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Sovereign Debt and Debt Restructuring:

A Case Study of Zambia

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Grieve Chelwa and Ntazana Siame Kaulule

Abstract

This paper uses a structural-historical perspective to examine Zambia's experience with sovereign debt. Three interconnected factors are advanced that help explain the country's 2020 public external debt default. The instability of copper-dependant growth, the constraints of structural adjustment initiatives (notably cash budgeting and privatisation), and the influence of developed countries' monetary policy on capital movements have had profound effects on Zambia's debt trajectory. Specifically, the paper shows how cyclicality in copper prices has led to unsustainable borrowing, while fiscal austerity and an infrastructure deficit, remnants of the IMF-imposed reforms of the 1990s, led to overreliance on expensive debt.The paper also argues that the challenges experienced by Zambia in restructuring its debt using the G20 Common Framework illustrate the broader weaknesses in the multilateral architecture for sovereign debt crises. For Zambia to avoid future debt crises, it is necessary to diversify its economy by incentivising the beneficiation of copper and establishing sovereign wealth funds and development banks with robust institutional and governance structures to drive the development agenda.

JEL Classification

E66; O11; O55

Key words

Sovereign debt, Debt restructuring, Structural adjustment,
Copper dependency, Eurobonds, IMF conditionality, Capital flows

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1. INTRODUCTION

Zambia has been in sovereign default since November 2020 (Kessler, 2023), when the country ceased servicing its public external debt obligations. The public external debt on which the country defaulted – which is the focus of this paper – consists of public and publicly guaranteed (PPG) foreign debt only. Zambia's sovereign debt default, besides creating considerable uncertainty in the economy and the economic lives of its citizens, has generated scholarly and public policy interest across the world. Much of this interest has been focused on how and why Zambia accumulated so much public external debt in a relatively short time span.

From a public external debt position of just under USD2 billion in 2011 (Bank of Zambia, 2011), Zambia's public external debt stock had increased to over USD12 billion by 2019, representing an increase of over 500% in 8 years (Bank of Zambia, 2019). Interest payments on public external debt went from USD87.4 million in 2011 to USD1.2 billion in 2019 (Bank of Zambia, 2019: p. 23). With such a reckless rate of debt accumulation, Zambia was destined to default at some point. The arrival of the Covid-19 pandemic in early 2020 hastened the date of default.

Since its default in November 2020, Zambia had been engaged in a protracted process of restructuring its public external debt (Jones et al., 2024). The milestones of this process were the country's application for public external debt treatment under the G20's Common Framework in April 2021 (Bavier, 2021) and the IMF agreeing to an Extended Credit Facility (ECF) in September 2022 (IMF, 2022). In June 2024, the country's Eurobond investors finally agreed to a public external debt restructuring deal proposed by the Zambian government (Jones et al., 2024). The announcement in June 2024 came on the back of many false starts owing to differences in opinion and interests between private creditors on the one hand and official creditors on the other (Chelwa, 2023b). It had taken a total of three-and-a-half years for the country to breathe a sigh of relief since applying to the Common Framework in April of 2021. This prolonged process has, however, not been without its costs. The lack of a clear path to resolve the country's public external debt engendered an atmosphere of economic uncertainty, leading to macroeconomic instability. This, coupled with the austere conditions required by the IMF's Extended Credit Facility (ECF) loan, have created a cost-of-living crisis in Zambia, the brunt of which has largely been borne by the country's poor. For example, the price of kerosene, a major source of cooking and lighting for many Zambians, increased by 71.3% between January 2022 and July 2024 (Energy Regulation Board, 2022 & Energy Regulation Board, 2024). The price of maize meal, the country's staple, increased by 110% over the same time frame (Zambia Statistics Agency, 2021). Even though Zambia's creditors have agreed to some measure of public external debt restructuring, it is not yet clear that the country is completely out of the woods (Chelwa, 2024).

How did a country that was largely debt-free not too long ago find itself in a debt crisis in a matter of a few years? How is it that a country that is a top 10 producer of copper with copper export revenues of approximately USD 90 billion between 2010 and 2023 (Bank of Zambia, 2024) fail to settle payments associated with a public external debt stock of just USD 12 billion? And why did such a major copper producer see the need to accumulate public external debt stock of more than USD12 billion in the first place? Further, why is it that four years after Zambia's default there is not yet a comprehensive solution in sight? This case study attempts to answer these questions by utilising a "structural-historical approach" that places Zambia's debt in historical perspective. The case study argues that three separate and interlocking historical forces explain Zambia's current debt conjuncture. In other words, we argue that the forces that gave rise to Zambia's debt crisis began many decades ago.

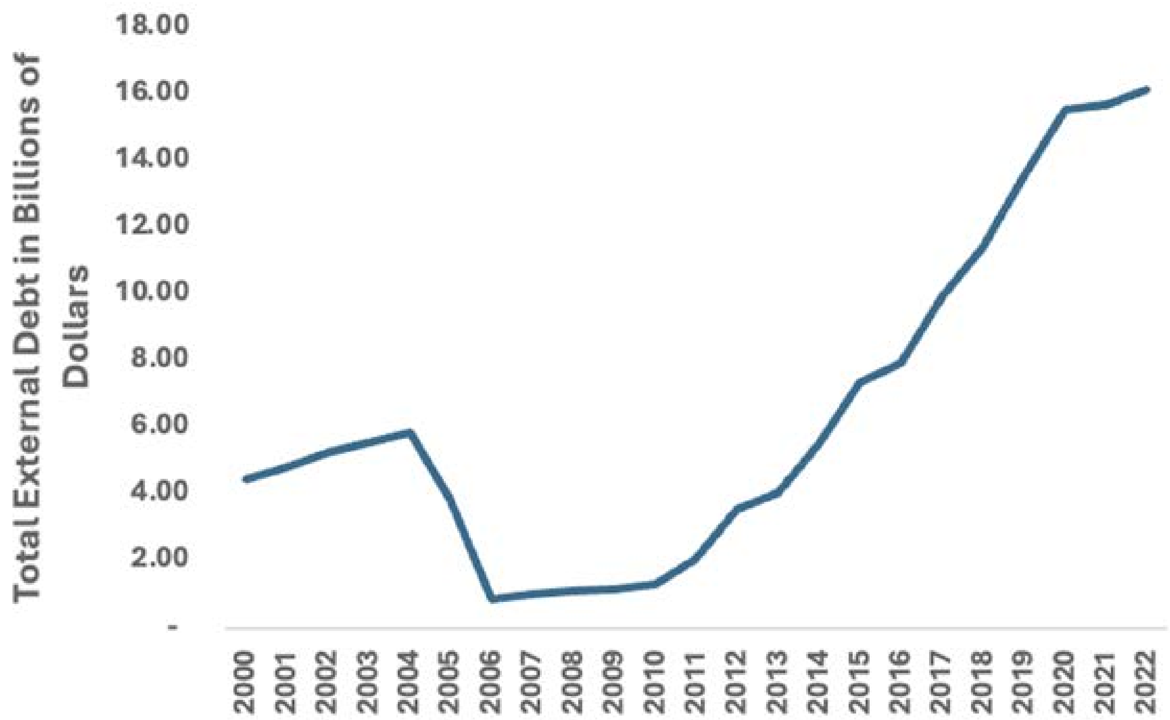
First, we consider the role played by global and local copper dynamics in influencing Zambia's fiscal health. Second, we consider the role played by the IMF and World Bank's Structural Adjustment Programmes (SAPs) through the imposition of strict fiscal constraints on infrastructure expenditure. Third, we consider the role played by US monetary policy in influencing global financial flows. We argue that these three historical forces have at various times 'conspired' in influencing debt dynamics in Zambia. That is, they explain debt build-ups and debt crises. We believe that a better understanding of the historical influences of Zambia's debt will allow for a richer conversation of strategies to prevent future crises.

The case study unfolds as follows: Section 2 provides the facts and figures that, taken together, constitute Zambia's debt crisis; Section 3 discusses the historical role played by Zambia's copper industry in influencing the economy and debt dynamics, while Section 4 discusses the role played by SAPs. Section 5 considers the historical role played by US monetary policy. Section 6 discusses the current attempt at the resolution of the crisis, and Section 7 concludes.

2. ZAMBIA'S DEBT CRISIS

The 1990s brought Zambia's public external debt problems into sharp focus. As part of efforts to resolve the unsustainable debt levels facing the country, Zambia applied for and was admitted to the Highly Indebted Poor Countries (HIPC) initiative that was spearheaded by the IMF and World Bank (IMF, 2023). Upon reaching the HIPC completion point in April 2005, over USD5.6 billion, representing 85% of total public external debt, had been completely written off (see Figure 1). This resulted in Zambia's public external debt declining to USD860 million in 2006.

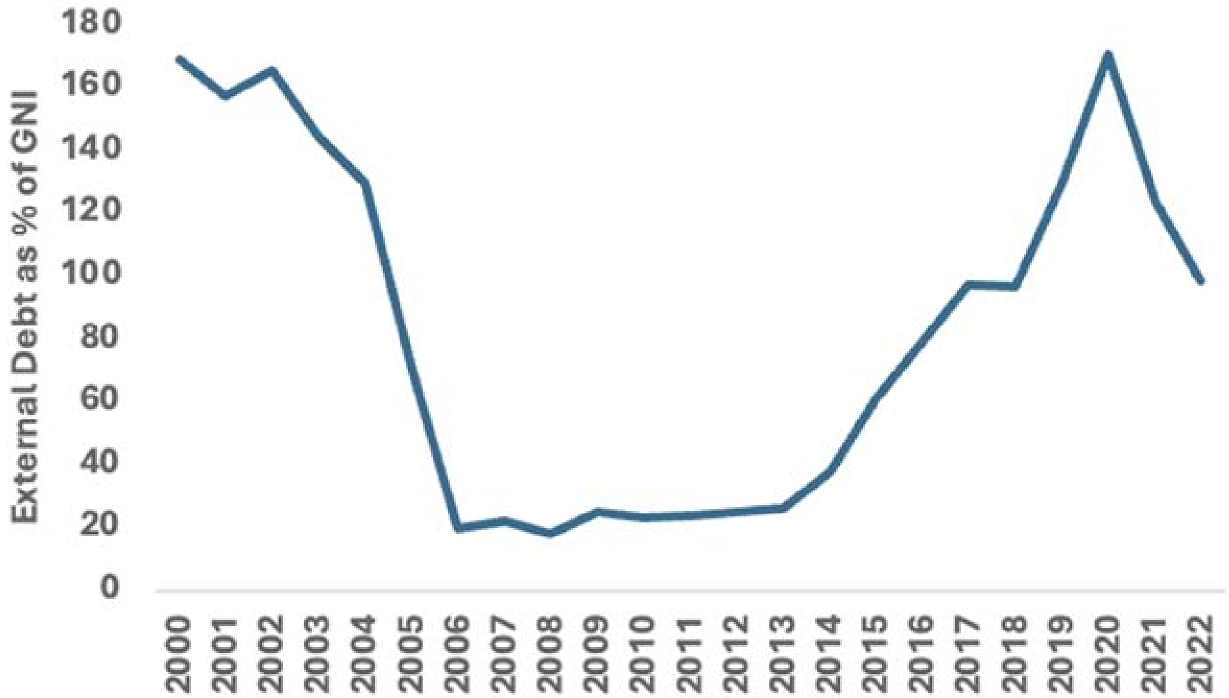
Figure 1: Zambia's public external debt, 2000 to 2022



Source: Authors, based on World Bank Group (2024)-World Development Indicators

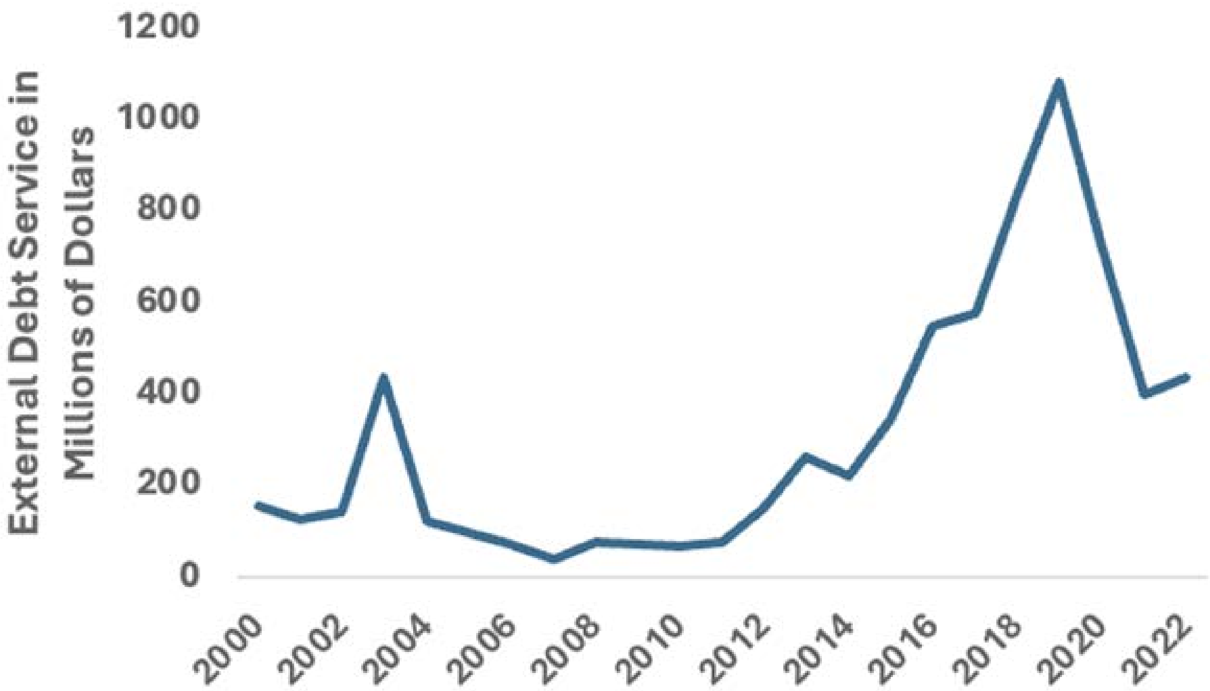
The immediate impact of attaining the HIPC completion point was that the country's public external debt burden went from 166% of Gross National Income (GNI) in 2002 to 20% in 2006 (see Figure 2). The public external debt burden remained in the 20% to 25% range over the period 2006 to 2011 and well below the World Bank's debt overhang threshold of 30% to 37%. Additionally, as shown in Figure 3, debt relief freed up fiscal resources as debt repayments fell from USD 438 million in 2003 to USD71 million by the end of 2006.

Figure 2: Public external debt as a percentage of Gross National Income, 2000 to 2022



Source: Authors, based on World Bank Group, (2024)- World Development Indicators

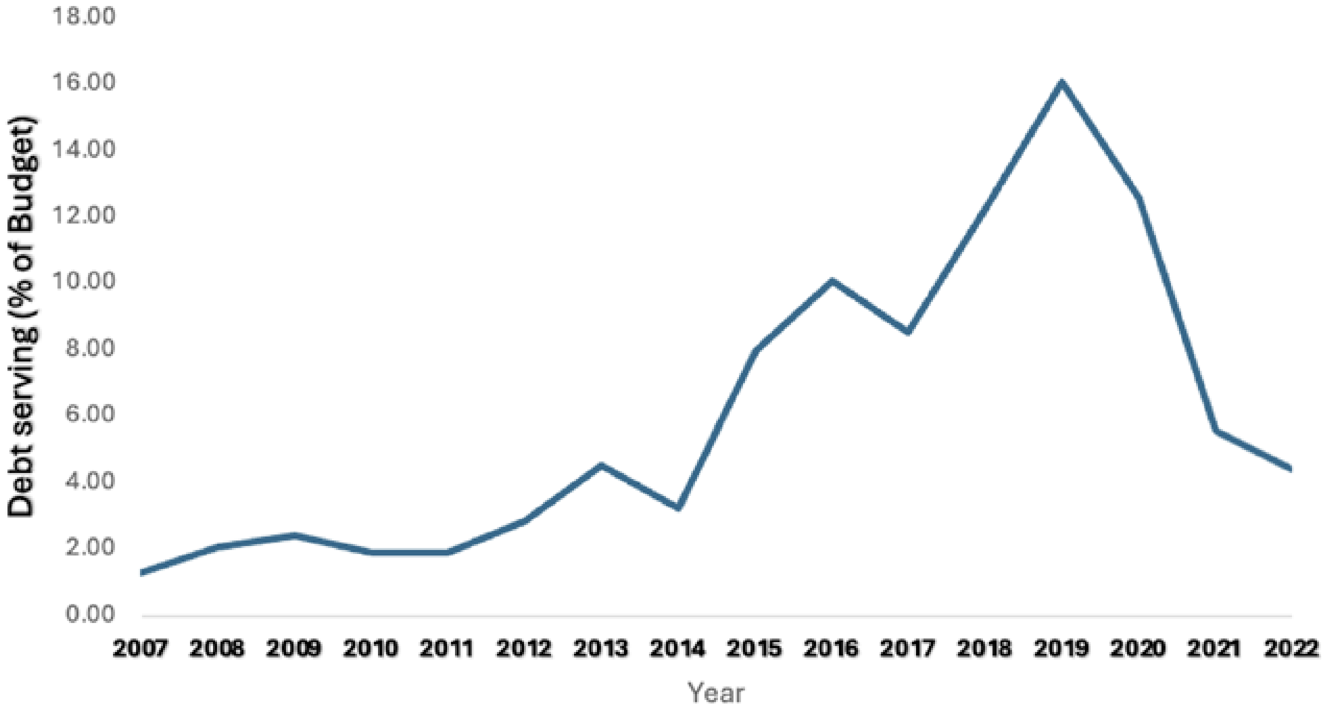
Figure 3: Public external debt service, 2000 to 2022



Source: Authors, based on World Bank Group (2024)- World Development Indicators

When taken as a percentage of the national budget, debt servicing remained below 3% for the 6 years following attainment of the HIPC completion point (see Figure 4). The subsequent decrease in external debt servicing costs enabled the government to increase expenditure in health and education (Chelwa, 2019).

Figure 4: Public external debt service as percentage of the National Budget, 2000 to 2022



Source: Authors, based on Minister of Finance Budget speeches, 2007 to 2022

As Figure 1 shows, Zambia did not contract much public external debt between 2006 and 2010. The country averaged a debt stock of USD1 billion over this period, equivalent to an average burden of 22% of GNI over the same period. However, beginning in 2011, Zambia's public external debt began to rise at a very fast rate, largely facilitated by the attainment of an inaugural sovereign debt rating from the Fitch ratings agency in 2011. In 2012, 2014 and 2015, the country issued three Eurobonds with values of USD750 million, USD1 billion and USD1.25 billion respectively. The proceeds of these bond issues were meant to support the development of critical infrastructure in the transport, energy and water sectors.

There was some level of transparency around how the proceeds of the 2012 Eurobond were utilised. About 91% of the 2012 Eurobond proceeds were allocated to Zambia Electricity Supply Corporation (ZESCO), Zambia Railways, National Road Fund Agency, and Road Development Agency. The funds were invested in electricity supply distribution, rail network repair and expansion, and rehabilitation of roads, respectively (Parliamentary Committee Report, 2014). However, this kind of detailed disclosure on the utilisation of the 2014 and 2015 Eurobonds has been lacking. The only disclosure that was made in relation to the use of the 2014 and 2015 Eurobonds by the then Minister of Finance, Mr. Alexander Chikwanda, was that the proceeds were used towards infrastructure development in transport, health, education, agriculture, water and sanitation infrastructure, recapitalisation of state-owned enterprises and developing newly created districts (Chikwanda, 2015). However, no details were provided as to which institutions received these funds and how they were spent. Therefore, the picture that emerges is that the infrastructure, if any, that these funds were invested in was not readily identifiable.

The issuance of the three Eurobonds between 2012 and 2015 increased the country's public external debt stock by 265%, as shown by the steep rise in the graph between 2012 and 2015 in Figure 1. As Figures 2, 3 and 4 show, this surge in debt contraction drove up the public external debt burden to over 170% of GNI. Consequently, debt servicing began to rise from USD67 million in 2011 to over USD1 billion in 2019, with some 16% of the national budget committed to public external debt servicing in 2019, up from about 2% in 2011.

Additionally, the structure of Zambia's public external debt changed in the twenty-first century. Whereas previously, the country's creditors consisted mainly of multilateral and Paris Club bilateral lenders, this time around new creditors had entered the fray. China and private bondholders became major lenders to Zambia. For instance, of the USD10 billion debt that has been agreed on to be restructured, China held about 40%, while private bondholders held about 30% of that debt, with the remainder held by official bilateral creditors. As Chitonge and Stein (2024) show, the exponential growth in private creditors' holding of Zambia's public external debt between 2012 and 2020 significantly contributed to the change in Zambia's debt dynamics.

Chitonge and Stein (2024) explored the factors that led to Zambia's public external debt default in November 2020. They analysed the structural factors that contributed to Zambia's public external debt default in 2020. They find that structural vulnerabilities, debt composition, a colonial economic structure and fiscal imbalances were at the centre of Zambia's debt default. Structurally, Zambia's heavy reliance on copper exports made it susceptible to commodity shocks. Thus, a fall in copper prices led to a fall in export earnings for the country. The fall in copper export earnings precipitated the country's debt distress.

In addition, Chitonge and Stein (2024) highlight that the change in debt composition played a very significant role in the country's public external debt default. The reclassification of the country from a low-income to lower-middle-income country in 2011 reduced the country's access to concessional loans. This, coupled with the inaugural sovereign debt rating, accelerated the country's entry into the commercial debt market (Musokotwane, 2011). Thus, after 2011, the country's debt portfolio comprised mainly non-concessional loans with high interest rates and short repayment terms (Chitonge and Stein, 2024).

The new entrants (i.e., China and the Eurobond investors) became very important creditors to Zambia which later complicated attempts at debt resolution. By 2019, with a debt of USD12 billion, or 130% of GNI, it was clear that the situation had become unsustainable. The deterioration of other economic indicators such as the debt service to reserve ratio, external debt to export revenue and debt service to export revenue reflected increasing pressure on the Zambian economy (Chitonge and Stein 2024, p. 7). The end of 2020 saw Zambia becoming the first African country in the Covid era to default on its public external debt, barely 14 years after successfully implementing the HIPC initiative.

This section has shown that Zambia's debt crisis was not just a result of bad borrowing decisions and bad investment decisions. As Chitonge and Stein (2024) highlight in their paper and as will be discussed in the sections that follow, multiple factors—structural vulnerabilities, debt composition, a colonial economic structure, US monetary policy and fiscal imbalances—all played a critical role in leaving the country in debt distress.

3. COPPER, GROWTH AND DEBT IN ZAMBIA

The story of Zambia is the story of copper. In a review of the book "Zambia: Building Prosperity from Resource Wealth", Chelwa (2017a, p. 229) made the following observation:

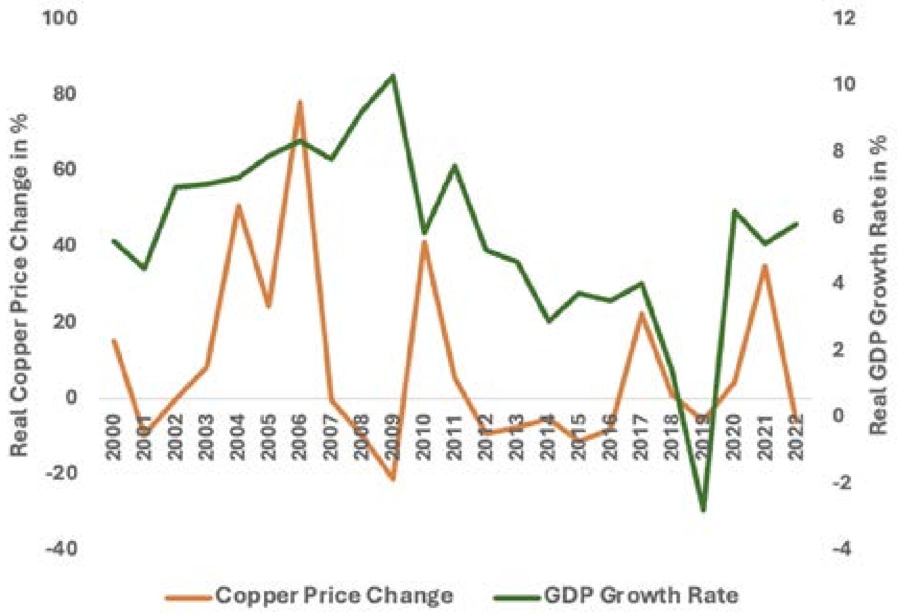
> "Any retelling of Zambia's history is a story of the prominence of copper. From its "discovery" by outsiders in the late-nineteenth century (locals had known about it for centuries) up until present day, copper has shaped and continues to shape history in Zambia. The development of the country's most urbanised corridor, from the northerly Copperbelt Province all the way to Livingstone in the south, is a story of copper. The corridor grew alongside a rail line that the British South Africa Company had laid to facilitate the transportation of ore to South Africa via Zimbabwe (then known as Southern Rhodesia)."

Copper's role in shaping the Zambian economy is especially visible in macroeconomic statistics. According to the Bank of Zambia, copper earnings made up an average of 71% of the country's foreign exchange earned between the years 2010 and 2023 (Bank of Zambia 2024), representing a combined total of approximately USD90 billion worth of copper exports over this period. Over the same period, copper's contribution to Zambia's Gross Domestic Product averaged 26% (Bank of Zambia, 2023b), making it one of the single largest contributors to the country's GDP.

Given copper's importance to the Zambian economy, dynamics in the market for copper impact the country's economic performance. Figure 5 below shows the relationship between real GDP growth and changes in the real price of copper over the period 2000 to 2022. Strictly speaking, Figure 5 presents a lagged relationship in the sense that GDP growth is lagged one year relative to copper price changes. In other words, the relationship shows the behaviour in GDP growth in a particular year relative to the change in the copper price in the previous year. As is clear from Figure 5, changes in the copper price in one year impact economic growth in the subsequent year. For instance, between 2002 and 2008, the change in the copper price was positive (i.e., prices were increasing), and over the same period, economic growth increased. Between 2010 and 2017, the percentage change in the copper price was negative, meaning that copper prices were in decline in this period and thus had a slowing effect on real GDP growth.

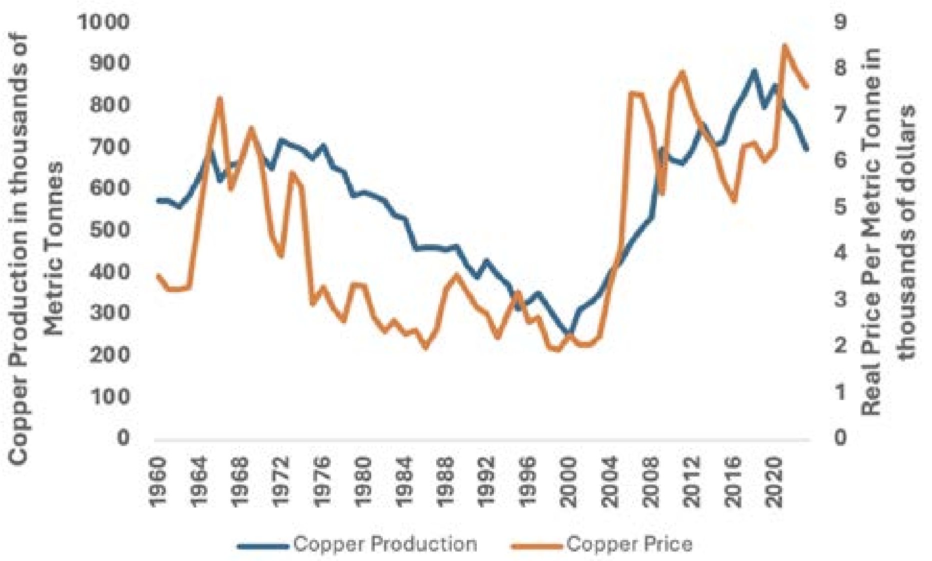
The reason why copper prices have this impact on economic growth is seen clearly in Figure 6, which shows the long-run relationship between copper production and real copper prices over the period 1960 to 2023. Copper production has tended to decline in periods when real copper prices are in decline, and production has tended to rise in periods when copper prices are rising. For example, over the 30-year period from 1970 to 2001, real copper prices declined by about 70%. Over the same period, copper production declined by about 55%. Between 2001 and 2023, real copper prices increased by a staggering 250%, and over the same period, copper production unsurprisingly increased by 120%. Therefore, copper remains the fundamental driver of dynamics in the Zambian economy, conforming to the "declining terms of trade" argument put forward many years ago by Raul Prebisch and Hans Singer (Prebisch, 1950 and Singer, 1975).

Figure 5: Relationship between copper price and GDP growth, 2000 to 2023



Source: Authors, based on World Bank Group (2024)- World Development Indicators

Figure 6: Zambia's copper production and copper prices, 1960 to 2023



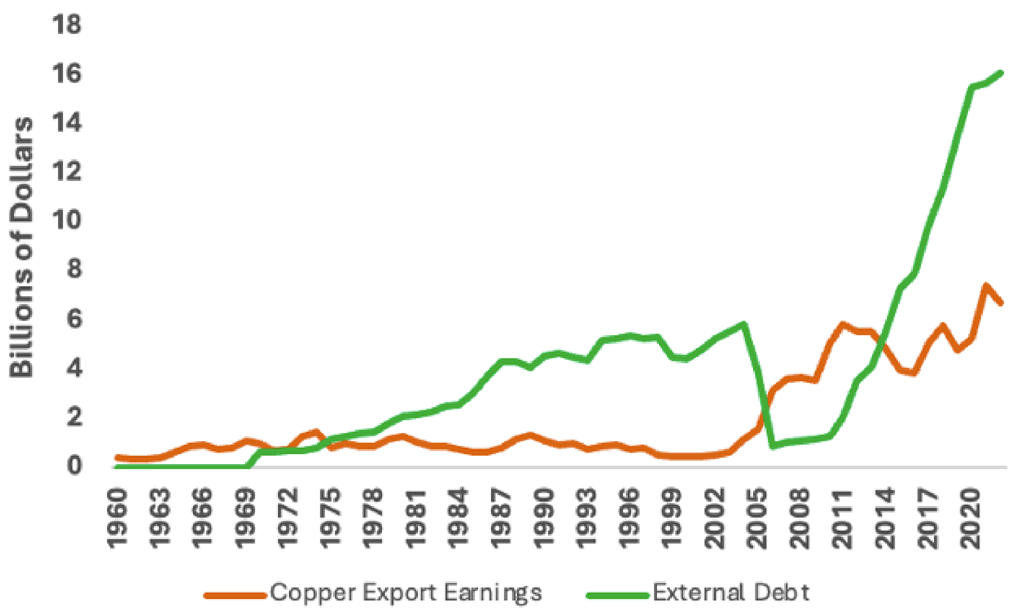
Source: Authors, based on US Geological Survey Reports and the World Bank Reports

The importance of copper to Zambia is also understood in the role it has historically played in the accumulation of public external debt. Periods in which copper export earnings have been high relative to public external debt have led to periods of dangerous debt build-up. This has in turn led to debt crises. In other words, there is a sense in which the Zambian state has expected the good times to continue *ad infinitum*. Therefore, loans have been taken out under the assumption that they will be able to pay them back out of the ever-higher copper export earnings, only for export earnings to decline shortly thereafter. Figure 7 below shows the historic relationship between public external debt and copper export earnings from 1960 to 2023.

We see in Figure 7 that between 1960 and 1970, copper export earnings dwarfed public external debt, setting the scene for the dangerous accumulation of debt. This resulted in Zambia's first debt crisis, which was only 'resolved' in 2004 with the attainment of the HIPC completion point. After attaining the HIPC completion point, copper export earnings yet again dwarfed the stock of public external debt, setting the scene for yet another dangerous accumulation of debt in subsequent periods, ultimately leading to the country's second and current debt crisis.

It is worth pointing out that the decisions to begin accumulating debt on the back of high copper export earnings have been for the right reasons. For example, in 1970 the Zambian government decided to issue dollar-denominated bonds equal to USD264 million (about USD2 billion in present-day terms) that were meant to finance the purchase of majority stakes in Zambia's mines. Unfortunately, these bonds were backed by copper receipts, and the subsequent underperformance of copper on international markets sowed the seeds of Zambia's first debt crisis that was only resolved in 2004. The current debt crisis, as we expand in the next section, was the result of the need to borrow for infrastructure expenditure requirements. There was a big push to fast-track Zambia's development agenda. Therefore, when copper prices began to rise in or around 2006, the accompanying debt acquisition appeared justified as it became necessary to build new infrastructure to support and sustain the growth of the economy. However, Zambia was soon in a state of debt distress as soon as copper prices began to fall.

Figure 7: Zambia's copper export Earnings and public external debt, 1960 to 2022



Source: Authors, based on US Geological Survey Reports and World Bank Reports

A natural question arises: why did Zambia not accumulate enough savings in the good times to avoid borrowing altogether or at least to adequately provide for debt service? For example, the information in Figure 7 shows that from 1960 to 1969, copper export earnings totalled USD7 billion, a number greater than the USD6 billion that was subsequently 'forgiven' as part of the HIPC initiative in 2006. Similarly, from 2005 to 2012, the total amount of copper export earnings was USD32 billion, a number that is twice the stock of public external debt at the end of 2023.

The answer to the question lies in the ownership structure. From 1960 to 1969, Zambia's copper industry was in the hands of foreign multinationals and, therefore, much of the earnings in this period were largely externalised (Chelwa, 2017b). And as alluded to earlier, the first debt crisis came about because of the country's effort to regain control of its copper resources. Pertaining to the second debt crisis, by 2005 the copper mines had been re-privatised. The privatisation of the mining sector was part of the structural adjustment program (SAP) initiated in 1992 by the Zambian government as part of IMF/World Bank conditions for financial support to help deal with the country's economic collapse. Following the privatisation, the externalisation of export earnings resumed unabated just as before (Fraser and Lungu, 2007). The Malawian economist Thandika Mkandawire estimated that had Zambia set up a copper-backed sovereign wealth fund between 2002 and 2014, it would have accumulated a total of USD20 billion in savings (Mkandawire, 2015). This would have been enough money to avoid borrowing externally altogether.

Another more pernicious, yet less considered effect of the re-privatisation of the mining sector, which contributed to the current debt crisis, has been the syphoning of private wealth from Zambia by multinational mining corporations. Before privatisation, the government had control and access to the revenue generated by the mining sector. Following privatisation of the sector, the government ceded this control of the mines to the new private owners. Thus, the government had little control over the financial flows in and out of the mining sector.

Fischer (2020) studied the financial flows into and out of Zambia over a 15-year period from 2005 to 2020. His findings show that immediately after Zambia achieved the HIPC completion point, a startling and disturbing trend of financial flows emerged. The study found that during this period when copper prices improved, Zambian residents' (this includes subsidiaries or affiliates of multinational corporations) net acquisition of foreign debt instruments increased. Money that left the country through these debt acquisitions has never made a return, as purported repayments of the debts have remained offshore.

Private wealth was also being syphoned out of the country through trade mis-invoicing. Trade mis-invoicing happens when firms overprice imports and underprice exports. It is used to evade customs duties and circumvent capital controls (Mudenda and Ndikumana, 2024). It is estimated that between 1971 and 2018, Zambia lost a net of USD31 billion from trade mis-invoicing (Mudenda and Ndikumana, 2024). The net outflow of private wealth peaked in 2012 at some 20% of GDP in value (Fischer, 2020). The value of these outflows in the years in 2005, 2006, 2007, 2012, 2015 and 2017 alone amounted to USD12.8 billion (Fischer, 2020). This amount is equivalent to Zambia's public external debt stock at the time of defaulting on its obligations. The findings by Fischer (2020) and Mudenda and Ndikumana (2024) lend credence to the argument that Zambia has not benefitted from its natural resources in ways that could have reduced the need to borrow in the first place.

The first thing that becomes apparent from the studies by Fischer (2020) and Mudenda and Ndikumana (2024) is that multinational mining firms and their offshore owners, and not Zambia, were the greatest beneficiaries from the commodity boom. The massive amounts of money that the country was losing through the outflow of private wealth undermined any possibility of Zambia achieving external financial stability, as the country had to borrow to advance any meaningful development.

Second, the externalisation of private wealth of this extent happened due to the liberalisation of the capital account. The capital account was liberalised as part of the structural adjustment programs of the 1990s. As Mudenda and Ndikumana (2024) argue, by operating an open capital account system, Zambia does not require investors to return export proceeds back into the country. These policies prevent the country from fully benefiting from the proceeds of its mineral wealth and help create a financial vacuum that results in the government having to acquire debt from international financial markets to finance development.

4. STRUCTURAL ADJUSTMENT, CONSTRAINTS ON INFRASTRUCTURE EXPENDITURE AND DEBT

At the start of the 1990s, the Zambian economy was undergoing severe economic distress. The country's public external debt stood at over USD7.2 billion and the country was experiencing a severe shortage of essential commodities (Henriot, 1997). The economy experienced a recession over three consecutive years in 1990, 1991 and 1992, with the economy contracting by an average of 1% per year during those three years. Inflation was also out of control, having exceeded 100% in 1989 and peaking at 183% in 1993 (World Bank Group, 2024). Government finances were also in trouble, with the government registering a budget deficit of 10% in 1990 (Adam and Bevan, 2000, p. 185).

At the behest of the International Monetary Fund (IMF), the newly elected Movement for Multiparty Democracy (MMD) government adopted a structural adjustment program with the hope that economic reform would change the country's fortunes. The 1992 budget speech provided the clearest signal of the type of reform that the government was to embark on. Economic stabilisation, privatisation and parastatal reforms, tax system reform, financial liberalisation, the devaluation of the kwacha and a commitment to reduce inflation were among the key reforms that the MMD set out to implement (McPherson, 1995).

Tax reforms began with the creation of the Zambia Revenue Authority (ZRA) as collector of taxes for the government. Sales tax was abolished and replaced with value added tax (VAT). Tariffs on imported goods were significantly reduced, customs duties were simplified, and rates were reduced from as high as 100% of the value of imported goods to a range between 0 and 25% of the value of the goods (World Bank, 2004). These reforms changed the trade regime from one that had been inward-oriented and encouraged domestic manufacturing to one that was outward-looking and extremely favourable to the importation of goods (DiJohn, 2010).

The privatisation of parastatal companies also formed a key part of the structural adjustment program. This was because it was an important condition for the country to secure concessionary finance from the World Bank, IMF and other Western donors (Craig, 2000). It was argued that most of the parastatals were loss-making and were in effect being subsidised by the central government. For example, the World Bank estimated that before privatisation, the Zambian mining conglomerate Zambia Consolidated Copper Mines (ZCCM) was contributing 10 percent of GDP to Zambia's quasi-fiscal deficit (World Bank, 2001). Thus, privatisation was heralded as being a solution to stopping these losses and necessary to create a vibrant, private sector-led economy (DiJohn, 2010 and Seekings & Tembo, 2022).

As a necessary accompaniment to creating a market-based economy, the financial sector was likewise liberalised. By the end of the 1990s, foreign exchange controls on current account transactions were removed, and borrowing and lending rates were deregulated, which allowed for the use of market-determined rates (Martínez, 2006). In addition, import and export licenses were removed and a treasury bill tender system with market determined interest rates was also introduced (McPherson, 1995).

As part of these reforms, the Zambian government instituted the 'Cash-Budget Policy' in 1993, which restricted government expenditure to revenues. This was aimed at preventing increases in public debt (McPherson, 1995). According to Adam and Bevan (2000, p. 186):

"the 1993 Budget Speech saw the Minister of Finance commit the [Zambian] government not only to a balanced budget for the year but to one on an ongoing month-to-month basis." In essence, public expenditure was to be restricted to what could be financed from cash in hand (positive balances held in accounts with the Central Bank) with no recourse to domestic deficit financing. The cash budget removed all discretion over the aggregate fiscal stance and simultaneously severely curtailed the scope for discretion over the composition of expenditure."

From its inception in 1993, the cash budget system continued for over a decade. According to Adam and Bevan (2000) and Adugna et al. (2002), cash budgeting had a positive and immediate impact on the budget deficit and inflation. For instance, in 1994, the first year after its introduction, the rate of inflation declined to 53% from 183% in the previous year and continued this downward trend throughout the decade. The budget deficit declined from 10% of GDP in 1990 to about 4% of GDP in 1995.

However, the cash budget had a significant negative impact on capital expenditure necessary for the long-term economic viability of the country. Adams and Bevan (2000, p. 199) write that between 1991 and 1996, because of the cash budget, "domestically funded government capital expenditure collapsed from 4.8% of GDP to 1.4% of GDP…net of depreciation…the public capital stock was hardly growing at all and was falling on a per capita basis." Further, they write that capital expenditure suffered the highest level of volatility because of cash budgeting:

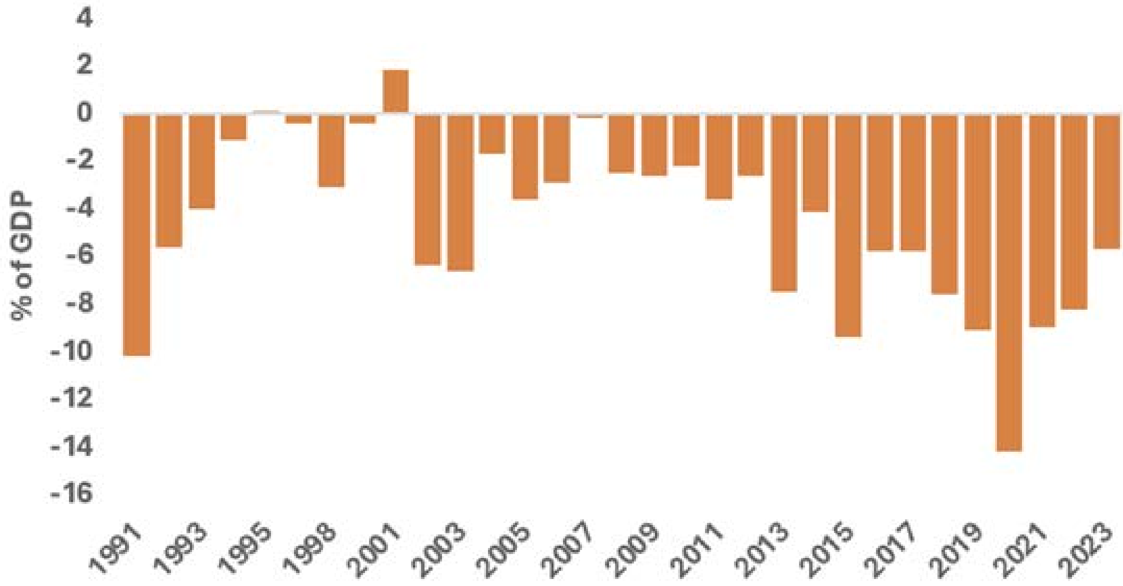
"not surprisingly, the mean absolute deviation [a measure of volatility] for capital expenditure was the highest at 126%. Even in a fully smoothed expenditure system, we would expect much greater volatility in capital expenditure because of indivisibilities of expenditure… but it is still hard to believe that month-to-month variation on this scale…is not extremely damaging to the orderly conduct of government business and to the provision of public services" (Adam and Bevan, 2000, p. 205).

Adugna et al. (2002, pp. 8-9) also studied the impact of the cash budget on capital expenditure. Writing about the Ministry of Works and Supply, the ministry in charge of infrastructure expenditure, they wrote:

"for the Ministry of Works and Supply, capital expenditures in its Roads Department for road maintenance and rehabilitation constitute by far the most important expenditure item, accounting for well over 90% of its total budget. This kind of work needs to be planned more than a few weeks ahead; it is disrupted by abrupt cash release fluctuations which are also costly. Cash release fluctuations to this department were among the worst, with a coefficient of variation of 0.55 [a measure of volatility] and monthly cash releases which ranged from zero in January [in 1998] to K9.9 billion in October [of the same year]. These figures do not refer to expenditure commitments that could be expected to fluctuate widely when major new projects come on stream but to authorisations for actual payments, which should be fairly smooth in tune with the gradual progress in project implementation. These findings are consistent with the account circulating in the Ministry of Finance and National Planning about the road project aborted for lack of funds at a critical junction even though the total amount of cash eventually released would have been sufficient to complete it. According to these accounts, the money was not there when it was needed; when it finally arrived, the project had already died."

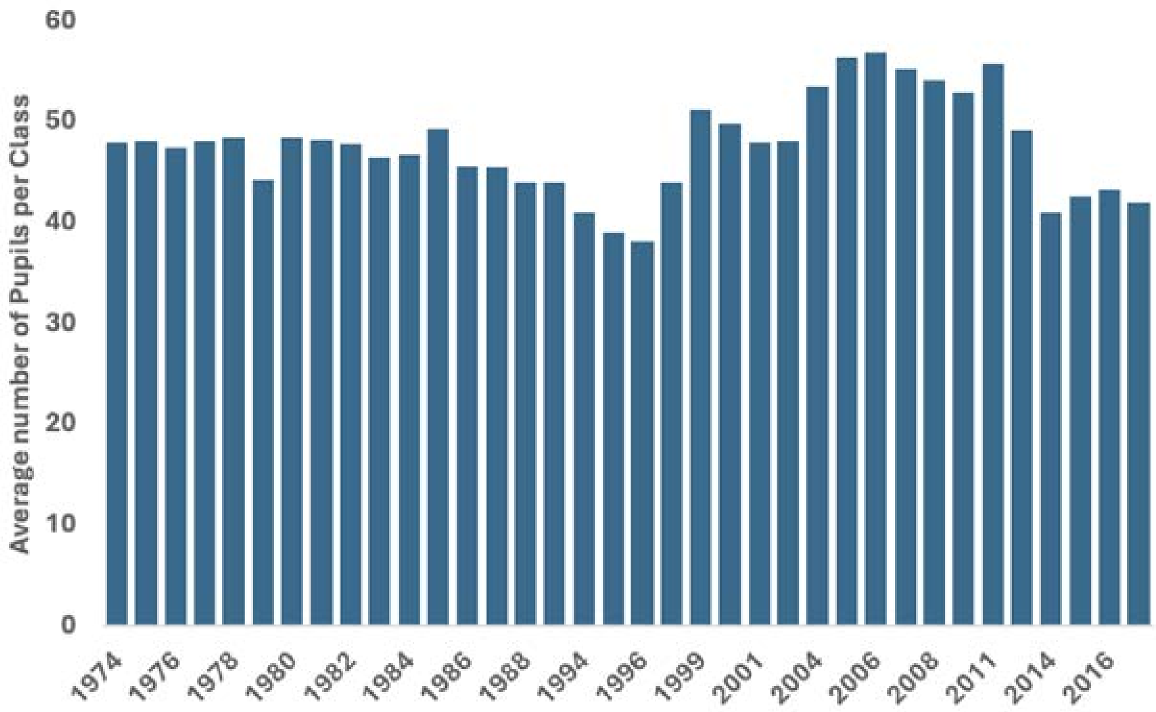
The impact of the cash budget can also be seen in its impact on the evolution of the budget deficit. Figure 8 charts the path of Zambia's budget deficit from 1991 to 2023 and show that during the period of cash budgeting from 1993 to the 2000s, Zambia featured relatively low budget deficits and even recorded surpluses in 1995 and in 2001. However, as described above, relatively low budget deficits in this period must have come at the expense of capital expenditure. This is because from about 2011 onwards, large budget deficits became the order of the day as the government tried to redress the infrastructural backlog that resulted from the small deficits of the previous era.

Figure 8: Evolution of the budget deficit in Zambia, 1991 to 2023



Source: Authors, based on Adam and Bevin (2000) and Bank of Zambia Annual Reports

Figure 9: Average primary school class size in Zambia, 1974 to 2017



Source: Authors, based on World Bank Group, (2024)- World Development Indicators

Some evidence of the impact of cash budgeting on infrastructure expenditure is seen in Figure 9, which shows the evolution of average class sizes in Zambian primary schools from 1974 to 2017. Starting at an average class size of 48 pupils in 1974, the class size gradually declined to about 38 students in the mid-1990s as the government built schools and hired additional teachers (Chelwa, Pellicer and Maboshe, 2019). Thereafter, class sizes began to rise sharply, reaching a historically high average of 57 students per caste as the government failed to keep up with growing demands for schooling. In the 2010s onwards, average class sizes declined once more as the government responded by building more schools and hiring teachers. It is striking how the patterns in Figure 9 reflect dynamics in the budget deficit in Figure 8. Additional evidence of the deficits in infrastructure that the country was undergoing in the 2000s is contained in a research report published in 2010 by researchers at the World Bank (Foster and Dominguez, 2011). Foster and Dominguez show that by 2008, Zambia was falling behind its peers in terms of road, power, railways and water infrastructure.

The evidence presented in this section shows that the structural adjustment program had an overall negative effect on the country's capacity to invest in its infrastructure. The limited resource envelope, partly impacted by changes to the tax policy, meant that infrastructure development was least on the set of priorities for a government that was attempting to restructure the economy while adhering to stringent IMF and World Bank conditionalities.

The privatisation of the mines had an adverse effect on infrastructure investments, especially on the Copperbelt Province, where the mines played a pivotal role in building and maintaining most of the public infrastructure, such as roads, schools, hospitals and public housing. It was not surprising that the country embarked on unprecedented borrowing in the 2010s in hopes of regaining some of the ground that had been lost in terms of infrastructure spending over the preceding two decades.

5. THE ROLE OF US MONETARY POLICY

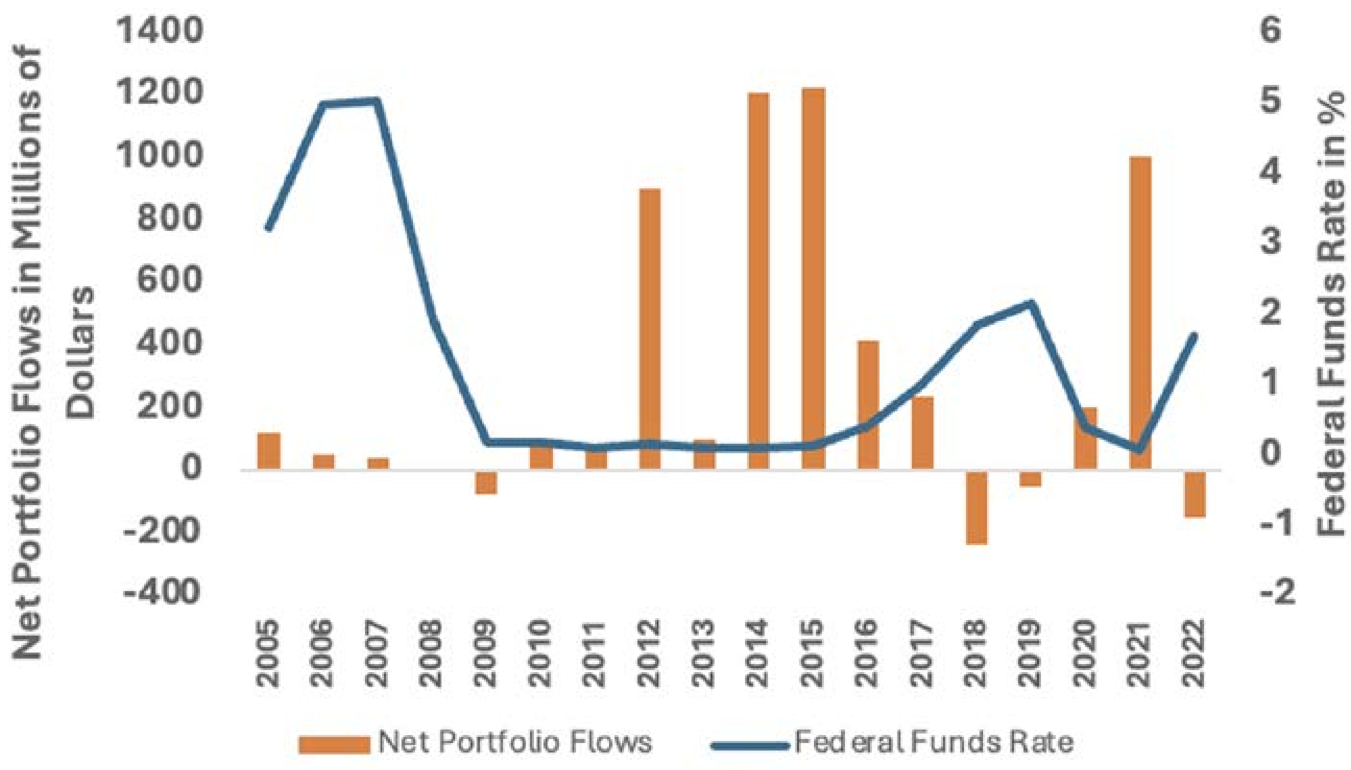
There is ample literature on the link between portfolio flows to the rest of the world and the stance of developed country monetary policy, especially that of the US. For example, Anaya et al. (2017) studied this issue and found that expansionary US monetary policy significantly increases portfolio outflows from the US, leading to increased portfolio inflows in emerging market economies. This generally results in an increase in real output growth and real equity returns and an appreciation of the real exchange rate. It is therefore logical to investigate whether developed country monetary policy had any impact on Zambia's public external debt acquisition. Specifically, we consider the role of US monetary policy given the fact that various studies by Ahmed et al. (2021), Dahlhaus and Vasishtha (2014), and Chen et al. (2014) have shown the importance of US monetary policy for the rest of the world.

Figure 10 shows the relationship between net portfolio flows into Zambia and the US federal funds rate over the period 2005 to 2022. Net portfolio flows are defined as external flows into Zambia minus portfolio flows out of Zambia for a given year. Portfolio flows include purchases of equity and investments in fixed income assets. In the Zambian case, data from the Bank of Zambia shows that the overwhelming majority of portfolio flows into Zambia are invested in fixed income assets such as bonds. Therefore, net portfolio inflows raise Zambia's liability position. On the other hand, the federal funds rate is the benchmark interest rate set by the US central bank, the Federal Reserve Bank, which, as discussed earlier, has implications for much of the global economy. Theoretically, a relatively high federal funds rate makes investing in the US relatively more attractive than investing elsewhere, resulting in net portfolio outflows in other parts of the world and vice versa.

Remarkably, Figure 10 shows that periods of relatively low interest rates in the US have been followed by massive portfolio inflows into Zambia. Conversely, periods of relatively high interest rates in the US have been followed by low portfolio flows into Zambia and at times, even portfolio outflows. For example, between 2009 and 2016, when the federal funds rate was close to zero, Zambia experienced an unprecedented inflow of funds from abroad amounting to USD4 billion over this period. This amount included investments into the three inaugural Eurobonds issued in 2012 (USD750 million), 2014 (USD1 billion) and 2015 (USD1.25 billion). It is doubtful whether the country would have successfully issued these bonds if interest rates in the US were not close to zero.

Figure 10 also shows that from 2017 to 2019, when the federal funds rate averaged about 2%, net portfolio flows slowed down and, in some cases, were negative. The period from 2017 to 2019 experienced a total net portfolio outflow equal to USD56 million. As soon as interest rates in the US were once again reduced to almost zero on the onset of the COVID-19 pandemic in 2020, net portfolio flows resumed their entrance into Zambia once more. Between 2020 and 2021, net portfolio flows were positive and totalled USD1.2 billion. Thereafter, the federal funds rate began to rise yet again, and net portfolio flows turned negative. This pattern is also repeated in the earlier years, from 2005 to 2008, when the federal funds rate was at its highest level and net portfolio flows into Zambia were negligible. The evidence presented in Figure 10 shows that the build-up of debt after 2011 has a lot to do with the stance of US monetary policy.

Figure 10: Relationship between Net portfolio flows and the Federal funds rate, 2005 to 2022



Note: Negative net portfolio flow is a net outflow
Sources: Authors, based on World Development Indicators, US Federal Reserve and Bank of Zambia

If Figure 10 shows how debt can build up because of loose monetary policy in the US, Figure 11 shows how a debt crisis can be triggered because of such monetary policy. Figure 11 shows the relationship between the federal funds rate and the domestic exchange rate defined as Kwacha needed to purchase a single US dollar. Given that public external debt is serviced in US dollars, the exchange rate is a good measure of the domestic cost of public external debt service. A depreciating exchange rate means the authorities need more kwacha to service the same level of public external debt as before. Seen this way, a depreciating exchange rate can trigger a crisis and is itself a bellwether of a crisis. Figure 10 and Figure 11 are related in the sense that net portfolio inflows tend to lead to an appreciation in the exchange rate (i.e., have a positive effect on the exchange rate), while outflows tend to depreciate it (i.e., have a negative effect on the exchange rate).

Figure 11 shows that in periods when the federal funds rate was close to zero, the exchange rate was also low. For example, between 2009 and 2015, the exchange rate averaged K6 to one US dollar. However, from 2016 onwards, when the federal funds rate began to rise, the domestic currency began a trajectory of depreciation that continues to the present day despite a short-lived cut in the funds rate in the wake of the COVID-19 pandemic. This depreciating exchange rate, which has averaged double digits since 2016, has triggered the debt crisis in the sense defined above.

6. HALF-HEARTED ATTEMPTS AT DEBT RESOLUTION

The rapid contraction of debt in the decade preceding the 2020 default left the Zambian treasury in a perilous state. In April of 2021, Zambia applied for the restructuring of its foreign debt under the G20 Common Framework. The purpose of the Common Framework was to create a mechanism that expedites debt resolution for poor countries by bringing various official creditors and borrowers together to manage debt on comparable terms. However, for Zambia, this process was fraught with delays and marred with geopolitical posturing by official creditors (Chelwa, 2023a).

Despite signing memoranda of understanding between 2022 and 2023, it was clear that the Common Framework was not intent on delivering equal treatment. Private bondholders continually attempted to negotiate far more favourable conditions for themselves than what the official creditors had agreed to under the Common Framework. China was singled out as the main hindrance to progress under the framework (Shalal and Do Rosario, 2022). This was because earlier in the process, China had insisted that "local debt owned by foreign investors be included in the debt restructuring process, and that multilateral development banks also take a haircut" (Shalal, 2023).

Towards the end of 2023, nearly two and a half years after applying for debt treatment under the common framework, progress was achieved with the agreement of a common template for debt restructuring. The common template specified an average maturity extension of 12 years on existing debt and a reduction in and capping of interest rates to 1% for the first 14 years, then raising to a maximum of 2.5% thereafter (Ministry of Finance & National Planning, 2023). However, Zambia was expected to reach binding agreement with each creditor. This approach nearly collapsed the entire process of debt structuring because private bondholders wanted more favourable terms than what was contained in the common template for debt treatment (Savage & Strohecker, 2023). Thus, the agreement reached between Zambia and bondholders was rejected by the official creditors as it was deemed to have given more favourable treatment to the bondholders than it did to the official creditors. For example, "the deal with bondholders proposed annual returns ranging from 4.4 percent to 5.8 percent, while the agreement with official creditors had proposed capping interest rates at 1% for the first 12 years after restructuring" (Zucker-Marques, 2023).

The impasse around differential treatment of creditors created uncertainty over concluding an agreement for debt restructuring. It became very apparent that the common framework was not the ideal mechanism for such debt restructuring. While creditors were busy jostling among themselves, poor Zambians had to contend with the havoc wreaked by the uncertainties of unresolved debt. The value of the Zambian Kwacha was destabilized during this period, causing an increase in the prices of essential commodities and deteriorating the economic outlook for the country.

In March 2024, a deal was agreed upon with bondholders on substantially the same terms as the official creditors. Bondholders of the 2022, 2024 and 2027 maturing bonds agreed to swap these bonds with two amortising bonds, with one of those bonds offering higher payments if the country's economic outlook and debt-carrying capacity improve. This agreement allowed Zambia to emerge from more than three years of debt default, though the country would not emerged unscathed. A process that was designed to expedite engagement with creditors became contentious and ultimately delayed the finalisation of negotiations.

Zambia's experience demonstrates the need to rethink multilateral approaches to debt resolution and restructuring. The global credit landscape has significantly changed since the 1990s, when the predominant creditors were the Paris Club of creditor countries. Today, the likes of China have become serious suppliers of credit, necessitating a rethinking of the multilateral architecture for sovereign reform in poor countries.

The success or failure of the G20's Common Framework should go beyond delivering mere memoranda of understanding. A satisfactory multilateral approach must enable defaulting countries to meaningfully restructure their debt without jeopardising the space for autonomous policy formulation and implementation. While Zambia has managed to restructure its debt, this has been achieved under the heavy hand of IMF austerity conditions, which require "a large, front-loaded, and sustained fiscal consolidation" (IMF, 2022). Fiscal consolidation requires the removal of subsidies on fuel, electricity and agricultural inputs. Additionally, VAT receipts may increase in the future by limiting VAT-exempt commodities and by increasing the VAT rate (Chelwa, 2022).

Furthermore, it is not entirely clear that the agreed debt restructuring deal will enable Zambia to permanently escape the debt trap. In exchange for the three Eurobonds that were due to mature in 2022, 2024 and 2027, two new bonds have been agreed to, Bond A and Bond B. Bond A worth USD1.7 billion will be payable between 2024 and 2033 at a rate of 5.75% for the first 7 years and 7.5% thereafter.

Bond B, worth USD1.5 billion, will be payable either between 2051 and 2053 with interest capped at 0.5%, if the current debt-carrying capacity and economic performance remain unchanged (the base case), or should economic performance improve between 2026 and 2028, the bond will be due for payment between 2032 and 2035. Notably, interest on Bond B will increase anywhere from 0.5% to 7.5% for the period between 2025 and 2035. The second scenario would likely result in debt servicing costs of around USD700 million between 2032 and 2033 on the two bonds alone (Chelwa, 2024), as payments between Bond A and Bond B coincide. Adding this amount to other debt obligations may yet again result in another cycle of debt distress. The likelihood of this materialising calls into question the efficacy of the current framework for debt structuring. This is because in the current instance, debt restructuring would have only worked to improve economic performance, which then triggers higher debt repayments which themselves lead to slower economic performance (Chelwa, 2024).

7. SUMMARY AND CONCLUSIONS

The analysis presented in this case study has demonstrated that three structural forces have been at the centre of explaining Zambia's debt dynamics. Foremost is the role that copper extraction continues to play in shaping Zambia's economic fortunes and misfortunes. At any given point in Zambia's history, rising copper prices have led to dangerous debt contraction premised on the misguided idea that copper prices would continue to rise ad infinitum. Conversely, declining copper prices have led to debt crises as the country grapples with the problems of declining foreign exchange revenues and rising debt service costs.

Secondly, the "lost decades" of the 1980s and 90s, characterised by deep austerity measures under the aegis of the IMF and World Bank, have also influenced Zambia's debt trajectory. The shift to cash budgets necessitated by structural adjustment meant that the country was unable to periodically invest in infrastructure to support its economic aspirations and sustain a growing population. Cash budgeting adversely affected Zambia's ability to plan and constrained the state's capacity to restructure the economy in the face of modern-day challenges. Therefore, the reckless borrowing that has occurred over the last decade or two can be seen as an attempt by Zambia to recover some of the deficit in infrastructure spending that arose out of the structural adjustment era of the 1990s.

The role played by US monetary policy also continues to influence credit flows to emerging and developing markets. Whenever interest rates in the West, and the US in particular, have been relatively low, credit has flown to Zambia, thereby increasing the country's liabilities. Conversely, the raising of interest rates in the West and the US has led to debt crises as Zambia grapples with increasing costs of debt service.

The report by Focus 2030 (2023) points out that the Bretton Woods institutions and other international financial institutions have become obsolete in their purpose, instruments and ability to respond to 21st century challenges. The current debt crises have resulted in poor countries facing a fiscal squeeze amidst the continued social, health and geopolitical crises. The failure by multilateral financial institutions to respond promptly to the debt crisis is due to their failure to adjust the governance architecture and address systemic vulnerabilities faced by poor and low-income countries. Part of the necessary reforms must include more objective and transparent credit rating criteria and the creation of new risk assessment mechanisms for developing markets.

Invariably, copper will continue to play a critical role in Zambia's future economic outlook. To break the commodity price cycle that has been largely responsible for the country's debt crises, prudent macroeconomic management is essential. This entails managing revenue volatility to prevent the slow-to-negative economic growth in times of low commodity prices. This can be achieved by creating a sovereign wealth fund to stabilise government expenditure and offset capital flows (Sachs and Maennling, 2015) and creating or recapitalising national development banks to help with diversifying the economy.

Sovereign wealth funds are created either for the purpose of fiscal stabilization—providing economic and budgetary support during times of internal and/or external shocks caused by commodity volatility, or development funds—investing in socioeconomic projects such as public infrastructure, or intergenerational savings, which are intended to secure wealth for future generations (Addison and Lebdioui, 2022 and Bahoo et al., 2018). There are clear benefits from creating sovereign wealth funds, such as reducing the need and cost of external borrowing as a country can utilise the resources kept in reserve (Bruce-Clark and Monk, 2017). Also, they could help in dealing with emergencies and crises without the need for external assistance. The success of Botswana's Pula Fund is a good example of how beneficial sovereign wealth funds can be when managed prudently.

However, Addison and Lebdioui (2022) argue that sovereign wealth funds have failed to deliver development for most African countries. This is because of a lack of transparency, weak institutional arrangements, a lack of financial expertise to create an investment portfolio that matches the funds' goals, and vulnerability to mismanagement and corruption by politicians. Thus, they argue that creating or strengthening national development banks is a more desirable option because national development banks have a greater potential of stimulating long-term transformation than sovereign wealth funds. According to Addison and Lebdioui (2022, p. 19) national development banks "help fix market failures, promote structural transformation, and provide positive social externalities for enterprise development for the economy and provision of social goods."

However, Zambia's experience with national development banks has not been encouraging. The Development Bank of Zambia (DBZ), which was Zambia's only development bank since its establishment in 1972, was recently placed under liquidation by the Central Bank for being undercapitalised and non-compliant with banking laws (Bank of Zambia, 2023a). This happened only 11 years after DBZ was recapitalised with some of the proceeds from the 2012 Eurobond issuance (Parliamentary Committee Report, 2014). Among the reasons for the failure of DBZ was political mismanagement and bad investments in local enterprises.

Given Zambia's past challenges with national development banks, a combination of creating a sovereign wealth fund and re-establishing a national development bank could help the country's long-term developmental agenda. A sovereign wealth fund could help the country save proceeds from windfalls from copper exports, which can be used to stabilise government expenditure, save for future generations, and/or ring-fence revenue from mismanagement. The reestablishment of a national development bank could help drive long-term investment in public infrastructure. However, the success of the fund and/or the development bank will depend on them having very clear objectives and rules. Additionally, it is important that they both have transparent disclosure requirements, clear investment guidelines, and clear institutional structures to prevent the central government from abusing them for short-term political gains. It will be important to ensure that both are well run and governed (Griffith-Jones et al., 2024). Valuable lessons can be drawn from the failure of DBZ to help with structuring a robust governance system.

Whatever policy choice is made in choosing either a sovereign wealth fund or re-establishing a national development bank or both, the main objective must be to maximise the development impact and not profits. The success of either institution rests largely on them having clear mandates and strong governance structures that limit political influence.

As the last decade has shown, Zambia needs to diversify its economy away from copper. A diversified economy is less prone to natural resource price and production shocks. This can be achieved by developing a pro-development agenda that will maximise the integration of the extractive industry into the wider economic architecture. Developing production linkages could help with greater retention of revenue generated from the country's natural resources. By incentivising the beneficiation of output from the mining sector, the government can support the development of downstream industries that focus on value addition. This will help reduce dependency on the extractive sector and help build a more resilient economy (Collaborative Africa budget reform initiative, 2024).

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