The Road to Zambia's 2020 Sovereign Default

March 2023

On 13th November 2020[1], Zambia became the first African country in the Covid-19 era to default on its Eurobond debt, after the Government missed a coupon payment of US$42.5 million on its 2024 Eurobond. The Government has remained in default ever since and sought external assistance to bring the debt levels to sustainable levels. Consequently, in 2020, the Government applied for the G20/Paris-Club Common Framework for Debt Treatment Beyond the DSSI. This note discusses Zambia's macroeconomic and fiscal landscape leading up to the debt distress, to better understand the conditions that gave rise to the 2020 sovereign default. This note also recounts the 20 years leading to this economically treacherous and costly process.

Overview of the Macroeconomic Environment

Two periods characterize the long-term evolution of the debt dynamics in Zambia: the period prior to the rapid debt accumulation from 2000 to 2011 and the period of rapid accumulation ,from2012-2019.

In the 2000s, Zambia was characterized by positive developments on the macroeconomic front due to various reforms implemented in the early 2000s. As a result of these reforms and favourable global economic conditions, and following the Heavily Indebted Poor Countries (HIPC) debt relief, the years leading up to 2010 recorded impressive real GDP growth, averaging 6.4 percent per annum and hitting 10.3 percent in 2010. The key contributors to growth were the mining, of which Zambia is a key exporter, agricultural and construction sectors. Inflation trended downwards to a single digit, averaging 8 percent in 2010 from over 17 percent in 2003. The exchange rate was fairly stable and the external position was strengthening.

Up to 2012, when the Government issued its first Eurobond, the fundamentals were fairly strong, but things took a turn for the worse sometime around 2013 when the macroeconomic environment began to deteriorate. GDP growth, which peaked at 7.6 percent in 2012, declined to 4.7 percent in 2014, and remained sluggish for the rest of the period until the 2.8 percent recession in 2020. While the Covid-19 pandemic explains the significant economic decline registered in 2020, the trends in macroeconomic indicators indicate that the Zambian economy was already struggling even before the pandemic hit.

[1] This short note is an excerpt of a forthcoming study by ZIPAR (Sylvia Mwamba, Ignatius Masilokwa, Mbewe Kalikeka ,Margret Mbewe) with support of the Finance for Development Lab. We thank Théodore Humann for his help.

Table 1: Select Macroeconomic Indicators

Description	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP Growth rate (%)	7.6	6.3	7.6	5.1	4.7	2.9	3.8	3.4	4.0	1.4	-2.8	3.6
Average Inflation Rate (%)	7.9	7.2	6.60	7.0	7.80	10.00	18.20	6.60	7.50	9.10	15.70	22.10
Average Exchange Rate vs USD	4.4	4.68	5.14	5.39	6.15	8.63	10.31	9.54	10.45	12.91	18.28	20.05
Deficits (% GDP)	3.3	3.6	4.8	6.5	5.2	9.4	5.8	7.8	7.6	9.1	14.5	

Sources: BoZ & MoFNP Reports

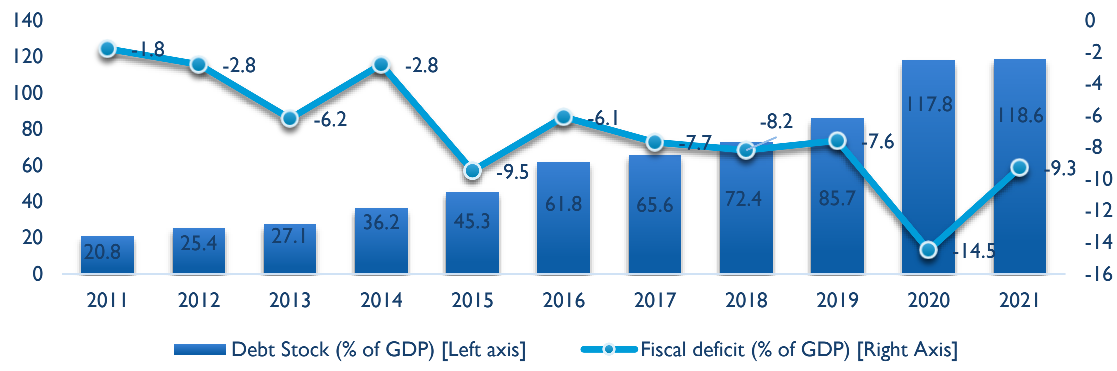
Zambia's Path to the Debt Crisis

In 2005, Zambia managed to get debt relief under the HIPC and the Multilateral Debt Relief Initiative (MDRI), reducing debt levels from US$7.1 billion to around US$500 million. Thereafter, the Government only ran small deficits averaging 1.6 percent of GDP, and the debt stock was recorded at 19 percent of GDP in 2010.

After a change of Government in 2011, the Patriotic Front (PF) administration adopted an expansionary fiscal policy stance primarily focused on an ambitious infrastructural drive and a bloated civil service. This generated excessive spending manifesting in raising of the salaries of over 200,000 civil servants, creation of an additional 20 districts, and expansion of subsidy programs. The increase in expenditure was however not accompanied by commensurate increase in revenues. As a result, over 2011-2014, revenues averaged around 17 percent of GDP while expenditures increased from 20 percent of GDP to 23 percent of GDP. As a result, the fiscal deficit on a cash basis rose from 2.8 percent of GDP in 2012 to 5.2 percent in 2014.

The sluggish economic growth, weak public finance management (PFM) frameworks, and inadequate legislation all combined to initiate the progressive weakening of the country's fiscal position, creating an enabling environment for rapid debt accumulation. Consequently,the debt stock which was recorded at 20.8 percent of GDP in 2011, leaped to 117.8 percent of GDP in 2020, which was way above the IMF prescribed threshold of 55 percent of GDP . Further, with a rising debt stock came debt servicing costs which rose from 10 percent in 2014 to over 30 percent of expenditure in 2020.

Figure 1: Debt Stock and Fiscal Deficit, 2011 - 2021



Source: MOFNP Economic Reports and Fiscal Tables

Details on the Composition of the Growing Public Debt

Before 2015, multilateral loans accounted for most of the country's debt stock, at about 64 percent of total external public debt stock in 2011. However, this proportion began to dwindle to about 15 percent or US$2 billion by the end of 2021. From 2011, bilateral debt has grown moderately, accounting for 6 percent of the total external debt profile in 2021. Considering export suppliers credits separately, they increased from US$448 million in 2011 to over US$4 billion in 2021, averaging 26 percent of external debt over the reference period. The major country creditor under this category is China, mainly through the Exim Bank of China and CATIC, to finance infrastructure projects.

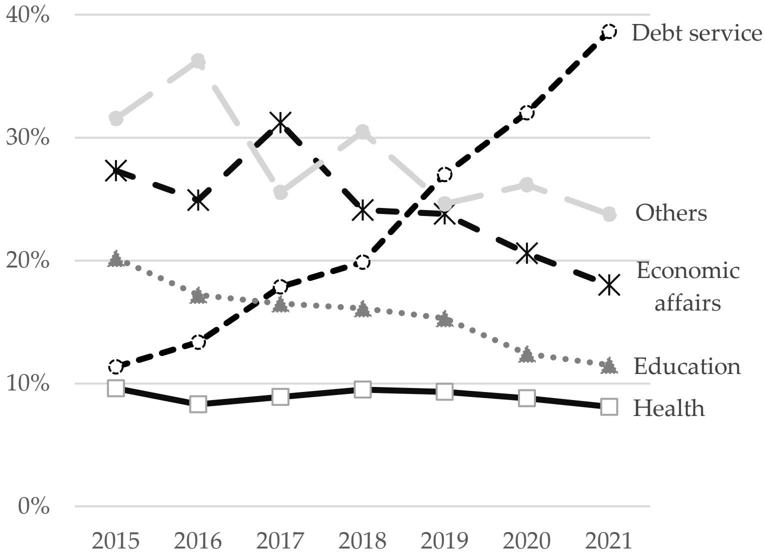
The Government turned to the external commercial markets as concessional sources of finance had begun to dwindle. Zambia issued three Eurobonds in 2012, 2014, and 2015, amounting respectively to US$750 million, US$1.0 billion, and US$1.25 billion. In less than five years, Zambia's Eurobond debt had soared to US$3.0 billion, increasing the proportion of commercial debt to external debt to 45.3 percent in 2015 from 28.7 percent in 2012 (Figure 1). By 2019, commercial debt accounted for 50.3 percent of the total external debt.

This switch to more expensive commercial loans amidst weak PFM frameworks accelerated the Country's fiscal crisis. The Eurobonds' proceeds funded largely infrastructure projects, especially in the transportation sector. Successful implementation of these projects was challenging, and the envisaged results were not fully actualised. In addition, while the size of each bond grew, the transparency of use of proceeds declined, with $410 million "unspecified" for the bond issued in 2015.To finance its growing deficits and satisfy its appetite for spending, the Government also turned to the issuance of domestic government securities, leading domestic debt to increase from US$2.8 billion in 2015 to US$7.1 billion in 2020.

On the Edge of Default

The Government fiscal challenges slowly begun to manifest. The massive external debt stock came with huge debt servicing costs. From 2015 to 2022, debt payments accounted for almost 44 percent of general public services in 2015 and almost doubled to 80 percent in 2021. Other expenditure categories, but particularly related to social sectors, were squeezed. Economic affairs (which includes infrastructure spending) rose sharply in 2016-17 but also experiences a sharp decline

Figure 2: Expenditure by Functional Allocation, 2015 – 2022 (selected)



Source: Annual Budget Speeches

In 2020, when Zambia bowed to economic pressures and defaulted, Kwacha was volatile and in freefall, depreciating by over 250 percent against the US dollar. The instability and inconsistencies in the mining fiscal regime and pressure on the demand side adversely impacted the exchange rate. Internationally, the falling copper prices due to China's economic slowdown and the downgrading of Zambia's credit score worsened the performance of the Kwacha.

The endorsement in April 2020 of the Debt Service Suspension Initiative (DSSI) following the COVID-19 pandemic led Zambia to apply for debt suspension for the period May to December 2020. As the realisation dawned that debt was not sustainable, Zambia issued a consent solicitation memorandum in 2020 requesting a six-month coupon payments standstill on Eurobonds due in 2022, 2024, and 2025 – 2027, which bondholders rejected citing a lack of transparency in the treatment of all creditors, particularly Chinese creditors. This triggered a formal Government default on a US$42.5 million coupon payment on the 2024 Eurobond due on 13 October 2020, making Zambia the first sovereign default in COVID-19 times.

Conclusion: reforms but no deal

Zambia thus applied in early 2021 for a debt treatment under the Common Framework and saw its creditor committee formed in June 2022, headed by France and China. Unfortunately, the implementation of the framework has been slow due to coordination challenges. It provided financing assurances in August 2022, paving the way for an IMF program. In August 2022, the IMF approved a $1.3 billion (38-month) Extended Credit Facility (ECF) for the period 2022-2025 in August 2022.

The ECF is concessional, at zero interest rates, with no repayments required for five years. Key objectives to be achieved with this deal include restoring macroeconomic stability and fostering higher, more resilient, and inclusive growth. Key reforms under the IMF deal include eliminating fuel subsidies, enhancing agricultural subsidies, and curbing inefficient public investment.

The Government also committed to major PFM reforms, with the adoption of the Public Debt Management (PDM) Act (2022), which responds to previous weaknesses by providing for stronger parliamentary oversight over debt contraction. Also, by providing for debt limits, the PDM allows Zambia to turn toward debt sustainability. However, there is still room for progress for the institutional and legal frameworks.

These commitments allowed the IMF to disburse a first tranche of financing under the ECF, but uncertainty remains considerable as little progress has been achieved in negotiating debt relief with official and private creditors. At the heart of coordination challenges is the dual problem of setting an appropriate quantum of debt treatment to reach a "sustainable" level, and the diverse views across creditors, between Chinese creditors and private creditors, as well as the role of the International Financial Institutions (IFIs).