of Zambia acts as the fiscal agent of Government as it is assigned the responsibility of issuing Government securities and provide financial advice (African Forum and Network on Debt and Development, 2011). Besides IDM, other departments in the Ministry of Finance involved in the management of debt are the Economic Management Department (EMD) and Budget Office. In the Bank of Zambia, at least two departments (Economics, Financial Markets) are involved in debt management.

This study focuses particularly on the functions of IDM. As with the legal frameworks in the previous section, we have compared and contrasted the Zambian institutional arrangements with those which are considered best practice.

Currently, the IDM department is organised along lines based on the source of debt, i.e. multilateral, bilateral and commercial debt, and government securities. The external debt unit is responsible for External Debt management that include multilateral, bilateral and commercial debt. It is primarily responsible for external borrowing and has both front and back office functions. The unit's tasks include back office functions of recording of new debt, grants and disbursements in the Data Management and Financial Analysis System (DMFAS), a system developed by the United Nations Conference on Trade and Development (UNCTAD), data validation and reconciliation, and initiation of debt service payments. Its front office responsibilities include monitoring the outstanding stock of debt, and calculating the grant element for external loans.

The Domestic Debt unit is responsible for domestic debt management with products such as traditional (Government securities) and non-traditional (arrears, awards and compensation) debt. The unit coordinates with the Bank of Zambia to auction government securities.

Other units are the Government Investments unit responsible for performance monitoring and supervision of Government investments including state-owned enterprises; and Accounting, Audit and Debt Data units responsible for finance management, auditing and data recording functions, respectively. Both the external and domestic debt units perform limited middle office functions of analysing the debt portfolio and monitoring risk indicators.

Box II: Sound practice for institutional framework for debt management

To achieve sound debt management and reduce operational risks, the World Bank recommends that the institutional set up of the debt office ought to be organised by functions (front, middle and back offices) rather than products (external, domestic debt) or lenders (multilateral, bilateral, etc.). The Front Office is responsible for the analysis and efficient execution of all portfolio transactions, consistent with the debt management policy and strategy. The core competence of the Middle Office is the design of a public debt strategy which involves risk/cost modelling and an analysis of macroeconomic and market constraints. Another important but more operational function is monitoring and compliance. The core competence of the Back Office is operational, involving transaction confirmation, settlements, reconciliation and payments, as well as maintaining records of new contracts, disbursements, payments, debt restructuring and on-lending (World Bank, 2011).

3.2.2 Issues for Consideration

The current organisational framework leads to operational inefficiency and poor coordination and does not clearly reflect the division of responsibilities between different debt management functions. Theoretically, domestic and external financing would be assigned to one unit, whereas recording and debt servicing of domestic and external loans would be assigned to separate units. However, External Debt and Domestic Debt units are responsible for both sides of debt transactions, namely issuance (front office), analysis and recording as well as settlement of debt (back-office). This exposes the department to operational risks.

The operational risks include inadequate debt data recording system and poor information flow across the

departments in the Ministry of Finance involved, consequently leading to inaccurate and incomplete debt records. It also makes it difficult to verify creditor claims due to conflicting figures from the various bodies handling the debt management function.

Another operational risk is the inadequate staffing levels. For instance, scaling up the middle office functions would require a critical mix of skills including finance and risk analysis, public policy skills to understand the role of debt management within the context of overall macroeconomic policies, and strong mathematical and modelling skills. Additionally, the critical debt data unit only has three members of staff who are all IT personnel. Besides staff with strong IT skills, internationally acceptable standards recommend that this unit requires staff with specialisations that will reflect the environment in which they work, including economics, basic finance and financial markets, and statistics.

3.3 Conclusion

The existing legal and institutional frameworks for debt management in Zambia were appropriate for a time when the country borrowed almost entirely from bilateral and multilateral lenders such as the World Bank. But since 2010, when Zambia became a middle income country, it has had to consider borrowing commercially. But the legal and institutional arrangements are yet to be updated to ensure that they adapt to changed circumstances.

The legal framework excludes clear objectives for public debt management and the requirements of a debt management strategy for achieving these objectives. It also requires consistency with fiscal and monetary policy through appropriate coordination mechanism and oversight role of Parliament. The current organisational framework leads to operational inefficiency and poor coordination and does not clearly reflect the division of responsibilities between different debt management functions. With increased commercial debt, it is imperative that these systems are realigned to effectively manage this debt.

4 Understanding Sovereign Credit Ratings

A credit rating is an assessment of the credit worthiness of a borrower in general terms or with respect to a particular debt or financial obligation (Investopedia, 2015). A credit rating can be assigned to any entity that seeks to borrow money – an individual, corporation, state or provincial authority, or sovereign government. It is a forward-looking opinion about the ability and willingness of an issuer to meet its financial obligations in full and on time. The credit rating of a country or sovereign entity is called a sovereign credit rating, while the ratings of corporations are called corporate credit ratings. This section deals with sovereign credit ratings.

Governments generally seek credit ratings in order to ease their access to international capital markets and to be able to generally gauge themselves with other sovereigns. Many investors prefer rated securities over unrated securities of apparently similar credit risk. Before going onto the international capital market to borrow funds to finance its infrastructure development projects, the Zambian Government obtained sovereign credit ratings. The sovereign credit ratings are simply risk assessments assigned by the credit rating agencies to the obligation of central Governments (Cantor, 1995).

Rating agencies assess the ability of a country to manage its debts. A Government's ability to pay back its debt is a function of its economic position. A country with a strong economy, manageable debt burden, stable currency, strong tax administrative system and positive demographics will likely have the ability to pay back its debt. This ability will usually be reflected in a strong credit rating by the major ratings agencies. On the other hand, a country with a weak economy, high debt burden, weak or volatile currency, little ability to collect taxes and poor demographics may find itself in a position where it is unable to pay back its debt.

There are a number of credit rating agencies in the world, with the top three being Moody's Investors Service, Standard & Poor's and Fitch Ratings. The ratings assigned by these international credit watchdogs are adjusted depending on their perceived credit worthiness of a country. The ratings also take into account overall economic environment and political conditions. Investors often consider credit ratings when evaluating the general investment climate of a country. An investment grade rating is expected to allow a country to attract more job-generating medium to long term sustainable foreign direct investments.

Each rating agency has its own methodology in measuring credit worthiness and uses a specific rating scale for its credit rating opinion. However, these are generally comparable.

4.1 How Sovereign Ratings are Calculated

To rate sovereign Governments, rating agencies make judgements on the future ability and willingness of an issuer to make timely payments of principal and interest on a security over the life of the instrument. The more likely the borrower will repay both the principal and interest, in accordance with the time schedule in the borrowing agreement, the higher will be the rating assigned to the debt security (Sinclair, 1993).

Rating agencies take into account political risk, regulatory risk and other unique factors to determine the likelihood of a default. They use a variety of quantitative and qualitative methods to calculate sovereign ratings.

Standard & Poor's sovereign rating methodology addresses the factors that affect a sovereign Government's

willingness and ability to service its debt on time and in full. The five key factors that form the foundation of Standard & Poor's sovereign credit analysis are:

- Institutional and governance effectiveness and security risks, reflected in the institutional and governance effectiveness score.
- Economic structure and growth prospects, reflected in the economic score.
- External liquidity and international investment position, reflected in the external score.
- Fiscal performance and flexibility, as well as debt burden, reflected in the fiscal score.
- Monetary flexibility, reflected in the monetary score.

Moody's uses similar rating criteria to Standard & Poor's. Moody's looks at interplay of four key factors, given by economic strength, institutional strength, fiscal strength, and susceptibility to event risk. Just like for Standard & Poor's, these key factors are then combined via scores into Moody's sovereign rating.

In contrast to both Standard & Poor's and Moody's, **Fitch** uses what it calls a cooperative rating process. This starts off with a modelling approach, and then a committee from Fitch discusses this rating with the sovereign, relying both on quantitative and qualitative data. Factors assessed include fiscal and monetary policy, prospects for the country's tradeable sectors, how the country might react if faced with certain international economic shocks, and an assessment of political risk.

4.2 Rating Agency Credit Scale

Credit rating agencies use different designations to identify a bond's credit quality rating. The bond ratings are broadly grouped into two categories: investment grade and speculative grade.

Investment grade bonds are bonds which are rated Baa3 or higher by Moody's or BBB- or higher by Standard & Poor's and Fitch. These ratings are indicators of default risk on a particular bond issue -- with higher rating suggesting lower risk. Investment-grade bonds might not offer huge returns, but the risk of the borrower defaulting on interest payments is much smaller.

Speculative grade bonds are bonds which fall below the investment grade threshold (also known as high yield bonds, non-investment grade bonds or junk bonds). These are rated Ba1 or lower for Moody's and BB+ or lower for S&P and Fitch. Table 4(a) and 4(b) list the ratings which would qualify an issue as investment grade and those that qualify as speculative or non-investment grade.

Table 4 (a): Rating Symbols for long term debt (Investment Grade)

Moody's	S&P	Fitch	Rating Grade	Rating Grade Description
Aaa	AAA	AAA	Investment Grade	Highest credit quality; Minimal credit risk.
Aa1	AA+	AA+		High credit quality; Very low credit risk
Aa2	AA	AA		
Aa3	AA-	AA-		
A1	A+	A+		Strong payment capacity; Low credit risk
A2	A	A		
A3	A-	A-		
Baa1	BBB+	BBB+		Adequate payment capacity; Moderate credit risk
Baa2	BBB	BBB		
Baa3	BBB-	BBB-		

Table 4 (b): Rating Symbols for long term debt (Speculative Grade)

Moody's	S&P	Fitch	Rating Grade	Rating Grade Description
Ba1	BB+	BB+	Speculative Grade	Likely to fulfill obligations; substantial credit risk
Ba2	BB	BB		
Ba3	BB-	BB-		
B1 (Zambia)	B+ (Zambia)	B+		High credit risk
B2	B	B (Zambia)		
B3	B-	B-		
Caa1	CCC+	CCC+		Very high credit risk
Caa2	CCC	CCC		
Caa3	CCC-	CCC-		
Ca	CC	CC		In or near default, with a possibility of recovery
	C	C		
C	SD	DDD		In default, with little chance of recovery
	D	DD		
		D		

4.3 Zambia's Credit Ratings

Moody's long-term credit rating for Zambia's sovereign debt is B1; Standard & Poor's current rating of Zambia is B+ while Fitch rates the country as B. Far from being deemed favourable, as has often been touted, the current ratings mean that Zambia's credit rating is four notches below investment grade. These ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favourable business and economic environment.

Zambia is among the 26 countries in Africa that have a sovereign credit rating by at least one of the three major rating agencies in 2015. Only 5 countries are rated in the investment grade category. Botswana has the highest rating and has strong payment capacity with low credit risk. The ratings for Botswana are supported by its strong institutions and both external and fiscal balance sheets, and a well-managed minerals-based economy. Mauritius, South Africa, Morocco and Namibia complete the top 5.

Angola, Gabon, Lesotho, Nigeria, Congo DR and Tunisia are just below investment grade. They have substantial credit risk but are likely to fulfil their debt obligations. The rest of the countries, including Zambia, are considered to be of high credit risk.

5 Benefits, Costs and Risks of Sovereign Bond Issuance

Issuance of sovereign bonds on the international market offers a number of opportunities for Zambia and countries in Sub-Saharan Africa. Sub-Saharan Africa governments have issued international sovereign bonds for a variety of reasons. These include deficit financing (including for increasing public infrastructure spending), benchmarking (including for expanding international market access for firms), and public debt management (including debt restructuring) (International Monetary Fund, 2014).

5.1 Benefits of Sovereign Bond Issuance

Issuance of sovereign bonds on the international market offers a number of benefits for Zambia.

Diversification of financing sources: It allows access to a much wider pool of capital than available from concessional financing and domestic savings, and thus help finance desired infrastructure projects more rapidly. Proceeds from Zambia's first Eurobond were mainly earmarked for the much-needed energy and transport infrastructure required to sustain growth. See Box III for details.

Helps finance import-intensive expenditure: It also provides a source of foreign exchange, to help finance import-intensive expenditure (the energy and transport infrastructure that Government is financing) without the need to tap into existing reserves or risk weakening of the Kwacha. The projects that utilised the first Eurobond are outlined in Box III. It is assumed that the second Eurobond in 2014 was used to augment funding to the selected infrastructure projects. The remaining proceeds from the 2014 Eurobond amounting to K2.4 billion were incorporated into the 2015 budget.

Strengthening macroeconomic discipline: Accessing international markets through a sovereign bond can strengthen macroeconomic discipline and move forward transparency and structural reforms as a result of increased scrutiny by international market participants.

Benchmark for pricing corporate bonds: International sovereign bond issuance can provide a benchmark for pricing corporate bonds in international markets, over time expanding the yield curve, and help increase access to international financial markets for the private sector and parastatal companies. For instance, Nigeria's Guaranty Trust Bank successfully offered US\$500 million, a five-year Eurobond, four months after the sovereign in 2011, followed by Access Finances BV in 2012, and then Fidelity Bank Plc and First Bank of Nigeria in the same month as the sovereign issued in 2013. Following the inaugural US\$750 million Eurobond from Ghana in September 2007, Ghana Telecom placed a US\$200 million issue in the international market two months later (Moody's Investor Service, 2013).

5.2 Costs and Risks of Issuing Sovereign Bonds

However, there are also a number of risks or challenges that international bond issuance pose to fragile credit markets like Zambia. These include high interest payments, high fees and transaction costs and threats to macroeconomic stability.

High interest payments: The interest payments on the two Eurobonds, which are in excess of US\$125 million, constituted over 40% of the total interest payments on external debt in 2014 and were higher than the entire grant allocation to local authorities.

Fees and transaction costs: Aside from interest costs, Government has had to pay fees and transaction costs amounting to US\$1.4 million on the 2012 Eurobond for financial and legal advice and services.

Foreign Exchange Risks: Eurobond issuances are also susceptible to foreign exchange risks given that they are denominated in US dollars. Zambia's exposure to currency risks is high given the country's heavy reliance on copper exports for foreign exchange. The recent sharp fall in the prices of copper poses the risk of currency depreciation and hence exposure to currency risks. The fall in the value of the Kwacha against the US dollar in the first quarter of 2015 implies an increase in the cost of servicing the two Eurobonds in Kwacha terms. Intuitively, this means Government will have to spend increasingly more in Kwacha terms in interest payments on the two Eurobonds in the event that the Kwacha continues to depreciate. The seriousness of currency risks cannot be overstated, not least the effect it may have on the pursuance of prudent macroeconomic fiscal policies.

Threats to macroeconomic stability: Bonds, in particular those with a bullet repayment structure, as is the case with the two Eurobonds, may have to be repaid at a time of higher interest rates, or when the currency may be weaker. As a copper-dependent economy, with copper accounting for about two-thirds of total exports, nearly a third of budget revenue, and over ten percent of GDP, payment of principal could be due at the time when the copper prices are low. This could threaten the macroeconomic stability of the country. Additionally, excessive fiscal expansion and public debt management challenges could negatively affect macroeconomic stability.

Capacity constraints: Limited administrative capacity, weak fiscal institutions, low efficiency of public investment expenditure, poses a risk that increased public spending or investment projects financed by bond issuance may be poorly selected or executed and therefore would not render value for money. Increased public investment spending may also be accompanied by a rise in recurrent primary spending, particularly personal emoluments, which may be hard to reverse, considering these payments are protected by the constitution.

Box III: Use of proceeds from Zambia's debut Eurobond: are they on high return projects?

Government allocated the proceeds of the 2012 Eurobond to several "growth promoting infrastructure project" in energy, transport and health, as well as access to finance. This is shown in the table below.

PROJECT		ALLOCATION
1	Energy (Generation and Transmission)	US US\$255million
	Of which:	
	Kafue Gorge Lower Hydropower Project	USUS\$186 million
	Power distribution projects	USUS\$69 million
2	Transport (Road and Rail)	US US\$430 million
	Of which:	
	Zambia Railways recapitalisation	USUS\$120 million
	Road projects	USUS\$310 million
3	Human Capital and Access to Finance	US US\$49 million
	Of which:	
	Rehabilitation of Central Hospitals	US US\$29.4 million
	Access to finance for SMEs (Development Bank of Zambia)	US US\$20 million
4	Fees and Transaction Costs	USUS\$1.4 million
5	Discount Premium	USUS\$14.2 million
Total		USUS\$750 million

Source: 2013 Budget Speech, Ministry of Finance, 2012; 2013 Auditor General's Report.

The 2013 Auditor General's report suggests a "business as usual" and imprudent use of the Eurobond proceeds. Even though most of the selected projects can potentially boost growth, the future economic benefits are likely to be delayed, thereby affecting the mechanisms for paying back the debt.

Below are the challenges highlighted in the 2013 Auditor General's report:

- Of the US\$186 million allocated to ZESCO for the Kafue Lower Hydropower project, US\$144 million was returned to the Bank of Zambia. The US\$69 million allocated for power distribution networks was not utilised by December 2013.
- The entire US\$120 million was allocated to Zambia Railways Limited. However, the Auditor General's report highlights failure to recover advance payment guarantee from a supplier who failed to deliver various locomotive spare parts, misapplication of rehabilitation funds and lack of receipt and disposal details, as some of the problems that faced ZRL in 2013.
- Despite receiving US\$20 million for onward lending to SMEs, the Development Bank of Zambia had by September 2014 not submitted a detailed lending framework to Government on how they would use the loan proceeds. Additionally, there was no evidence of a follow up by the Ministry of Finance. The Auditor General's report also mentioned delayed disbursement of the proceeds as well as irregular disbursement of funds to other financial institutions for lending to SMEs contrary to the Subsidiary Loan Agreement between Government and DBZ. This highlights the lack of capacity to use the allocated funds.
- The Ministry of Health was allocated US\$29 million for the rehabilitation of tertiary hospitals. However, the Ministry's engagement of contractors without clearance from the Office of the Attorney General, inadequately supported payments, and failure to obtain advance payment guarantees and performance bonds for signed contracts, are some of the problems experienced in the administration of the Eurobond proceeds.

Although sovereign bond issues could help increase private sector and parastatal entities' access to international capital markets, sometimes corporate governance structures and debt monitoring capacity may not be in place to contain macroeconomic and structural vulnerabilities arising from increased private sector and parastatal external debt and currency risk exposure. Both the Asian crisis and the financial turmoil in Europe are reminders of the drawbacks of excessive private foreign debt.

5.3 Conclusion

Eurobonds offer a number of opportunities that enable deficit financing and debt management. Benefits of sovereign bond issuance include the diversification of income sources, helping to finance import-intensive expenditure, strengthening macroeconomic discipline, lowering debt servicing costs and benchmarking for pricing corporate bonds.

However, they also carry significant costs and risks which the debt managers need to be fully aware of and take into account when setting policy and managing Zambia's public debt. The costs associated with bonds include high interest payments and high fees and transaction costs. The risks include threats to macroeconomic stability and limited administrative capacity, weak fiscal institutions, and low efficiency of public investment expenditure.

The 2013 Auditor General's report which assessed how the proceeds of the first Eurobond were used reveals a "business as usual" approach and imprudent use of the Eurobond proceeds, contrary to the expectation that commercially-borrowed money would be used more prudently.

Overall, Zambia will need to continue to borrow commercially. However, in order to help manage some of these risks it will need to do so with confidence that it has the most robust institutional and legal frameworks in place. This is examined in detail in section 7.

6 Measuring the Cost of Default

Sovereign borrowing is a risky business. There has been a lot of apprehension about Zambia's ability to pay back the debt come maturity in 2022 and 2024. The World Bank's Country Policy and Institutional Assessment (CPIA) rank for Zambia is 3.4, which makes the country a medium policy performer. The relevant thresholds of external debt for a medium performer are that the solvency indicators of the present value of debt to GDP should not exceed 40%, debt to exports should not exceed 150%, while debt to revenue should be less than 250%. Additionally, the liquidity indicators, i.e. external debt service to exports and the external debt service to budget revenue, should not exceed 20% of GDP.

The Ministry of Finance's 2014 Debt Sustainability Analysis shows that, from a solvency perspective, Zambia's debt indicators remain below the policy-dependent debt burden thresholds. However, the liquidity indicators suggest potential for Zambia to experience liquidity challenges in 2022 and 2024 due to the maturing sovereign bonds (Ministry of Finance, 2014). If the country will face liquidity challenges, it is highly likely to default on its debt obligations.

From a legal stand point, a sovereign default event is an episode in which a scheduled debt service is not paid beyond a grace period specified in the debt contract (Hatchondo, Martinez, & Saprizza, 2007). In the event that Zambia defaults on its sovereign bond debt, it is likely to have implications on growth, trade and investments. In this section, we summarise lessons from existing works on this issue.

6.1 Sovereign Default and Growth

While most studies agree that sovereign defaults have a negative impact on growth, the literature is mixed as there is no consensus on the size and duration of the impact. The size of output losses range from 0.6% to 10%, and the losses can last up to 10 years.

Table 6: Cost of debt crises on economic growth

Author	Number of defaults	Size of output losses and duration
Sturzenegger (2004)	100 countries during 1974-1999	0.6% of GDP
De Paoli, Hoggarth and Saporta (2009)	35 countries during 1970-2000	5.0% per year lasting up to 10 years
Mendoza and Yue (2011)	23 countries during 1977-2009	GDP & consumption fall about 5% below trend
Levy Yeyati and Panizza (2011)	40 countries in the '80s and from 1990-2006	Economic growth picks up fast: one year after a default.
Furceri and Zdzienicka (2012)	An unbalanced panel of 154 countries from 1970 to 2008	10% of output after 8 years

Source: *Sovereign defaults, business cycles and economic growth in Latin America, 1870-2012*

From the foregoing, there is no running away from the fact that if the bonds are not restructured and the country defaults on its principal payment, say, for the first Eurobond in 2022, there is likely to be an economic contraction in the subsequent years which will further affect the payment of the 2024 debt, compounding the

default further.

The literature distinguishes a number of transmission channels of debt defaults on economic growth. These include exclusion from international capital markets, reputational and political costs.

6.1.1 Exclusion from International Capital Markets

There is well documented economic literature on the fact that countries suffer exclusion from international capital markets in the wake of sovereign debt crises. In their paper on the duration of capital market exclusion, Richmond and Dias (2008) find that exclusion from international capital markets after a sovereign default lasted on average 4 years: 5.5 years for debt crisis episodes in the 1980s, 4.1 years in the 1990s, and 2.5 years in the 2000s (Richmond & Dias, 2008). In the same vein, Gelos et al. (2013) show that after a sovereign default in the 1980s, countries were excluded from international capital markets for about 5.4 years on average, while in the 1990s they were excluded for 0.9 years. (R. Gaston Gelos, 2013).

6.1.2 Impact on Trade

Trade credit may naturally shrink after default. Alternatively, creditors may wish to punish default with reduced trade benefits, in order to discourage future default, or default by third parties. In practice, default seems to be strongly associated with reduced trade. Rose (2002) uses a large panel data set spanning 50 years and covering over 200 trading partners to estimate a “gravity” model of trade. He shows that debt renegotiation is associated with a decline in bilateral trade, adding up to a year’s worth of trade, although the effect is spread over 15 years (Rose, 2002).

6.1.3 Effect on the Financial Sector

The current debt crisis in Europe illustrates the link between public default and financial turmoil. From 2009, reports of bad news regarding the sustainability of public debt in Greece, Italy, and Portugal undermined the banking sectors in these countries precisely because the banks were exposed to their Governments’ bonds. These events played a key role in the decision to refinance the European Financial Stability Fund: averting sovereign defaults was seen as a key prerequisite to avoid widespread banking crises. While this scenario seems far-fetched in the Zambian context where the financial sector is not very well developed, it is still a possibility.

6.1.4 Reputational Costs

Following a default, there is a lot of pessimism that may be experienced thereby undermining confidence in the Government, with direct consequences on the corporate sector. A sovereign default leads to a decline in Foreign Direct Investment (FDI) inflows, as well as a collapse of foreign credit to the private sector. It would also lead to the country being downgraded by the major credit rating agencies. Downgrading announcements receive a great deal of public attention, both domestically and internationally. Foreign investors may therefore interpret negative rating news as a signal of worsening fundamentals in the country, even if the fundamentals are still strong. This may subsequently lead to the withdrawal of their funds from the Zambian market. Such a reaction may worsen the fundamental economic situation and trigger even further withdrawals. The rating announcements would then become a self-fulfilling prophecy and probably trigger a currency and financial crisis, as was the case in the 1997 Asian financial crisis.

6.1.5 Political Costs

A default may bring into question the competence of the incumbent policymakers. For instance, the poor economic conditions that trigger a default decision can be interpreted as the result of bad economic policies and may typically cost the ruling party their mandate in the next election (Borensztein and Panizza, 2009).

6.2 Evidence from Recent Sovereign Defaults, 2001-2012

Argentina, US\$82 billion, December 2001: In December 2001, Argentina suffered a severe financial crisis, leading to the largest sovereign debt default in history at that time. Argentina owed private investors bonds with a face value of US\$81.8 billion, the Paris Club countries US\$6.3 billion, and the IMF US\$9.5 billion, among other domestic and multilateral obligations (Hornbeck, 2013). Addressing the large private-sector debt was Argentina's most pressing problem. The debt crisis was as result of many factors, which were mainly due to over borrowing under persistently bad macroeconomic policies. First, a strengthening dollar – which the Argentine peso had been linked to – hurt commodity exports at a time when prices were already falling. Second, Brazil's 1999 devaluation of its currency caused a flood of foreign investment into Brazil at Argentina's expense. Third, a growing fiscal deficit was pushing domestic interest rates up and squeezing out private investment. Companies shut down, unemployment soared, and the recession that had already plagued Argentina for six years deepened further. The situation was compounded by a global recession, and international credit markets that lent generously to Argentina with inadequate regard to risk, by chasing high yield even after risk factors began to rise to worrisome levels. Together, these factors propelled Argentina toward a position of unsustainable debt that ended in financial crisis, unprecedented default, and a controversial restructuring scheme.

Faced with the compounded macroeconomic problems described above, and falling international credibility, Argentina was unable to roll over its debt. The financial crisis hit Argentina hard. The combined effect of capital flight and large peso devaluation resulted in the country's wealth evaporating overnight. Additionally, poverty and unemployment skyrocketed.

Seychelles, US\$230 million, 2008: In 2008, Seychelles failed to pay the principal on a privately placed €54.75 million amortising note that was due in 2011. In the same year, it missed an interest payment on its US\$230 million global bond due in 2011.

The Seychelles' default occurred in the context of a difficult economic environment, severe fiscal and balance-of-payments constraints, an unsustainable debt burden, and a depleted international reserves position. The defaults came in the wake of several years of waning economic growth, expansionary fiscal policy and increased indebtedness. This was exacerbated by devastating economic losses due to damages to hotels, housing, public utilities, and the fishing industry following the 2004 Tsunami, and balance of payments constraints which led to a fall in tourism, the mainstay of the Seychelles economy, following the global economic crisis of 2008.

Prior to the default, Seychelles had embarked on a reform process in 2004. Though it had positive results, the reforms put a lot of pressure on the country's fiscal and external balances. Due to the accrual of arrears with multilateral creditors, commercial borrowing was pursued instead. The expansionary fiscal policy was coupled with a restrictive currency regime, low foreign exchange reserves and rapid import growth. The liquidity pressures culminated in a balance-of payments crisis in November 2008 when a floating currency system was put in place. This led to a currency depreciation of 50%. The rise in interest rates of up to 30% helped to stabilise the currency (Moody's, 2009).

Jamaica, US\$7.9 billion, February 2010: Jamaica's public debt as a share of GDP (both domestic and external) nearly doubled from 71% in 1997 to 129% in 2010. While there are other countries with higher debt-to-GDP ratios, the interest burden on Jamaica's public debt swelled to 13% of GDP in 2010⁶. With the Government spending 45% of its budget just on meeting interest payments, Jamaica had little left for public investment and social spending. The country's economic growth suffered as a result and in January 2010, it launched the Jamaica Debt Exchange as a pre-emptive debt-restructuring effort. The negotiation concluded in February 2010, cutting the average coupon rate from 17% to 11% and extending the average debt maturity from two to five years.

Cote d'Ivoire, US\$2.3 billion, January 2011: Cote d'Ivoire has had a history of defaults due to political turmoil. In 2011, it reneged on US\$2.3 billion of Eurobonds, after failing to pay US\$29 million of interest which had become

⁶ By comparison, Japan, while holding public debt that is 220% of GDP, only pays about 2% of GDP in annual net interest.

due. The problem stemmed from a political stand-off following a disputed presidential election. Earlier to this in 2000, Cote d'Ivoire reneged on US\$3.5 billion of "Brady bonds", which were fixed income securities created as part of a debt restructuring plan for developing countries. This was after a coup in 1999.

Despite these setbacks, Cote d'Ivoire has been able to bounce back. Less than four years after the US\$2.3 billion default in 2011, it went back to the international capital market in July 2014 and sold US\$750 million of 10-year bonds at a coupon rate of 5.375%.

Greece, US\$138 billion, March 2012: This was the biggest sovereign default in history. Greece had impressive growth rates in the Eurozone during 2000-2007. However, it had failed to record a budget surplus since 1973. Since 1981, the Greek Government had run particularly large deficits to finance huge expenditures. Tax evasion had also long been a prominent problem. Studies showed that as much as €30 billion (US\$41.1 billion) in taxes went uncollected in the years leading up to the crash. These deep, structural problems came to a head when a new Government that came into power in 2009 revealed the true extent of Greece's financial woes: a whopping US\$410 billion in public debt. A deal was reached in March 2010 in which Greek debt holders agreed to wipe out some US\$138 billion of what they were owed. A bailout worth €110 billion from the European Union and IMF followed the Government-instituted harsh austerity measures consisting of major spending cuts and tax hikes. This sparked protests and riots in the country.

6.3 Evidence from a Country on the Brink of Default

Venezuela, 2015: Venezuela has the highest known stock of oil reserves in the world and oil revenues account for 96% of total export earnings, about 45% of budget revenues and around 12% of GDP. However, the recent plunge in oil prices has hit Venezuela hard and is on the brink of defaulting on its sovereign debt. In theory, Venezuela's oil exports could generate the income to pay its foreign creditors. In 2013, oil brought in an estimated US\$86 billion. But the oil price is falling, worsening the terms of trade and the general economic situation. The fiscal deficit has ballooned to 16.9% of GDP – this is higher than that of countries like Greece and Spain during the 2012 Eurozone crisis. The Government has resorted to rationing of commodities and price controls amid a scramble for foreign exchange. Inflation is over 60%. The IMF projected that Venezuela's economy shrunk by 3% in 2014 and will shrink by a further 1% in 2015 (International Monetary Fund, 2014).

Venezuela's difficulties were precipitated by a spending spree around elections in 2012, when it borrowed heavily from the international capital markets at short maturities. Those bonds are now beginning to come due. External debt service cost US\$7 billion in 2014 and is estimated to average US\$9 billion in the next three years! Against these obligations Venezuela has thinning reserves of just over US\$20 billion, down by about half since 2008 (Daily Mail UK, 2014). The Government's failure to address the economic distortions has led Standard and Poor's to downgrade the long term credit ratings to 'CCC' from 'CCC+'.

6.4 Conclusion

The liquidity indicators in the Ministry of Finance's 2014 DSA suggest potential for Zambia to experience liquidity challenges in 2022 and 2024 due to the maturing sovereign. In the unfortunate event that the country faces liquidity challenges, it is highly likely to default on its debt obligations.

Countries that have either defaulted or are at the brink of a default show that defaults are often preceded by macroeconomic instability. Greece, which currently holds the record of the highest default in history, has been running particularly large fiscal deficits and is reputed for tax evasion; Argentina, which has been dragged to court by creditors, was over-borrowing under poor macroeconomic policies; Jamaica was faced with unsustainable interest payments on its equally unsustainable debt; Cote d'Ivoire defaulted following political turmoil; and Venezuela whose economy is heavily dependent on oil exports is on the brink of a default following plunging oil prices. Zambia ought to draw lessons from these countries. Key lessons include the following:

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

A sovereign default in Zambia is likely to have implications on growth, trade and investments. Sovereign defaults have a negative impact on growth, with the size of output losses range from 0.6% to 10%, and the losses can have durations of up to 10 years. A number of transmission channels of debt defaults on economic growth include exclusion from international capital markets, reputational and political costs.

7 Mitigation of Vulnerabilities

Zambia is faced with a likelihood of defaulting on its debt commitments if macroeconomic conditions deteriorate. It is imperative that the country sustains the high economic growth that it has been enjoying for over a decade averaging over 6%. However, a big challenge currently facing the Zambian economy, which is derailing this growth, is the high fiscal deficit which needs to be addressed through fiscal consolidation, a policy aimed at reducing fiscal deficits and debt accumulation. There is also need to strengthen the legal and institutional frameworks for managing debt. The liquidity challenges that the country is likely to face in 2022 and 2024 also require considering several financing options for paying back the debt. We explore each of these options in detail.

7.1 Fiscal Consolidation

Government's medium term policy is to reduce the fiscal deficit to the SADC threshold of below 3% of GDP. Although reducing the fiscal deficit is an economic imperative, the measures that need to be taken for its realisation are not politically expedient. A number of factors have been responsible for the burgeoning fiscal deficit in the last three years. These include the unprecedented increase in wages of public sector workers and other recurrent expenditures, higher than programmed expenditures on roads and other infrastructure, purchasing of maize beyond the strategic food reserve requirements, a presidential and numerous parliamentary bye-elections and revenue underperformance due to reduced copper prices on the international market. The lifting of the two-year wage and recruitments freeze, repaying of VAT arrears for exporters, the need to hire more teachers, health care personnel and agriculture extension workers, and a general increased spending ahead of the 2016 elections are some of the measures that are likely to derail the reduction of the deficit in the medium term. Bringing down the fiscal deficit therefore requires a strong resolve on the part of the Government to undertake reforms on the revenue side and on public expenditure.

a) Increasing the revenue base

Government revenue, excluding grants, of about 20% of GDP during the last five years is below its middle income peers in Sub-Saharan Africa. These countries averaged 27% - or 23% if South Africa is excluded (International Monetary Fund, 2014). Increasing government revenue is certainly important to reduce the deficit, but it is not sufficient. The low tax revenues are due to inconsistent tax regimes (particularly for mining, which is the main source of Zambia's export revenue), tax exemptions, and inefficiencies in tax administration, tax avoidance and evasion.

There is need for comprehensive tax reforms that will improve efficiency in tax administration and thereby increase compliance by the tax payers. This will increase revenue collection especially from tax types such as personal income tax which is withheld at source. A recent study by ZIPAR shows that potentially uncollected PAYE for the self-employed and paid employees amounted to 6.7% of GDP and 40.3% of total tax in 2010 (ZIPAR, 2014). There is also need to improve poorly performing tax types such as corporate income tax and domestic VAT. Government's reversal of the 2015 mining tax regime which had abolished corporate income tax for underground and open-cast mining operations and replaced it with mineral royalty calls for broad consultation and research on the effective implementation of a mining tax

regime before implementation. The recent rolling out of the TaxOnline payment system by the Zambia Revenue Authority (ZRA) is expected to improve efficiency in administration of consumption taxes such as VAT through early filing of returns and e-payment of taxes. There is also need to enhance the capacity of the Zambia Revenue Authority both in terms of staffing and training in forensic auditing and transfer pricing to stem illicit financial flows.

b) Rationalising expenditure

There is need for Government to rein in spending by prioritising expenditure on growth-enhancing programmes with parliament offering proper oversight to root out all forms of unplanned government spending.

Reducing public expenditure through more prudent public expenditure on the basis of economic and social prioritisation is necessary. In the 2015 National Budget, Government proposed measures to contain the fiscal deficit by limiting the public sector wage bill and streamlining expenditures towards priority programmes. Specifically, Government intends to control recurrent expenditures of the budget, limit expenditure on maize marketing, and ensure cost reflective fuel pricing and rationalise capital expenditure.

Capital projects take up a significant allocation of the national budget. Postponement of capital projects not yet begun can save resources with relatively little disruption of day-to-day government operations. However, postponement of already existing infrastructure projects may lead to a lower growth rate and consequent future fiscal costs. Moreover, if capital expenditure is cut by eliminating or slowing down projects already under way, there may be a substantial loss of sunk costs. Hence, the need to devise a long-term infrastructure investment plan (Box IV).

Box IV: Development of a long-term infrastructure investment plan

One way to rationalise capital expenditure is for Government to devise a national infrastructure investment plan in line with the existing development plans. Government has in the last three years embarked on huge infrastructure development projects. However, the infrastructure gaps remain enormous and may take over a decade to fully accomplish. Zambia Railways Limited, which was allocated US\$120 million from the debut Eurobond requested for more funding when the second Eurobond was issued. ZESCO's development of energy infrastructure still requires funding. Newly created districts require the building of public infrastructure. The Government's plan to make Lusaka a regional hub for air transportation also requires massive infrastructure development. Then there is the Link Zambia 8000, an ambitious project to construct 8,000 km of road network, out of which less than 500km have been completed so far.

Despite the proceeds of the Eurobonds being primarily used to develop infrastructure in the country, aside from the 2013-2016 Revised Sixth National Development Plan, there is no stand-alone long term plan for infrastructure development which could help address the historic problems of short-term decision making, uncertainty in funding and financing [adding to the fiscal deficit], and failures in delivery. Such a plan would also improve transparency in how Eurobond monies are utilised and identify funding sources and financing gaps; as well as the action Government needs to take to address these funding gaps.

7.2 Strengthening Existing Legal and Institutional Frameworks

Government should institute short, medium and long term measures to address the existing institutional and legal bottlenecks in debt management.

Short term measures

- **The Ministry of Finance needs to finalise the Medium Term Debt Management Strategy as a matter of urgency.** At the time of writing, the Ministry of Finance had a draft rolling Medium Term Debt Management Strategy in place. It is imperative that this MTDS be finalised and should be in line with the Medium Term Expenditure Framework to ensure debt sustainability and enhance the debt-servicing capacity of the country. Additionally, the MTDS should prioritise concessional borrowing for social sector spending. It should also guide the timing of the debt contraction to avoid interest payment 'humps' as is currently the case with the two Eurobonds whose interest payments are made in March and April (first hump) and September and October (second hump). The drafting of the MTDS is the primary responsibility of the Investment and Debt Management department of the Ministry of Finance.

- **The Ministry of Finance should conduct a Debt Sustainability Analysis on an annual basis.** The MTDS will be informed by the findings of the Debt Sustainability Analysis (DSA) which should be conducted much more regularly than is currently the case. A DSA is a vital tool for prudent debt management conducted to assess the sustainability of a country's current level of debt and its prospective new borrowing requirements in the medium to long term. The DSA also enables a country to assess the vulnerabilities of its current debt portfolio to exogenous shocks, thereby establishing the likelihood of debt distress.
- **The Ministry of Finance should build staff capacity in debt management, project appraisal and fiscal management.** Considering that the development of the debt management strategy is essential for sound public debt management, the capacity of staff should be strengthened both in terms of staffing and training.
- **The Ministry of Finance should continuously monitor and evaluate the utilisation of borrowed funds.** This is to ensure that projects are implemented as designed and funds utilised for the intended purposes. Additionally, there is need for the establishment of statutory or legal basis for think-tanks and academic institutions to conduct independent ex-ante feasibility studies as well as ex-post M&E assessment of the full debt contraction process and provide these outputs as inputs to Parliament.
- **The Access to Information bill currently under consideration should explicitly include provisions for accessing information on public debt.** Zambia is currently considering passing access to information legislation, thereby facilitating a legal process by which citizens can formally access Government-held information. This should include information on public debt. The legislation must clearly stipulate that information on the use of borrowed funds and loan contracts (and their terms) must be made available to the public especially civic groups which are interested in monitoring Government loans and grants.

Medium term measures

- **Organise the debt management office by functional lines.** There would be need to structure IDM along functional lines (front, medium and back offices) in order to provide clear reporting lines and help manage the operational risk. This would also support specialisation of the staff according to different functions rather than on the basis of the financing sources. At the current level of operations and debt transactions, there is no great urgency to reorganise IDM in the short term. However, in the medium term, as the level of sophistication increases, the need to manage public debt more efficiently and to minimise operational risks could become a challenge. Therefore, IDM should keep in mind the suggested functional structure and steer gradually in that direction. Gradual reforms would support a strengthening of institutions and capacity to prepare for this situation.
- **Inclusion of clear objectives for public debt management in the primary legislation.** These objectives could include the devising of a debt management strategy. This would further enhance the importance of a strategy based on cost and risk preferences of the policy makers and in coordination with macroeconomic policies. In addition, this legal requirement would ensure a continuous focus on the medium term debt management strategy and its implementation.
- **Parliament needs to enhance its oversight role over loan contraction and management.** It must play the critical role of ensuring accountability and transparency in loan contraction and debt management processes. It should mitigate against the risks of excessive borrowing by reinforcing the countervailing mechanisms of Government accountability and legislative scrutiny, and exert pressure on the executive to improve fiscal and budgetary performance by, among other things, holding the Minister of Finance accountable for the contraction and management (or mismanagement) of debt.
- **Civil Society Organisations (CSOs) are also encouraged to build their capacity to engage on the authorities on loans.** CSOs must play an advisory role in the process of loan contraction and debt management as 'think tanks' working closely with negotiators and Governments by influencing policy

decisions, giving legal, technical or expert advice. They should carry out research and advocacy during the project/programme proposal development and loan agreement negotiation stages. They must monitor development projects and programmes, including how they are financed. This allows civic groups to monitor the effect of loan-funded programmes and projects, as well as the funds freed up as a result of debt relief initiatives. CSOs should conscientise the public and raise awareness on issues of loans, grants and development finance issues.

Long term measures

- **Development of guidelines for subnational borrowing.** Although sovereign bond issues could help increase private sector and parastatal entities' access to international capital markets, sometimes corporate governance structures and debt monitoring capacity may not be in place to contain macroeconomic and structural vulnerabilities arising from increased private sector and parastatal external debt and currency risk exposure. Both the Asian crisis and the financial turmoil in Europe are reminders of the drawbacks of excessive private foreign debt. IDM should develop procedures for subnational borrowing by guiding subnational entities on technical issues such as operational steps, procedures, and the design and implementation of a debt management strategy at subnational level. .
- **Strengthen the credit environment and improve the credit culture.** Though often vilified, external credit rating agencies offer objective quantitative and qualitative assessments of a sovereign's vulnerabilities to determine the risk of default. It would be folly for the Government to dismiss these ratings when they are not in the country's favour. As part of the Financial Sector Development Plan, the setting up of an independent local credit rating agency, the Credit Rating Agency Limited, will give a local perspective to the credit ratings and bridge the gap in the financial sector by rating corporates and bonds issued by corporate entities in the country thereby enhancing regulation for subnational borrowing.

7.3 Financing Options

The move from concessional and non-concessional borrowing to more market-based financing requires more sophistication in debt management. In order to lower the refinancing risks highlighted by the 2014 DSA, Government needs to put in place measures to mitigate these vulnerabilities.

7.3.1 Setting up a Joint Sinking Fund

As provided for in the Loans and Guarantees Act of the Laws of Zambia, the Ministry of Finance has the option of setting up a joint sinking fund for the two Eurobonds to insulate against future adverse macroeconomic conditions, even though the maturities do not exceed ten years. A sinking fund is a fund formed by periodically setting aside money for the gradual repayment of a debt. Our peer – Ghana - announced the setting up of a sinking fund in 2014 to manage debt redemption using revenue from the country's growing petroleum resources.

If there are provisions in the legal contract for the purchase of the sovereign notes by the issuer on the open market or otherwise and at any price, Government should set up a joint sinking fund for the two bonds.

Through the sinking fund to be administered by the Bank of Zambia, Government would systematically commit to set aside funds annually that would be used to make payments against the principal. Since money is fungible, the sinking fund should be set up as a bond buy-back scheme rather than a reserve fund held in trust. With a sinking fund in place, the Government is less likely to default on interest payments and repayment of principal, making the bonds safer investments and more attractive to risk-averse investors.

The cost implications of setting up this sinking fund based on the provisions of the Loans and Guarantees (Authorisation) Act are discussed in Box IV.

7.3.2 Debt Restructuring

Another option available for mitigating vulnerabilities is debt restructuring. Ministry of Finance officials sparked media uproars in February 2015 when, appearing before the Committee of Estimates of the National Assembly, they said that Government was considering issuing another bond to pay off the Eurobonds.

A sovereign debt restructuring is an exchange of outstanding sovereign debt instruments for new debt instruments or cash through a formal process (Das, Papaioannou, & Trebesch, 2012). Debt restructuring usually involves relief for the debtor from the original terms and conditions of debt obligations it has entered into. This may be in response to liquidity issues, where the debtor does not have the cash to meet looming debt service payments, or sustainability issues, where the debtor is unlikely to be able to meet its debt obligations in the medium term (International Monetary Fund, 2009).

There are generally two main elements in a debt restructuring: (i) debt reduction, and (ii) debt rescheduling or refinancing. Debt reduction is a reduction in the face (nominal) value of the old instruments. The reduction of the debt stock is considered when there are solvency concerns - where the country is no longer able to meet the present value of its debt obligations without indefinitely accumulating debt. This is debt forgiveness. Since it is unlikely to arise in commercial debt such as Eurobonds, it is not discussed further.

Debt rescheduling and refinancing involve a change in an existing debt contract and replacement by a new debt contract, generally with lengthening of maturities of the old debt, preferably with lower interest rates and rescheduling the payment of arrears, if any. This is often done in situations of liquidity challenges – when a country’s liquid assets and available financing are insufficient to meet or rollover its maturing obligations, but there are good prospects that market access will be restored (International Monetary Fund, 2013). The difference between the two is that debt rescheduling involves rearrangements on the same type of instrument, with the same principal value and the same creditor as with the old debt, while debt refinancing entails a different debt instrument, generally at different value, and may be with a creditor different than that from the old debt.

While debt restructuring is broad concept that may include refinancing, it is typically done when a sovereign goes through some form of debt distress and usually

Box V: Cost implications of setting up a joint sinking fund

The Loans and Guarantees (Authorisation) Act stipulates that “Whenever a sinking fund is established ... in respect of any loan, the annual rate of contribution to such sinking fund shall be sufficient to provide for the redemption, upon the expiry of the period of such loan, of not less than seventy-five per centum of the principal of such loan”. It also gives provisions for setting up a joint sinking fund for two or more loans. And in the event of a deficiency of such sinking fund, the deficiency shall be charged upon the general revenue of the Republic.

If a joint sinking fund is to be set up in 2016, there will be 7 years remaining to repay the principal on the bond due in 2022 and 9 years for the bond due in 2024. Using the 75% minimum stipulation, and assuming equal annual instalments, this entails that Government would have to pay at least US\$80.4 million into the sinking fund for the first bond and US\$83.3 million for the second bond annually. This translates to about US\$164 million per annum. Government is already paying about US\$125 million in interest payments for the two bonds. This would total US\$289 million per annum in interest payments and principal buy-back. At current prices, this translates to about K2 billion per annum or 4% of the 2015 budget, equivalent to the entire Farmer Input Support Programme and Strategic Food Reserves budget for 2015.

So, where will the money come from? The most favoured option for amortisation of debt is from government revenue if it can be met out of a real revenue surplus. Based on the recent fiscal performance, this is not a viable option as we are unlikely to have a revenue surplus any time soon. Therefore, in the short term, a small part of the revenue receipts need to be earmarked for this fund notwithstanding the traditional view that such a practice should be adopted only in the case of a revenue surplus. Once set up, the level of funding to the sinking fund could be scaled up in the medium term. This would be based on the longer-term effects of containing the high fiscal deficit by having more effective tax collection, getting the public sector pay under control, rationalising spending on infrastructure projects, and generally growing the economy.

Budget Office will have to introduce a dedicated line item in the national budget for the sinking fund, and resources allocated on an annual basis to this fund. Using this fund, Government should also actively monitor the activities in the secondary bond market in order to purchase the bonds when the yield and prices are appropriate.

involves debt holders taking a loss. Debt refinancing does not involve any losses but is just taking one loan to pay another.

Zambia is currently not in debt distress and could consider refinancing the 2014 Eurobond by obtaining another sovereign bond at coupon rates lower than 8.5% and an extended maturity which will give more space between the principal payments as opposed to 2022 and 2024. The challenge will be finding investors that would be willing to buy bonds at lower interest rates than the existing Eurobonds considering the prevailing domestic and international macroeconomic conditions. The case of Ghana shows that this is possible. Despite being credit-rated one notch lower and experiencing worse fiscal conditions than Zambia in 2014, Ghana sold a US\$1 billion Eurobond in September 2014 at a coupon rate of 8.125%, lower than the Zambia issue 5 months earlier and lower than analysts had expected given Ghana's fiscal difficulties. It is therefore possible that Zambia can obtain more favourable terms on the international market for its second bond. The costs and consequences of debt refinancing should be carefully considered and compared against the alternative of not refinancing. This is an option that should be considered in the medium term.

The Government could draw lessons from a number of other developing countries that have refinanced their sovereign debt in the last decade:

- In 2007, Gabon used some of its Eurobond proceeds to buy back, at a discount, 15% of the country's debt from Paris Club creditors, an informal group of official creditors that coordinate sustainable solutions to payment difficulties experienced by debtor countries.
- Senegal issued a 10-year US\$500 million Eurobond in the first half of 2011, replacing a 5-year US\$200 million bond issued in 2009; this allowed it to achieve a significant maturity extension. The Senegalese government planned to use the US\$300 million net proceeds from the bond to finance future highly developmental infrastructure projects in the transport and energy sectors.
- Ghana issued a ten-year US\$750 million 8.5% coupon rate Eurobond in 2007, and its second US\$750 million 7.875% ten-year Eurobond in 2013. Soon after the second issue, Ghana launched an invitation to holders of the existing 2017 bond to exchange their holdings for up to US\$250 million of the new 7.875% notes due in 2023. The difference in interest costs between the Ghana 2017 bond (8.50%) and the new Ghana 2023 Bond (7.875%) translated into an estimated annual savings of US\$1.375 million.
- In 2014, the Jamaica government raised US\$800 million in debt from the international capital market. It carried a 7.625% interest rate. Proceeds from the issue were earmarked to pay off a €150 million bond with a higher interest rate of 10.5% and which became due at the end of October 2014. Receipts were also to be used for general budgetary purposes including financial investment and the refinancing of domestic and external indebtedness. The new bond matures in 2025, but principal repayments are to be made in three equal tranches from 2023 to 2025.

7.3.3 Widening of Creditor Sources

The huge infrastructure gaps will not only be filled by acquiring international bonds. Zambia needs to carefully assess its capacity and financing constraints in weighing the weaknesses and strengths of various sources of funding. Wide options exist and should be explored in filling the expenditure gap particularly that of infrastructure. Therefore, to moderate the appetite for Eurobonds, the country should diversify its funding options to include such mechanisms as Public Private Partnerships and borrowing from emerging sovereign donors.

7.3.3.1 Public-Private Partnerships

According to the OECD (2011), PPPs are a way of delivering and funding public services using a capital asset where project risks are shared between the public and the private sector. There is increasing interest in this financing modality, which features prominently in several national development strategies. However, in Zambia

the PPP concept is still being developed and nurtured (OECD, 2011).

PPPs are perceived as a financing modality to leverage private sector resources to contribute to large-scale infrastructure projects that the government may not otherwise be able to finance and/or implement. However, PPPs do not come without fiscal cost, and they can entail risks for debt sustainability (Caliari, 2014).

PPPs usually require upfront fiscal incentives and transfers from the host government. Although the debt to pay for the infrastructure in PPPs is officially taken on by the private sector and does not appear in the government's books, PPPs give rise to obligations on the part of the government to purchase services from a private operator and to honour calls on guarantees. In the same vein, services provided by private operators have implicit opportunity costs in terms of foregone revenues from levying tariffs or user fees. PPPs may also appear less fiscally onerous by pulling expenses off the balance sheets, bypassing controls and taking advantage of loopholes in accounting conventions with a lower level of transparency and accountability than on-budget public liabilities.

7.3.3.2 Borrowing from Emerging Sovereign Donors

Financial resources from non-traditional donors to developing countries have surged in recent years, especially from countries such as Brazil, China and India. They view their financing as based primarily on the principles of South–South cooperation, focusing on mutual benefits and in many a case without policy conditionality (Greenhill, Prizzon, & Rogerson, 2013).

According to the 2014 World Bank International Debt Statistics report, most bilateral debt inflows are coming from non-traditional developing country creditors, notably China, and to a lesser extent Brazil and India. The bulk of these flows (not necessarily concessional) have been directed to large-scale infrastructure projects. It is generally argued that there is little transparency on the exact terms of Chinese loans and to which countries the loans are given, so it is difficult to know if Chinese lending is a threat to the debt sustainability of poor countries, and if so how big a problem.

7.4 Conclusion

Zambia is currently faced with a challenging macroeconomic environment. The fiscal deficit continues to widen, the Kwacha has depreciated thereby increasing debt servicing costs and the low copper prices, coupled with an impasse on the mining tax regime have reduced the much-needed revenues used to service the debt. It is therefore imperative that Government puts measures in place that will mitigate these risks which are already on the horizon. These measures include:

- fiscal consolidation by improving revenue mobilisation and rationalising expenditure;
- addressing the existing institutional and legal bottlenecks in debt management; and
- consider other available financing options such as setting up a sinking fund to insulate against future macroeconomic conditions and lower the repayment risks, debt refinancing by obtaining another bond with longer maturity and lower interest rates and widening of creditor sources by considering PPPs and borrowing from emerging donors such as China and Brazil.

8 Conclusion

Zambia has been on an uninterrupted growth trajectory for over a decade, averaging over 6% per annum. The traditional sources of finance (tax and non-tax revenue, grants and bilateral and multilateral financing) are inadequate to meet the emerging infrastructure needs that are required to sustain this growth. Like other emerging African countries, Zambia has joined the bandwagon by borrowing commercially from the international capital markets through Eurobonds.

Eurobonds diversify income sources following the dwindling of funding from the traditional sources of finance after the 2008 financial crisis. They also help to finance import-intensive expenditure, strengthening macroeconomic discipline, lower debt servicing costs and serve as benchmarks for pricing corporate bonds.

However, they also carry significant costs and risks including high interest payments and high fees and transaction costs. The risks include threats to macroeconomic stability and limited administrative capacity, weak fiscal institutions, and low efficiency of public investment expenditure.

In the event that Zambia defaults on its sovereign bond debt, it is likely to affect economic growth, trade and investments. Sovereign defaults have a negative impact on growth, with the size of output losses range from 0.6% to 10%, and the losses can have durations of up to 10 years. A number of transmission channels of debt defaults on economic growth include exclusion from international capital markets, reputational and political costs.

It is imperative that the Government puts in place strategies that will encompass the new mode of borrowing and mitigation measures to reduce the risk of default when the bonds reach maturity. These include improving macroeconomic stability by among other things containing the fiscal deficit, strengthening the legal and institutional frameworks and considering various financing options such as setting up a sinking fund or pre-emptive debt restructuring and widening creditor sources.

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