

Supplement 2 - Zambia's External Debt

1. External debt and relief measures to 1995

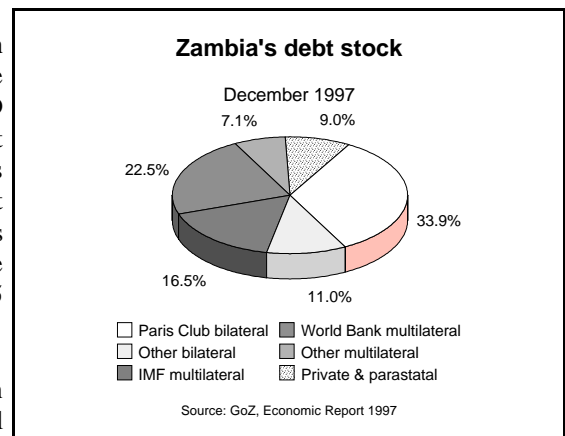
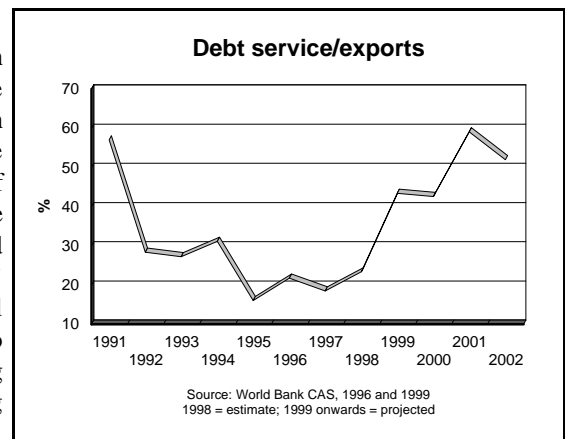
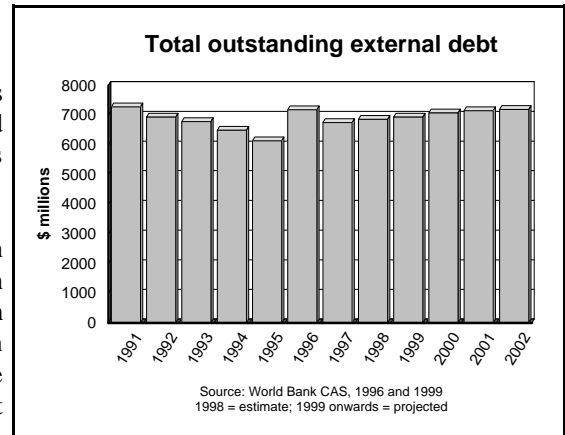
When the MMD Government came to power in 1991, Zambia's external debt stood at a colossal \$7.3 billion. This debt is owed mainly to foreign governments and multilateral financial institutions such as the World Bank and IMF.

The debt must be paid back in dollars or other foreign exchange. In order to determine whether Zambia can afford to repay its debts, both now and in the future, it is therefore necessary to look at how much Zambia owes and must repay in relation to how much it exports. In 1991, the equivalent of over half of all Zambia's earnings from the export of goods and services was required to meet the cost of debt servicing.

Given this crippling level of debt, the World Bank placed a high priority on making the burden more manageable. The key measure taken in the first half of the 1990s was to replace expensive loans with cheaper loans. In the past, while Zambia was considered to be more credit worthy, it only qualified for short-term loans at a higher rate of interest. 'Hard' loans of this type were provided by the arm of the World Bank known as the International Bank for Reconstruction and Development. Since 1988, Zambia has been eligible only for 'soft' loans from the part of the Bank known as the International Development Agency. Larger IDA commitments have helped to reduce the amount of money Zambia must find to meet debt servicing because maturing IBRD debt has been replaced by new IDA lending on highly concessional terms.

Most of Zambia's outstanding debt is owed to bilateral creditors, in particular the 'Paris Club' of important creditor governments.¹ The Paris Club agreed a number of debt relief measures with the MMD Government on its accession to power. These included debt rescheduling, by which the amount of time for repayments is extended. This has helped Zambia reduce its repayments in the short term. A relatively small amount of debt, arising from loans made as official development assistance, was also cancelled entirely. These measures combined had the effect of reducing Zambia's debt by \$1.5 billion by August 1992.²

The Bank has also pursued other actions. In 1994, it coordinated an initiative to buy-back \$181 million of debts owed to commercial banks. Although Zambia's overall stock of debt was not significantly reduced, the action was important in reducing debt servicing on such high interest loans. By 1995, the servicing on Zambia's debt had fallen to the equivalent of 16 per cent of export earnings.



2. The current situation: an unsustainable burden of debt

As a result of this first round of action, Zambia's creditworthiness was improved, its arrears were reduced, and the country was granted access to IMF and new World Bank resources. These sources of funds are crucial at a time when the Government's credit rating is such that it cannot borrow from commercial banks. Yet, at this juncture, and despite limited successes, the measures adopted to manage Zambia's debt burden have proved to be inadequate and sometimes inappropriate.

It is the inability of Zambia to generate sufficient foreign exchange to meet debt servicing costs and to pay for imports which has resulted in donors providing external assistance to Zambia in the form of balance of payments support. Such support meets the most immediate objective of keeping the Zambian Government solvent and thereby shores-up the confidence of private-sector investors buying into Zambia's industry and agriculture. However, criticism centres both on the self-serving nature of the support on offer and the rapid decline in its overall level.

The foreign exchange provided as balance of payments support by bilateral and multilateral creditors is aimed at ensuring that the Zambian Government has the necessary resources to meet the servicing on the debt which is owed to them in the first place. Furthermore, the level of BOP support which donors are willing to provide has declined sharply in recent years. When considered in isolation from other external assistance, it has precluded any net transfer of resources to Zambia and, increasingly, has fallen short of the cost of debt servicing. Hence resources, both from the Government's own reserves and from the donors, which could have been invested in the Zambian people and economy to promote long-term growth, have been diverted to meet debt servicing. The World Bank argues that, had this not been the case, even the moderate growth generated by private sector investment would not have occurred as investors would have perceived the risks of investing in Zambia as too great.

Zambia's level of debt is already unsustainable and the situation will grow more acute. Total outstanding debt at the end of 1997 had been reduced somewhat to around \$7 billion. By 1998, the total owed decreased further to \$6.86 billion, although the figure cited remains to be adjusted.³ Yet, to place Zambia's debt in perspective, the entire Zambian economy in 1998 generated in the region of \$3.4 billion, or only half the amount owed.⁴ Zambia's total overseas debt in 1998 was estimated at six and a half times the amount it earned through all exports of goods and services in the same year. The same total debt to exports ratio was predicted to peak at 730 per cent in 1999.⁵ In respect of debt servicing, the amount which the Zambian Government was required to find in 1998 to meet repayments and interest on this debt rose to the equivalent of almost a quarter of the country's entire export earnings.⁶ This debt service to exports ratio is predicted to increase further to around 43 per cent in 1999 and 2000, before rising markedly to almost 60 per cent in 2002.⁷ The debt burden places severe constraints on the amount of ready cash the Government has at present, and it will prove impossible to pay back in the future. This 'debt overhang' is caused by a number of factors:

- As has been noted, the foreign exchange generated from overseas sales must also pay for imports into Zambia. In five out of the last six years to 1998, Zambia has been importing more goods by value from overseas than it has been exporting. This means that the Zambian Government has simply not had the foreign exchange to service its debt. The 'financing gap', brought about by the necessity to repay debt and to pay for a relatively high level of imports, will not be closed by increasing exports - the assumptions made are already proving to be too optimistic; neither, as is apparent from recent donor policy, will it be closed by a continuing high level of balance of payments support.
- While rescheduling debt does give the Zambian Government longer to repay, the day of reckoning is postponed rather than removed altogether. Repayments on debt which have been rescheduled in the past are now becoming due making Zambia's debt situation increasingly unsustainable.
- Money lent by the IMF under its first Enhanced Structural Adjustment Facility becomes due for repayment from 2001 to 2003 and will mean that scheduled debt repayment will rise to above \$600 million per year, although the expectation is that new loans from the IMF will offset a substantial proportion of this sum.
- Although external assistance from bilateral donors is provided as grants and debt relief, an increasing amount of balance of payments support comes from the World Bank in the form of new loans. This new money is indeed lent on highly concessional terms at low interest over an extended period; nevertheless, it does add to the total amount Zambia owes. Debt service on such loans does not fall due until 2010-2020 but, over that period, there is concern that debt repayments will rise sharply once more.

3. Debt reduction to sustainable levels: the HIPC debt relief initiative

The *de facto* situation is that more fundamental action in the medium to long-term, as well as in the short-term, is required to tackle Zambia's debt burden. Of the greatest potential significance in this regard is the Heavily Indebted Poor Countries (HIPC) debt relief initiative, launched by the World Bank and IMF in 1996, with the support of bilateral and other creditors. The two stage HIPC initiative aims to reduce the overall debt in each case to sustainable levels.⁸

To be eligible for consideration under the initiative in the first place, a country must qualify for concessional IDA loans and be faced with an unsustainable debt situation. Zambia meets these criteria. Furthermore, it is an entry requirement that the country in question must agree to pursue or adopt World Bank/IMF adjustment programmes. In practice, this has meant agreeing an ESAF arrangement with the IMF. The Zambian Government completed a Rights Accumulation

Programme with the IMF in December 1995 and became eligible for ESAF funding. The first ESAF to Zambia, based on an agreed programme of adjustment, was approved by the IMF board on 6 December 1995.

In the first stage of the HIPC initiative, the 'Paris Club' of nine bilateral creditors provide debt relief on special terms, as agreed in Naples in 1996. Each creditor is to write-off or reschedule up to 67 per cent of the net present value of interest and principal repayments falling due on eligible debt during a consolidation period of three years. Other bilateral and commercial creditors are expected to provide comparable treatment. The Paris Club agreement on debt relief to Zambia was scheduled to enter into force in March 1997, after the completion of the midterm review of Zambia's adherence to economic reform under the ESAF.⁹ Zambia signed the necessary bilateral agreements under the Naples terms with all nine Paris Club creditors in the latter half of 1997.¹⁰ Yet before debt relief to Zambia is delivered, it must successfully complete the agreed program of reform.

In Zambia's case, the importance of these measures is diminished by the fact that only 15 per cent of Zambia's debt is owed to the Paris Club in the first place and significantly less qualifies for renegotiation under the Naples terms because it falls outside the qualifying period. The Naples terms only apply to debts incurred on non-concessional loans made after 1983. Furthermore, the delay in signing individual agreements with each bilateral creditor has resulted in the accumulation of arrears. While it is assumed that Zambia's bilateral non-Paris Club creditors will adopt similar debt relief measures, this is by no means certain in all cases.

4. Zambia's qualification for full debt relief under HIPC

In the case of countries such as Zambia, it is apparent that there is an urgent need to introduce additional, far-reaching debt-reduction measures. In this respect, it is the second stage of the HIPC initiative which is of vital importance. This provides greater Paris Club debt reduction - up to 80 per cent in net present value terms. Once more, the expectation is that other bilateral and commercial creditors will provide relief on comparable terms. Multilateral institutions will act to reduce the present value of their claims either by using funds from the HIPC Trust Fund or through parallel action measures. Special interim measures may also be employed by the multilaterals to assist countries with a good performance record of reform.

Zambia must first of all qualify to receive full relief under these terms. At the decision point, a joint analysis by the World Bank, IMF and officials from the debtor country provides the basis to determine whether a country's debt burden is unsustainable even after the application of current debt relief mechanisms. A country exits from the HIPC initiative if debt reduction and relief under traditional measures and the Naples terms will enable it to achieve sustainability. The level of sustainable debt is defined on a country-by country basis, but within a set range. This used to be 200 to 250 per cent for the debt-to-export ratio and 20 to 25 per cent for the debt service-to-exports ratio. However, a recent revision of the HIPC initiative is set to reduce the former ratio to 150 per cent and lower other sustainability thresholds.¹¹

A recent, updated debt sustainability analysis (DSA) suggests that the relevant debt ratios in Zambia meet these criteria. The country's external public debt burden will not be reduced to sustainable levels before the middle of the next decade, irrespective of adherence to strong financial policies, the avoidance of non-concessional borrowing, and existing debt-relief mechanisms:

'The baseline scenario indicates that the ratio of the net present value of debt to exports, which was estimated at 510 percent at end-1998, would remain above 250 percent until 2005 and would not fall below 200 percent until 2010. Debt service after rescheduling would not fall below 25 percent of exports of goods and services until 2004, and it would then still be equivalent to about 35 percent of government revenue and about 30 percent of expenditure.'¹²

This analysis is not yet confirmed. Qualification is also dependant upon the Zambian Government's continued commitment to sound economic management. In this respect, the approval by the IMF in March 1999 of ESAF II to support an economic reform programme over the period 1999 - 2001 is an important step. If Zambia's qualification is approved, and provided it adheres to this second IMF/World Bank adjustment programme, then debt will be unconditionally written-off in 2002. If, at this completion point, Zambia's debt remains unsustainable, creditors will be asked to adjust the amount of debt relief accordingly to achieve sustainability.

5. Recent developments

Proposals of longer-lasting effect, such as the HIPC initiative to reduce Zambia's debt stock, are conditional on the Government of Zambia's adherence to policies in the social and economic realms which can all too readily be perceived as conflicting. Hence qualification for HIPC requires, on the one hand, the continuation of austerity measures, the tight control of public finances, adjustment and progress towards privatisation. On the other hand, the Zambian Government must demonstrate its commitment to social reform and the improvement of basic health care and education. The issue is one of balance. The danger is that economic imperatives will predominate, the Government itself will not be able to find the necessary finance to deliver real improvements in health and education unless it is underpinned by aid money, and the cost of debt reduction tomorrow will be met by Zambia's poor today. If this does prove to be the case, the error of harsh economic reform at the expense of social development will be repeated when, ultimately, sustained growth of benefit to the majority in Zambia depends precisely upon improving the basic health, education, and skills of all of the Zambian people.

At the beginning of 1999, the World Bank and IMF consulted NGOs, churches, and governments over how HIPC could be enhanced to deliver (i) more effective debt relief suited to (ii) achieving poverty reduction. The Bank/IMF produced a paper, approved by both boards in April 1999, outlining options for an Enhanced HIPC Framework.¹³ This in turn received the support of the G-7 countries meeting at the Cologne Summit in June 1999. A commitment is made to provide HIPC countries such as Zambia with a permanent exit from the debt crisis. An unambiguous emphasis is placed on poverty reduction and the release of resources for investment in health, education and social services.

In order to deliver deeper, broader and faster debt relief, the enhanced framework, as has been noted, proposes lower debt sustainability thresholds. This will result in further reductions in the net present value of debt stock owed by many countries, although reducing the absolute level of money owed will not necessarily translate into manageable debt servicing for all. International financial institutions are to provide interim debt relief to reduce cash flow problems in meeting debt service payments. Debt relief is to be 'front-loaded' in the early years, representing a substantial increase in positive resource flows to highly indebted countries.¹⁴ Zambia stands to gain from these revised terms, provided its qualification is approved.

A number of measures are proposed to strengthen the link between debt relief and poverty reduction: Poverty Reduction Strategy Papers are to be agreed between the Bank/IMF and Government and would normally be in place prior to approval at the decision point; estimates of the cost of achieving poverty reduction, measured by appropriate indicators, are to be provided to ensure consistency with macroeconomic targets; funding for the overall strategy is to consider debt relief and other assistance as a whole; and each Country Assistance Strategy is to be used to update progress.

The Enhanced HIPC Framework and the Cologne initiative have been widely welcomed. However, concrete proposals to finance debt relief have not been finalised. Key development agencies have warned against switching development assistance from non-HIPC countries or converting aid into debt relief.¹⁵ There are fears that debt relief under the revised HIPC may be used to impose more stringent economic conditionalities, despite the emphasis on poverty reduction at Cologne and recent moves by the World Bank and IMF to integrate macro-economic and social planning.¹⁶

Notes

¹ The 'Paris Club' is an ad hoc grouping of creditors, comprising the original OECD member countries and Russia. It includes member governments of the powerful G8 (Canada, France, Germany, Italy, Japan, the UK, the USA, and Russia).

² *CAR*, para. 6.26.

³ Estimate cited in *CAS* (1999), Annex B7.

⁴ Estimate cited in *ibid.*, Annex B6.

⁵ Estimate cited in *ibid.*, Annex B7.

⁶ The total debt service/export of goods and services ratio in 1998 is estimated to be 23.4 per cent. See *ibid.*, Annex B7.

⁷ *Idem.*

⁸ See World Bank (1998c), *External Debt and the HIPC Debt Initiative*.

⁹ *SCR* (1997), para. 16.

¹⁰ *ER* 1997, para. 59.

¹¹ Other key elements of the revised Enhanced HIPC Framework include a lowering of the net present value debt-to-revenue target from 280 per cent to 250 per cent; and a reduction of the export/GDP and revenue/GDP thresholds to 30 per cent and 15 per cent respectively.

¹² *PPF* (1999 - 2001), para. 50.

¹³ See World Bank (1999c), 'Progress Through September 1999'.

¹⁴ Under the Enhanced HIPC Framework, debt relief will now be fixed at the decision point rather than at the completion point, as is currently the case. Furthermore, debt relief will be determined on the basis of actual instead of projected figures. The use of 'floating completion points' introduces flexibility by tying the completion point to the fulfilment of a set of reform commitments rather than fixing it at the end of a three year track record.

¹⁵ See, for example, Oxfam International & UNICEF (1999), *Debt Relief and Poverty Reduction: Meeting the Challenge*.

¹⁶ The World Bank is piloting a Comprehensive Development Framework in order to integrate macro-economic and financial reforms in a shared matrix alongside social and human development planning. Principles of Good Practice in Social Policy have also been adopted by the World Bank/IMF Development Committee.