CONSTRAINTS ON PUBLIC DEBT MANAGEMENT IN ZAMBIA 1991 – 2004 AND PROSPECTS FOR IMPROVED MANAGEMENT

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DECLARATION

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ABSTRACT

This work has examined constraints on public debt management in Zambia between 1991 and 2004 and suggested ways of improving it. The case study of Zambia identified five areas that impacted efficient and effective public debt management in Zambia. These were the public debt overhang, the policy environment, the management capacity, the legal and institutional framework and the influence of external aid.

The study used the historical method in which a survey of the public debt problem in Zambia was conducted using library research and detailed open ended interviews of public debt managers and other relevant stakeholders. The aim was to come up with a general position on constraints of public debt management in Zambia between 1991 and 2004. The data analysis was based on both empirical and qualitative historical approaches.

The central challenge of the study was the recognition that achievement and maintenance of public debt sustainability for Zambia and for any other Highly Indebted and Poor Initiative (HIPIC) country would be illusive if the country was stuck with an unsustainable public debt, poor policy framework, inadequate debt management capacity, an unsupportive legal and institutional environment, and misapplied aid or were over dependent on aid.

The thesis has shown that even if Zambia was able to obtain debt relief, including outright cancellation of its external debt, the debt crisis would still resurface in future if the country continued with a public policy environment that did not address the historical necessity of implementing policies that supported expansion of exports of goods and services, lacked management capacity, had a weak legal and institutional framework that did not control wastage of public resources arising from such practices as corruption and thefts, and was still tied to foreign aid that had the tendency to perpetuate dependency and complacency in recipient countries.

The study suggested that Zambia's debt overhang needed to be reduced, structural adjustment policies needed to be changed to allow for export led growth policies, management capacity of Zambia's debt managers needed to be improved, the law and institutional framework needed to be integrated and measures for compliance be instituted, and Zambia needed to adopt debt and aid exit strategies. The study results suggest an interaction of these variables. The effects of these constraints on public debt management and the possible improvements that could be made were dependent on the importance policy makers put on the necessary work of public debt management.

DEDICATION

To my parents Abraham Bines Chitala and Faby Chingoli Namwala who taught me to love and on dying to say I gave all to mankind.

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LIST OF ABBREVIATIONS AND ACRONYMS

ACC	Anti Corruption Commission
ADB	Africa Development Bank
AU	African Union
BOP	Balance of Payment
BOZ	Bank of Zambia
CSO	Central Statistics Office
DAC	Development Assistance Committee (of OECD)
DfID	Department of International Development of the UK
DSA	Debt Sustainability Analysis
ECA	Economic Commission for Africa
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
GRZ	Government of the Republic of Zambia
HIP	Harmonization in Practice
HIPC	Highly Indebted Poor Country
HPI	Human Poverty Index
IBRD	International Bank for Reconstruction and Development (World Bank)
ICT	Information and Communication Technology
IDA	International Development Association
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
KCM	Konkola Copper Mines
LuSE	Lusaka Stock Exchange
MDGs	Millennium Development Goals
MoFNP	Ministry of Finance and National Planning
MTEF	Medium Term Expenditure Framework

NEPAD	New Partnership for Africa's Development
NERP	New Economic Recovery Program
NGO	Non Governmental Organization
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
PEMFAR	Public Expenditure Management and Accountability Review
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PACAP	Public Sector Capacity building Program
SADC	Southern African Development Community
SAP	Structural Adjustment Program
SDR	Special Drawing Right
SEC	Securities and Exchange Commission
SSA	Sub Sahara Africa
ST	Secretary to the Treasury
UK	United Kingdom
UNO	United Nations Organization
UNDP	United Nations Development Program
UNICEF	United Nations International Child Emergency Fund
US	United States
ZANACO	Zambia National Commercial Bank
ZCCM	Zambia Consolidated Copper Mines
ZNTB	Zambia National Tender Board

CHAPTER ONE

INTRODUCTION AND BACKGROUND

THE GENESIS OF THE PUBLIC DEBT PROBLEM

The genesis of the debt crisis which emerged as a historical development of international finance capital is well documented[1]. After attaining political independence in the late 1950s and early 1960s, many developing countries set economic growth as the major target to allow greater access to goods and services to their people. To eradicate poverty and underdevelopment, it was contended that there was need for increased investment in both social and economic infrastructure. However, lack of domestic capital to make these additional investments which was exacerbated by, firstly, the collapse in world prices of commodities led to declines in export earnings for many developing countries. Secondly, the reduced export earnings compelled many developing countries to over borrow from commercial banks, multilateral financial institutions and bilateral countries awash with petrol dollars following the oil shocks of 1973-1974 and 1979-1980. External borrowing was seen as a viable option in some countries. The borrowings were in those days on normal market non-concessional conditions. In due course, interest rates on loans also grew as they were compounded. The sharp increase in international interest rates resulted in a build up of external debts for many developing countries in the post 1980 period which eventually led to the debt crisis.

[1] Lomax, D.F., 1986, *The Developing Country Debt Crisis*, McMillan Press, London.

The situation was not different with respect to Sub-Saharan African countries. Iyoha (1999)[2] has noted that on account of the borrowing policies that were adopted by many countries, there evolved a pronounced upward trend in its external debt stock. From a level of US$8.3 billion in 1970, the region's total external debt stock increased to US$22.7 billion in 1975, reached US$84 billion in 1980, US$162.6 billion in 1988 and stood at an astronomical level of US$223 billion in 1995, US$ 222.4billion in 2000 and US$ 267.2 billion in 2005[3]. This exponential rise in Sub Sahara Africa debt stock which was exacerbated by the effects of rising compound interest, led to a rapid increase in debt servicing obligations, emergence of debt servicing problems including risk of default and loss of credit worthiness and the problem of the debt overhang. The combined effect of all these factors and a sharp fall in real net resource flow to the region in the 1980s led to the public debt crisis of the region. Furthermore, the region suffered in other economic indicators. Appendix 3 for instance shows that the growth of real Gross National Product in Sub Sahara African countries had been low relative to all other regions. During the 1990 – 1993 period for instance, its real GDP growth was 0.6 per cent as compared to East Asia's 8.7 per cent and Latin America's 3.4 per cent. Appendix 4 and 5 further show that the growth of real per capita GDP for Sub Sahara African countries which averaged negative 2.3 per cent annually had consistently been lower than all other regions.

In order to determine the severity of a public debt problem in a country, there are many solvency and liquidity measures in the literature that have been suggested. The measures which are presented quantitatively include solvency ratios such as amortization payments

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[2] Iyoha, A.M., March, 1999, ***External Debt and Economic Growth in sub Saharan African Countries: An Econometric Study,*** (AERC Research Paper 90, AERC, Nairobi, Kenya.

[3] IMF ,*World Debt Tables* ,Washington D.C.USA (several years)

to disbursements, interest payments to export earnings, net resource transfers to Gross Domestic Product (GDP) or ratio of net flow to Gross National Product (GNP), net external debt ratio, international reserves to total external debt, international reserves to debt service payments, and actual debt service payments to scheduled debt service payments. Liquidity measures include ratio of short-term debt over reserves and exports over reserves and debt service over reserves. In some cases, macro economic factors are used to measure the severity of the debt problem. These include real economic growth, inflation, exchange rate and over valuation, fiscal balance and exchange rate volatility.

The use of several of these measures, did not adequately address the debt problem for Sub-Sahara African countries (SSA) during the period 1980-2004 leading to deterioration on all indicators. The debt burden increased while the debt service capacity deteriorated as the following facts attest. In 1986, 27 out of 47 countries in Sub Saharan Africa had payment arrears[4]. Between 1982 and 1987, 27 Sub Saharan African countries had negotiated their official bilateral debt through the Paris Club[5]. Aggregate debt to GNP ratio of Sub Saharan Africa was 97.1 per cent in 1988. IMF data further showed that many of the countries in the region were unable to repay debt rescheduled with a standard ten-year maturity, even with a five-year grace period[6].

Because of this incapability to service their debts, many Sub Saharan African countries were compelled to reschedule already rescheduled debt and were forced to further borrow to pay interest on past borrowing, which act tended to escalate their debt problems as they

[4] IMF, *International Financial Statistics,* 1970-2004
[5] IMF, ***International Financial Statistics,*** 1970-2004
[6] IMF, *International Financial Statistics,* 1970-2004

fell deeper into the debt trap. And all this was happening at a time when there was a massive decline in export revenues of many of these countries worsened by dwindling capital inflows. By 1995, the debt to export ratio of Sub Saharan African countries had reached 269.8 per cent and represented the highest ratio of any region in the world. The heavy debt service payments forced many of these countries to borrow and suffer huge fiscal deficits which in turn forced these countries to either raise taxes or resort to printing or borrowing from the domestic market. In this way, the process helped depress local investment and retard growth of the economies and made these countries extremely vulnerable to pressures on their balance of payments.

Other statistics also attest to the underperformance of Sub Saharan African countries. The tables referred to in appendix 3-6 show that between 1980 and 1990, per capita income of the region declined at an average annual rate of 2.2 per cent. Per capita private consumption fell by 14.8 per cent. The export volume of the region remained stagnant while the volume of imports plummeted at an annual rate of 4.3 per cent with the terms of trade falling by 9.1 per cent.

As a consequence of Sub Sahara African countries underperformance, the World Bank classified thirty seven countries of the region as being low income economies while the UNDP classified thirty seven of them as being "Low Human Development" countries. Furthermore, the IMF together with the World Bank classified thirty-three of these countries to be highly indebted and poor. These classifications are presented in Appendix 5 of this study.

In Zambia, the years after independence in 1964 exhibited a fairly small public debt.[7] In 1970 for instance, Zambia's internal and external debts were a mere US$ 177.2 million and US$ 132.2 million, respectively. By 1974 however, Zambia's internal debt jumped to US$ 282.1 million while external debt stood at US$ 354.4 million.

In the period from 1978 up to 2004, Zambia's debt burden increased at a rapid rate. The public debt for Zambia grew exponentially.[8] In 1978, external debt stood at US$999.5 million reaching US$3.3 billion in 1980 and further increasing to more than US$7.2 billion in 1990. The external public debt went down during the early 1990s reaching US$3.7 Billion in1992 but climbed back to more than US$7 billion by the end of 1996 and reaching US$7.2 Billion in 2004. On the other hand, domestic debt stock in 1978 was a mere US$378.5 million. In 2003, it had risen to ZMK3.9 Trillion while in 2004, it stood at Zambian Kwacha 5.5 Trillion. If converted from kwacha to United States Dollars at ZMK3000.00 per dollar, Zambia's internal debt rose from US$1.3 trillion in 2003 to US$1,8 trillion in 2004.

The total external debt alone represented over 120 percent of Zambia's Gross Domestic Product (GDP) in 2003. The external debt service of US$462 million in 2003 represented about 11 percent of GDP, 15.4 percent of total exports, about three times the national education budget and about four times the health budget. Indeed, the projected debt

[7] Zambia, Central Statistics Office, Monthly Digest of Statistics 1978-2004

[8] Fernholz F.R ,(2004) Debt Management and Debt Relief During the 1990s in Zambia (in) Hill C and McPherson M.F. , Promoting and Sustaining Economic Reform in Zambia , Harvard University, USA pp263-2293. See also various issues of Global Development Finance, Washington D.C.: The World Bank, published annually

service without any debt relief agreement with the major creditors in 2004 and 2005 would have been US$470 Million and US$475 Million representing 8.8 percent and 8.3 percent of Zambia's GDP, respectively. However, because of various debt cancellations and relief, the external debt service was reduced to ZMK229 billion and ZMK152 billion in 2003 and in 2004 respectively. The severity of this public debt liability which was still relatively very large for Zambia could be seen within the context where over 58 percent of Zambians lived in extreme poverty, a country plagued by diseases (malaria, HIV/AIDS, TB), a life expectancy at birth of below 40 years and a Human Development Index rank of 166 out of the 177 countries of the world[9].

Although issues related to the extent of the debt stock and the inability of Zambia to repay it resulting in various debt relief and rescheduling options, are current and well documented[10], the constraints of managing the public debt efficiently and effectively have not been given as much attention.

STATEMENT OF THE RESEARCH PROBLEM

This study therefore focussed on the problems of managing the public debt. Specifically, as already shown in the introduction of this chapter, the study wanted to investigate how public policies and programmes affected public debt management in Zambia. These public policies and programmes included the following: the magnitude of the debt and its sustainability; the public debt management capacity of the officials; the legal and

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[9] Zambia, Ministry of Finance, ***Annual Economic Reports, 1991-2004,*** Lusaka, Zambia; UNDP, 2005, ***Human Development Report*** (UNDP, New York) p22

[10] World Bank, 1991-2004 ***Zambia Country Assistance Reviews,*** IBRD, Washington D.C, USA..

institutional framework; and the dependence on foreign aid. The study's major contribution was to suggest ways and means how public debt management could be improved.

The case of Zambia's public debt management is quite ironical. While the public was called upon to sacrifice and the various creditor nations were asked for debt relief as well as for debt cancellation, the internal public policy practices of successive Zambian governments and the role of foreign aid tended not to address the need for Zambia to improve its management capacity in public debt management. In other words, even though some attempts by creditors were made to provide debt relief, by and large, little regard was given to the policy regime environment such as political commitment to sound debt management, a clear legal and institutional framework, coordination among many government departments, participation of and accountability to civil society, sound and effective management information system, and adequate numbers of well trained and motivated personnel. Furthermore, foreign aid was mostly accepted uncritically as making a positive contribution to the country's development process and its capacity and tendency to make debtor nations complacent was overlooked.

SCOPE, OBJECTIVES AND SIGNIFICANCE OF THE STUDY

Scope of the Study

The central challenge of this study is recognition that achievement and maintenance of public debt sustainability for Zambia and for any other country that has reached HIPC completion point will be elusive if the country is stuck with a poor policy and

institutional framework, has inadequate debt management capacity and misapplies external aid. We consider debts to be sustainable when the debt burden leaves a country such as Zambia with sufficient funds to meet its human rights obligations.

Because of the one sided approach to debt management, namely, anchoring around the debt management models of the World Bank (IBRD) and the International Monetary Fund (IMF), debt management in many developing countries have continued to pose a threat to the survival of these nations as viable states. Essentially, there have been no attempts to provide optional public debt management systems which are sustainable. For instance, apart from stressing debt repayments in various forms, the deliberate investment in the export sector to earn the foreign exchange necessary to support debt repayments is often given lukewarm attention or at best ignored.

The basic pitfall is that even if Zambia and other highly indebted and poor countries obtain debt relief including outright 100 percent cancellation, the debt crisis may re-surface in future if governments do not address two broad issues. Firstly, the debt problem must be seen as a symptom of the larger mismanagement of the economy which is reflected in the poor policy environment, lack of diversification of the economy, the weak legal and institutional framework for public debt management, the wastage of public resources through corrupt practices, the weak absorptive capacity of the economy and the ineffective and inefficient system of public debt management. Secondly, the global financial rules tend to encourage odious debt to accumulate, capital flight and other suffocating conditions such as the brain drain. The dilemma or problem posed by

these two broad issues requires that an analytical study be conducted for Zambia with a view of providing a suggestion to the possible strategy that a country such as Zambia must do to avoid the risks of getting back into the debt trap. The whole environment of public debt management needs to be reformed so that, instead of being an instrument for furthering the goals of the rich nations, perpetuating dependency and deepening Zambia's underdevelopment, it becomes a tool to boost the growth and development of Zambia.

As indicated in the research problem above, the purpose of this study was to examine and critically analyze the extent to which the Zambian governments' policies and programmes from 1990 to the year 2004 had affected efficient and effective sovereign debt management. This discussion was done with the knowledge and appreciation that there were other factors equally important factors that could have constrained effective public debt management in Zambia. These factors, for instance, could have included the absence of export diversification and possible poor fiscal revenue collection systems. These factors were not analyzed in this study and could therefore present a challenge for future research.

Five broad areas of constraints were identified for research in this study. These broad areas were as follows: First was the evolution of Zambia's public debt which became too large relative to the capacity of the economy to service it when it fell due. This analysis provided the background to the analysis of the various constraints in public debt management that the study identified for research. Most notable was the analysis to show the extent of sustainability of Zambia's public debt.

Second, were the public policy constraints on public debt management as shown in the structural adjustment programmes and policy regime? The problem to be investigated was how these factors affected effective and efficient public debt management in Zambia between 1991 and 2004.

Third was the management capacity of the persons mandated to administer the debt? How did management capacity affect the need for efficient and effective public debt management?

Fourth, were the legal and institutional framework, and the whole range of governance issues such as openness and accountability? To what extent did these factors affect Zambia's public debt management?

Fifth, were the uncontrollable factors as exhibited by the extent of dependency on external aid in financing the development agenda and debt repayments? Did donor dependence compromise efficient public debt management in Zambia during the period of study?

The study in the conclusion will discuss the prospects for improved public debt management in Zambia and give recommendations .

Objectives of the study

The objectives of this study were fivefold, namely;

a) To examine the evolution of the Public Debt problem in Zambia;

b) To identify and examine the effects of relevant Public Policies on effective and efficient public debt management in Zambia;

c) To analyze the extent the legal and institutional framework constrained public debt management in Zambia;

d) To examine the extent to which foreign aid negatively or positively impacted Zambia's public debt management; and

e) To suggest a framework in which Zambia's public debt management could be made effective and efficient.

Significance of the study

Zambia continued to be a Highly Indebted Poor Country with a foreign debt at end of December 2003 of US$6,815.40 million (K23,853,900.00 million)[11] while the domestic debt at the end December 2003 stood at US$ 1.48 billion (K5, 186.4 billion)[12]. This combined external and domestic debt remained unsustainable which adversely affected Zambia's capacity to accumulate investable surpluses that could have enabled Zambia to expand her productive base and allow for economic growth and development.

[11] Zambia, Ministry of Finance and National Planning,, 2004 **Zambia Debt Sustainability Analysis Report,** Livingstone, Zambia, November, p12

[12] Zambia, Ministry of Finance and National Planning,, 2004 **Zambia Debt Sustainability Analysis Report,** Livingstone, Zambia, November, p14

There is a strong case that a study on Zambia' public debt management would help policy makers and scholars appreciate the public policy and management constraints that Zambia has faced in its effort to improve public debt management. The study's contribution is the suggestion of a more effective and efficient approach for public debt management that is necessary in the fight against poverty and underdevelopment in Zambia.

ORGANIZATION OF THE THESIS

This thesis is organized in eight chapters. Chapter one is the introduction which sets out the statement of the problem, genesis of the public debt problems both globally and in the African context. The chapter also discusses the scope, objectives and significance of the study. It ends with a presentation of the organization of the study.

Chapter two reviews the literature on public debt management. The chapter first discusses the conceptual framework and definitions of relevant concepts on the subject of public debt management. The chapter then reviews the literature organized on the basis of the major themes that the study identified and ends with a presentation of hypotheses and questions that the study will endeavour to analyze. The chapter further discusses the research methodology and data analysis while Chapter four analyzes the evolution of the public debt highlighting its structure and quantity relative to it being sustainable. The role and evolution of both the domestic and external public debt are discussed and related to debt sustainability. The Chapter discusses the problem of debt sustainability analysis with a specific case study on Zambia. The analysis shows the flaws in some theoretical

paradigms and argues for a more human rights-based conceptualization of public debt sustainability.

Chapter three analyses the evolution of Zambia's public debt from 1991 to 2004. This was a time when Zambia's development policies were anchored on structural adjustment programs underwritten by the International Monetary Fund and the World Bank. The analysis shows that the country's public debt accumulated to unsustainable levels which tended to adversely affect Zambia's development efforts.

Chapter four identifies and analyzes the public policy and management constraints in public debt management in Zambia and relates the public policy to three constraints, namely, balance of payments constraints, the crowding out problems and the interest rate burden. It is argued that structural adjustment programs as prescribed by the IMF and the World Bank were negatively related to efficient and effective public debt management in Zambia.

Chapter five analyses the management capacity constraints. It is shown how poor public debt management compromises efficient and effective public debt management.

Chapter Six discusses the effect of the legal and institutional framework on public debt management in Zambia and contends that a poor legal and institutional framework is negatively related to efficient and effective public debt management. The chapter ends with case studies of the Commitment Control System (CCS) with respect to domestic

debt and Callable Guarantees (CG) with respect to external debt. These are presented in an addendum to the chapter. In terms of relevance, the non observance of the Commitment Control System by policy executioners in government resulted in unimpeded accumulation of the internal public debt which adversely affected efficient and effective public domestic debt management. The case studies on callable guarantees were aimed at showing why the disadvantages Zambia suffered as a result of the public servants contracting public debt in a a manner that not above board and which tended to adversely affect Zambia's public debt management.

Chapter seven discusses the role of foreign aid in Zambia and relates it to the role it played in assisting Zambia deal with its public debt. It is shown how aid had tended to make Zambia complacent and in this way constrained Zambia's capacity to effectively manage its public debt. An aid exit and debt exit strategy is suggested.

The study concludes with chapter eight where recommendations for improved public debt management in Zambia are suggested.

CHAPTER 2

CONCEPTUAL FRAMEWORK AND LITERATURE REVIEW

CONCEPTUAL FRAMEWORK AND DEFINITIONS

Policy makers and analysts often distinguish two parts of a country's public debt of a country, namely, domestic and external public debt. In this study, the central focus shall be to analyze the process of managing the total debt of a country, that is, both domestic and external.

Domestic Public Debt

The Commonwealth Secretariat (1999) defined domestic debt as "the debt a government incurs through borrowing in its own currency from residents of its own Country."[13] This definition of domestic debt is rather narrow, as it does not include contingent liabilities of the public sector and borrowing from central banks through overdrafts or accumulated debts that are turned into stocks.

In this study, the concept of public domestic debt has been widened to reflect the position adopted by the Ministry of Finance and National Planning[14] in which domestic public debt was defined as the totality outstanding payments for government securities (stocks,

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[13] Commonwealth Secretariat, 1999, *Effective Domestic Debt Management in Developing Countries,* London, England. (quoted) in MEFMI 2001 Sustainabilty of Domestic Debt (MFMI, Harare, Zimbabwe) p9

[14] Republic of Zambia, Ministry of Finance and National Planning, *Draft Zambia Domestic Debt Policy and Reduction Policy* ,Lusaka, March 2003.pp6-7

treasury bills, government bonds, special bonds and promissory notes), government corporation (parastatal) debt guaranteed or previously guaranteed by government, loans and advances which include direct borrowing from the Central Bank by the government through bridge loans and overdrafts; other domestic liabilities such as awards and compensation claims, domestic arrears for goods, works and services and un-remitted statutory contributions, and; local government debt which comprises of pension remittances, public works done by local councils and salary arrears.[15]

External Public Debt

In this study, external public debt refers to the liabilities of a country quoted in foreign currency to foreign governments, institutions and individuals. This is the accepted view by many policy analysts including the World Bank and the International Monetary Fund.[16] This definition does not include grants although some grants may have a component of debt. In this study however, aid in form of grants is not considered a debtor country's liability and is therefore not part of the debt a country may have.

Public Debt Management

Having provided the conceptual perspectives of public debt, it is necessary to situate them within the concept of public debt management. The common definition held by the IMF and the IBRD is that public debt management or sovereign debt management is the "process of establishing and executing a strategy for managing the government's debt to

[15] Republic of Zambia, Ministry of Finance and National Planning, *Draft Zambia Domestic Debt Policy and Reduction Policy* ,Lusaka, March 2003, p22-29

[16] See Susan George, (1988) *A Fate Worse than Debt,* Penguin Books,London UK p14. Percy Mistry (1991) African Debt Revisited, FONDAD, The Hague, The Nethrlands pp17-23

raise the required amount of funding, achieve its risk and cost objectives, and meet any other public debt management goals the government may have set, such as developing and maintaining an efficient and liquid market for government securities"[17]. This conceptualization captures all the salient features of public debt management.

Generally, many governments face borrowing problems. In an ideal situation, a government can balance its budget by ensuring that the value of the public debt is equal to the value of the future expected revenue or surpluses. A situation where such a situation is violated would naturally indicate that public finance policy cannot be sustained as the public debt would overtime grow at a rate faster than the growth of the economy. In other words, a sustainable public debt must be one where the rate of growth of debt to GDP is lower than the growth of real GDP. With this conception, it follows that public debt management involves many areas such as (i) capacity to develop a public debt management system; (ii) inclusion of domestic debt in a system of debt management (iii) the integration of public debt management into the overall economic and financial management of a country and (v) public debt sustainability or capacity of a country to pay its debts when they fall due and survive as a nation without endangering its long-term development as a viable nation.

The concept of public debt management has, therefore, both a macro-economic dimension as well as a public administrative dimension. It comprises several functions such as policy function formulation to ensure that the debt is sustainable; the regulatory

[17] UNDP, 1989, *Debt Management and Development Countries* , UNDP, New York. P5

function which sets up the rules for operating units; the accounting function that undertakes payments; the operational function which sources funds; and the supporting functions of resource management, auditing, statistics and information services. The guidelines for public debt management produced by the IMF/IBRD and published in 2001 argued that "governments should seek to ensure that both the level and the rate of growth in their public debt are fundamentally sustainable over time and can be serviced under a wide range of circumstances while meeting cost and risk objectives"[18].

An independent group of experts headed by Lars Kalderen presented a report to the United Nations Development Program in June, 1989 in which they contended that "excessive public debt had been an obstacle to economic growth and development for many countries throughout most of the 1980's and that it had also been one of the most contentious political issues between the North and the South"[19]. This situation therefore demands that scholars and policy makers analyze the problematic and design schemes and policies to overcome the negative effects of excessive public debt that a country may contract.

Public Policy

A policy in this study's context borrows the definition of S. Benjamin Prasad[20] who defined policy as a framework for facilitating managerial decisions about recurring or programmable problems. These problems occur within as well as between operating

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[18] IMF, 2001 *Guidelines for Debt Management*, Washington D.C., USA. P2

[19] Kalderen, L (Ed) 1989 *Debt Management and Developing Countries*, UNDP, New York.p10

[20] Prasad Benjamin S, (1983) Policy, Strategy, and Implementation, Random House, New York, USA p8

units. A policy's immediate goal is the uniform resolution of the problems. Its ultimate goal is efficiency. In contrast, a strategy serves as a framework for dealing with nonrecurring problems at the level of external integration. Its intermediate goal is competitive advantage while its ultimate goal is effective performance. In a study such as ours, it would be necessary to show how structural adjustment policies and programmes impacted on public debt management and suggest a framework for improvement on public debt management.

Public Debt Sustainability

In order to appreciate the problems of ensuring that the public debt is manageable and that the supportive management of the public debt is effective, one needs to first understand the meaning of the concept of public debt sustainability. Any attempt to define a public debt management strategy for a country such as Zambia must consider the long-term manageability of the public debt. Attaining a debt level that is sustainable over time is fundamental when considering public policy implications on its management.

In general, sustainability of public debt refers to a situation where the rate of growth of the public debt to the Gross Domestic Product (GDP) is lower than the growth of the real GDP. In other words, it refers to the level of public debt that can be financed over a determined period of time without incurring an unrealistically large future correction to the balance of income and expenditures. To simplify the analysis, it is better to distinguish between (a) domestic public debt sustainability and (b) external public debt sustainability.

a) Domestic Public Debt Sustainability

The concept of domestic debt sustainability refers to a process where domestic borrowing by the state does not create unnecessary and costly distortions in the economy. If The domestic debt affects the economy adversely through high interest rates, it may in turn lead to a slow down on economic growth. The central point is that whereas borrowing domestically is healthy, it must be within limits because excessive borrowing could be distortionary and it would tend to slow capital formation.

The Commonwealth Secretariat study (1999)[21] argued that the sustainability of domestic debt was a function of the primary deficit, the real rate of interest and the growth of the economy. The study contended that for domestic debt of a country to be sustainable, first, its fiscal deficit must not be more than 3 percent of GDP; secondly, the public debt service should not exceed 15 percent of government revenue; and thirdly, the public domestic debt should not be consistently higher than 200 percent of domestically generated government revenue.

One inherent weakness of the argument proposed by the Commonwealth study was that the proposed thresholds were subjective and therefore could not be made as universal pointers. This proposal may be valid in a country that uses deficit financing primarily for consumption or in a country where there is no fiscal discipline. However, in a situation

[21] Commonwealth Secretariat, 1999, *Effective Domestic Debt Management in Developing Countries*, London, England.

where deficit financing is applied in the productive sector, these rules may not be relevant.

Indeed as the Macro Economic and Finance and Management Institute of Eastern and Southern Africa (MEFMI) (2001)[22] noted, the commonwealth study made the test for sustainability ambiguous even though the rules or thresholds could be used as early warning signals for fiscal sustainability. The Commonwealth proposal in our view could be useful as it at least introduced rules to determine domestic debt sustainability.

After criticising the Commonwealth study, the MEFMI proposed another model. They started by first defining debt sustainability as that rate of growth of debt to GDP, which should be lower than the rate of growth of real GDP. They then suggested another model that utilized the linkages between fiscal deficit and public debt. According to MEFMI, their approach enabled some critical threshold of sustainability that was theoretically plausible to be developed.

The critical threshold of debt sustainability was defined in terms of co-integration analysis. This analysis examines the time profile of debt to GDP ratio and the profile of revenues and expenditures in order to develop some benchmark indicators for classifying countries. The MEFMI study using annual data spanning a 17 year period, conducted time series tests of sustainability and concluded that the domestic debt in Zambia was

[22] MEFMI, 2001, *Sustainability of Domestic Debt*, MEFMI, Harare Zimbabwe, pp5

unsustainable[23]. The MEFMI study further computed and contended that Zambia required adjustment, and to achieve debt sustainability, it had to achieve annual growth rates over of over 8 percent of the Gross Domestic Product (GDP) over a sustained period.

By and Large, the MEFMI study provided a good test for sustainability of domestic debt and also developed indicators of sustainability, which were useful and could suggest to a government to either increase tax and/or decrease expenditures in a country where the domestic public debt is unsustainable. It is however a complex quantitative model which has as yet to be grounded in reality.

Using another threshold model that is recommended by the International Monetary Fund (IMF) and the World Bank in their Highly Indebted and Poor Countries (HIPC) program, a study on Zambia was conducted and resulted in the publication of the Zambia Debt Sustainability Analysis Report (DSA)[24]. This approach stemmed from a preliminary report by the Debt Relief International (DRI)[25] who suggested benchmarks for deciding on the sustainability of domestic debt. The DRI in their study on Ghana suggested the ratios as presented in Table 1. According to the DRI, the ratio of the present value of Domestic Debt/Gross Domestic Product (PV/GDP) would measure the level of domestic indebtedness relative to the country's economic activity. The ratio would suggest how much of the GDP could be accessible to finance the domestic debt burden in a particular

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[23] MEFMI, 2001 , *Sustainability of Domestic Debt* , MEFMI, Harare Zimbabwe,
Ibid pp29-31

[24] IMF, *International Financial Statistics,* 1970-2004

[25] Debt Relief International (DRI) 2002, *Ghana's Domestic Debt Strategy Report*, Paper presented at WAIFEM/DRI Regional Workshop on Domestic Debt Strategy held at Kairaba Beach Hotel, 3-4 June.

year and the DRI suggested a threshold of 14 percent. The other solvency ratio concerning the present value of domestic debt to domestic budget revenue (PV/DBR) was meant to measure a days' cost of domestic debt compared with the government's ability to repay. This was the domestic debt overhang effect on the budget, and the DRI suggested a benchmark of 18%.

Table 1

Preliminary Benchmark Indicators for Domestic and Total Debt Sustainability

	Domestic Debt Indicators	Thresholds (%)
Solvency	**PV/GDP**	**14**
	PV/DBR	**18**
Liquidity	**TDS/DBR**	**28**
	INT/DBR	**6.8**
Total Debt (Ext.+Dom) Indicators		**Threshold**
	PV/DBR	**239**
	TDS/DBR	**40**

Source: Alison Johnson (2002) *Key issues for Analyzing Debt Sustainability*, Debt Relief International, London, Publication Number 5, p21

The liquidity ratio of Total Debt Service/Domestic Budget Revenue (TDS/DBR) was a ratio that measured the government's ability to pay debt service from domestic resources. The DRI suggested a benchmark of 28 per cent. With respect to the liquidity ratio of interest/Domestic Budget Revenue, the suggested threshold was 6.8 per cent.

And furthermore, the DRI preliminary report proposed indicators for total debt and suggested the ratios of Present Value/Domestic Budget Revenue (PV/DBR) and Total Debt Service/Domestic Budget Revenue (TDS/DBR). The thresholds suggested were 239 per cent and 40 per cent respectively.

In relating the above ratios to the question whether Zambia's domestic debt was sustainable or not, the study used the DRI benchmarks to determine the solvency and liquidity of Zambia's debt. This analysis involved asking the question whether it was advisable for the government to continue with its budgetary policy of contracting domestic debt without causing an increase in the Debt/GDP ratio and other ratios. The analysis showed that Zambia's domestic debt was unsustainable.

In general terms, as stated earlier, any pattern of debt contracted can be considered sustainable if it is possible to borrow and finance the interest on debt by additional borrowing. In reality, this does not happen as capacity to lend is sometimes affected by exogenous factors such as confidence. At a certain Debt/GDP ratio, creditors may perceive providing additional lending to be too high a risk and usually may stop advancing any more credit. At that point, the country or debtor will inevitably be in serious financial crisis.

While it is important for policy makers to analyze the debt sustainability of either external or domestic public debt of a country, it is sometimes unnecessary to deal with the internal debt if domestic debt is a small proportion of the total public debt of a country. In such a case, only the external debt will become the real issue. In the case of Zambia, the internal debt began to be an issue in the 1990's and therefore its sustainability needed to be assessed.

The Zambia Debt sustainability Analysis Report (2004)[26] produced by the Ministry of Finance and National Planning to establish Zambia's debt sustainability situation at HIPC Completion Point correctly noted that, where as, there were internationally accepted criteria for assessing external debt sustainability, there were no internationally accepted benchmark thresholds for assessing domestic debt. In the report, they used the averages presented in Table 2 below established with international studies among countries with domestic debt problems.

Table 2

Domestic Debt Sustainability Ratios and Threshold Ranges

YEAR	2004	2005	2006	2007	2013
PV/DBR Threshold	88.0	88	88	88	88
TDS/DBR Threshold	28.0	28	28	28	28
INT/DRR Threshold	4.6	4.6	4.6	4.6	4.6

Source: Ghana's Domestic Debt Strategy Report, WAIFE/DRI Regional Workshop on Domestic Debt Strategy Held at Kairaba Beach Hotel, 3-14 June, 2002, Accra Ghana, p17

Using these ratios, Zambian authorities analyzed several possibilities that the country could face in its public debt management as follows. The three scenarios were: First, was the baseline scenario which assumed that government would continue with its practice of rolling over all government securities at prevailing interest rates, continue to accrue loans and overdrafts with the Bank of Zambia, continue to pay all suppliers' arrears from the budget, continue to pay contingent liabilities and awards and compensation and fill in gap by issuance of government securities.

[26] Zambia, Ministry of Finance and National Planning (2004) Debt Sustainability Report (Lusaka, Zambia)

Secondly, the report analyzed the restructuring of domestic debt. It was assumed government would adopt policies that would lengthen the maturity of its short-term debt, consolidate all government loans and convert them into long-term instruments and fill any budget gap with new short-term debt.

The third scenario was the pessimistic scenario where it was assumed that government would be off track with the IMF under the PRGF resulting in drying up of most donors' Inflows and the country relying more on deficit financing to meet the budget gaps.The analysis of the report is summarized in Table 3.

Table 3:

Domestic Debt Sustainability Scenarios

BASELINE SCENARIO

NPV/DBR	92.7	84.1	85.6	79.8	64.1
TDR/DBR	21.5	54.1	56.7	57.6	38.1
INT/DBR	13.0	15.3	16.4	15.9	10.8

RESTRUCTURING SCENARIO

NPV/DBR	81.3	60.9	63.2	59.3	38.4
TDS/DDBR	19.5	52.2	54.7	55.6	36.4
INT/DBR	10.2	11.4	11.8	10.4	6.3

PESSIMISTIC SCENARIO

NPV/DBR	107.1	98.9	101.7	96.2	49.9
TDS/DBR	26.5	59.2	61.7	62.6	43.1
INT/DBR	14.6	16.2	16.9	18.1	12.3

Source: Zambia, MoFNP, DSA Report, 2004, p49

Having quantitatively provided the various ratios as shown above, the ratios were then related to a subjective threshold range as presented in Table 4 to establish public domestic debt sustainability.

Table 4

Domestic Debt Sustainability Ratios and Threshold Ranges for Zambia

DOMESTIC DEBT INDICATORS	THRESHOLD RANGE (%)
Present value of debt/revenue (NPV/DBR)	88-127
Total Debt Service/Revenue	28-63
Interest/Revenue	4.6-6.8
Debt/GDP	20-25
Debt/Revenue	97-167

Source: MoFNP, DSA Report, 2004, p49

In the domestic debt ratios shown in Table 4 above, they refer to the following conceptualization.

a) Present value/domestic budget revenue ratio referred to the measure of today's cost of debt service compared with the government's ability to pay;

b) Debt service/domestic budget revenue referred to the measure of the government's ability to pay debt service from domestic sources. Debt service was the sum of interest and principal;

c) Interest/domestic budget revenue ratio referred to the measure of the interest cost of domestic debt;

d) Debt stock/Gross Domestic Product ratio referred to the measure of the level of domestic indebtedness relative to the country's economic activity. It implicitly assumed that all GDP was accessible for financing the domestic debt burden, which was not necessarily the case;

e) Debt stock/domestic budget revenue ratio referred to the measure of the level of domestic indebtedness relative to the government's ability to repay. It demonstrated the number of years of revenue required to repay the entire debt stock.

A way of interpreting the above ratios and the threshold ranges in Table 4 was to give the example of solvency ratios of Net Present Value (NPV) of the domestic debt to the domestic budget revenue. The threshold range was 88 – 127 percent. If the calculated ratio fell below 88 percent, it meant the debt was sustainable. If it was between the thresholds, (88 -127) it meant that the debt was becoming unsustainable and if it was above 127 percent, it meant the debt was unsustainable. This interpretation could be inferred on the other debt indicators and the threshold ranges.

So, taking into perspective the baseline scenario, the NPV of the debt as a percentage of the budget revenue would reduce in 2004 from the unsustainable ratio of 92.7 and become sustainable after 2005. However, with respect to the liquidity ratios, the domestic debt would not be sustainable, as the total service to domestic budget revenue ratio would increase from 21.5 percent in 2004 to 54.1 percent in 2005, 56.7 percent in 2006, 57.6 percent in 2007 and 38.1 percent in 2013.

With respect to scenario where the domestic debt was restructured, the solvency ratio showed that between 2004 and 2013, the ratios for Zambia would be below 88 percent meaning that the domestic debt would be sustainable. With respect to the liquidity ratio, the total debt service was generally between 28-63 percent meaning that Zambia would still have liquidity problems, that the domestic debt would still be unsustainable.

As regards the pessimistic scenario, all solvency and liquidity ratios attested to an unsustainable domestic debt.

What can be said about this approach to explain the sustainability of domestic public debt in Zambia? In general, the suggested public debt thresholds are helpful and may assist policy makers appreciate the enormity of the public debt problem. With respect to domestic debt sustainability, it is important that a country such as Zambia borrows from the domestic market but in such a way that the domestic public debt is placed at a volume considered stable.

Whereas these ratios were useful pointers to determining a country's public debt sustainability, these benchmarks were not dynamic enough when applied to a country like Zambia. The conclusion that Zambia's domestic public debt will be sustainable after attaining HIPC completion point was of course contentious. Firstly, whereas there were no internationally accepted benchmark thresholds for assessing domestic debt, the study still used averages established with international studies in countries with debt problems and applied these ratios on Zambia. This could not be necessarily very relevant to Zambia's situation. It is contentious that the solvency and liquidity ratios in the study were all below the threshold points meaning that Zambia's public debt was going to be sustainable on reaching completion point. And secondly, the analyses of the threshold points were subjective and did not relate to the capacity of Zambia to pay the debt overhang.

Whereas in the literature it is generally considered that domestic debt as a proportion of GDP depended on the size of the debt, the primary deficit, the GDP growth rate, the real

interest rate, the rate of inflation and the degree of monetization (which determined the scope for seigniorage or monetization), other scholars have stressed other attributes. Dormar E.D (1944)[27] in his pioneering work on debt sustainability, defined the burden of public debt as the ratio of the total debt to the national income. With a growing national income, taxation required to finance interest liabilities on public debt would not impose an unbearable burden on the economy. The burden of debt is the interest to be paid on the debt. The higher the rate of interest, the greater the burden of debt. What is necessary is therefore to ensure that government expenditures are productive in the sense that they should contribute to the growth of national income. In other words, there is no need to worry about the growing public debt as such. What is important is that the debt is expended productively.

Singh S.K (2006, pp276)[28] quoting Samuelson and Nordhaus, however, observed that a large public debt creates an adverse effect on national income. A large government debt can clearly be detrimental to long run economic growth. First, as the debt accumulates, more and more private capital is displaced resulting in lower national output. Secondly, additional taxes are levied to pay interest on rising debt stock resulting in inefficiencies which in turn leads to lower output. Taking the two together, output and consumption will grow slowly than they would had there been no large government debt and deficit.

[27] Dormar E.D, 1944, The Burden of Debt and the National Income, *American Economic Review*, Dec. 1944

[28] Singh, S.K, 2004, *Public Finance in Theory and Practice*, S. Chand, New Dehli, pp276

In many approaches , the underlying theoretical premise of debt sustainability implies that the debt-income ratio does not grow relentlessly to explosive proportions. Singh, S. K. (2006, pp558)[29] in emphasizing the importance the primary balance plays in stabilizing the debt burden, he noted that "if growth in output exceeds the real interest rate, persistence of primary deficit may lead to a steady growth in debt/GDP ratio. The steady growth in the debt equity-income ratio may continue to a limit, where private saving may not be sufficient to absorb the borrowing required s of the government. Larger stock of debt means greater need to raise resources through tax and non tax revenue measures in order to stabilize the debt/GDP ratio. Solvency condition finally requires generation of adequate primary surpluses. But the people may be unwilling to accept bonds beyond a certain limit and the taxable capacity of an economy is limited. So, the government may be forced to borrow from the Central Bank, that is, take recourse to deficit financing, leading to the generation of inflationary pressures. Sustainable debt is, therefore, identified with stable long-run equilibrium path of the economy."

It is however important that in attempting to determine a domestic public debt that is sustainable, an analyst must first locate a fiscal deficit that is compatible with a sustainable domestic public debt. Primary balance is another macroeconomic tool that can be used to assess debt sustainability. A debt stabilizing deficit can be calculated using an econometric formula suggested by a UNDP sponsored study authored by John Weeks (2006)[30] as follows, where, **Y** represents GDP, **M** represents Money Supply, **B** represents

[29] Singh, S. K. 2004, *Public Finance in Theory and Practice*, S. Chand, New Dehli, , p558

[30] Weeks, J, 2006, *Economic Policies for Growth, Employment and Poverty Reduction: Case Study for Zambia*, UNDP, Lusaka.pp 183-184

Domestic Public Debt Stock, **N** represents Nominal fiscal deficit, **P** represents the Primary Deficit, **I** represents nominal interest rate, **R** represents real interest rate, **Y** real GDP growth rate, and **11** rate of inflation.

Nt = Pt + iBt-1 = (Mt– Mt-t) +(Bt – Bt-1)

Since I = (1 + 11)(1 + r) – 1

P1 + [(1 + 11)(1 + r) – 1]Bt-1 = (Mt –Mt-1) + (Bt – Bt-1)

Simplifying and re arranging

Bt =P1 + (1 + 11)(1 + r)Bt-1 –(Mt – Mt-1)

Using the above formulae, an attempt to establish Zambia's primary deficit compatible with a sustainable domestic public debt can be attempted. In the year 2004, the parameters for Zambia were as follows:

Real Interest rate 10% per annum

GDP growth rate 5%

Debt stock 20% of GDP

Ratio of money to GDP rose between 7 –8% during the year

Inflation 20%

On computing the Zambian parameters, it became apparent that if the economic growth rate was two percent, the maximum primary deficit compatible with the stabilization of the domestic public debt declined to 0.7 percent of GDP. In other words, if the primary deficit exceeded 0.7% of GDP, the domestic public debt would increase. Similarly if the GDP growth rate was 5% but the real interest rate was zero, the maximum primary deficit would be as high as 3.4% of GDP.s for the above scenario were that low interest rates

and rapid GDP growth could make a substantial difference for debt sustainability. As the domestic public debt rose as a share of GDP, macroeconomic stabilization would become a more demanding exercise requiring lower fiscal deficits. Furthermore, the difference between the current primary deficit and its domestic debt stabilizing level would indicate the size of the required adjustment to stabilize the domestic public debt. This stabilization could take the form of expenditure cuts, tax increases or reduction of the interest rates among several measures possible.

(b) External Public Debt Sustainability

The Debt Sustainability Analysis (DSA) Report[31] suggested a number of ratios to determine both liquidity and solvency of a country's external public debt. These ratios, which are the targets provided by the HIPC Initiative and are the basis on which a country may qualify to obtain debt relief, are presented in Table 5.

Table 5

Proposed HIPIC Targets on Debt Sustainability

For Solvency	For Liquidity
NPV/XGS>150%	TDS/XGS>15%
NPV/DBR>250%	TDS/DBR>3%
And if	And if
NPV/XGS<150%	TDS/XGS>15%
NPV/DBR<250%	TDS/DBR>3%

Source: Ministry of Finance (2004) DSA Report (Lusaka, Zambia), p46

Table 5 presents a situation where a country's debt is sustainable if in relation to solvency criteria the net present value of goods and services (NPV/XGS), which is a ratio that measures a country's debt overhang, is below the critical range of 150 percent. The fiscal

[31] MoFNP ,2004, *Debt Sustainability Analysis Report,* MoFNP, Lusaka, Zambia p46

criteria, the Net Present Value to Domestic Budget which ratio measures the effect of a country's debt overhang on the budget must be below the critical range of 250 percent.

Indeed, with respect to liquidity criteria, the Debt Service to exports of goods and Services (TDS/XGS), which is a ratio that measures the liquidity burden of the debt, must be below the critical range of 15 percent. The ratio of the Total Debt Service to the Domestic Budget Revenue must also be below the critical range of 3 percent.

If a country's debt, exceeds the critical ranges given above, then its debt would be considered unsustainable and that it may require assistance under the HIPIC Initiative.

In determining Zambia's debt sustainability, the DSA study[32] on Zambia designed a baseline strategy that took into account seventeen subjective assumptions as the basis for determining whether Zambia's external debt would be sustainable over the years. The DSA report computed the sustainability ratios under the HIPC baseline scenario and the results are as shown in Table 6.

Table 6

Sustainability of Zambia's External Public Debt by Ratio 2002-2006

YEAR	2002	2003	2004	2005	2006

[32] MoFNP, 2004, *Debt Sustainability Analysis Report,* MoFNP, Lusaka, Zambia p32

NPV/XGS(%)	**142.5**	**125.6**	**109.6**	**88.8**	**82.7**
NPV/DBR(%)	**211.8**	**203.2**	**191.2**	**168.5**	**159.6**
TDS/XGS(%)	**1.7**	**10.6**	**14.1**	**11.9**	**4.8**
TDS/DBR(%)	**2.8**	**19.6**	**28.2**	**25.6**	**9.9**

Source: Ministry of Finance (2004) DSA Report (Lusaka, Zambia), p46

The computation in Table 6 shows that solvency condition of Zambia's external debt would be sustainable after the HIPIC debt relief as both the ratios NPV/XGS and NPV/DBR would be below their threshold values of 150 percent and 250 percent respectively throughout the years studied beginning with the year 2002. Starting with a high value of 142.5 % in 2002, the NPV/XGS would decline steadily to lower values. The fiscal criteria NPV/DBR in the DSA study also showed that Zambia's external debt would be sustainable after attaining HIPIC completion point as the threshold would also steadily decline from 211.8 percent in 2002 to 159.8 in 2006 and reach 108.8 percent in 2012. These ratios are far below the critical threshold range of 250 percent. All these assumptions, according to the analysis, would mean that Zambia would not be eligible for supplementary debt relief.

With respect to the liquidity ratios or the debt service, TDS/XGS would rise to a peak of 14.1 in 2004 and then start declining reaching 4.8 percent in 2006 .The TDS/DBR ratio also would follow a similar progression and would all be below the threshold of 15 percent. This means that the Zambia's fiscal budget revenue would exhibit liquidity problems during the period as the resultant ratios are too close to the threshold.

It is quite clear that the preconditions for debt sustainability used by the study cited above were factually implausible. They represented subjective conjecture, which was unrelated to the actual happenings in Zambia. For instance, inflation remained high. From 107 per cent in 1990, it remained in double digits during the period of study. The external debt remained unsustainable as the country failed to reach the HIPIC completion point in 2004.

The objectives of the HIPC initiative were to provide a permanent exit from debt rescheduling by debt distressed countries like Zambia, to raise their long-term growth prospects by removing the debt overhang and to contribute to poverty reduction by using those freed up resources for higher spending on education, health and other social sectors. As already alluded to, all these objectives were unlikely to be met because of many reasons. Firstly, the criterion which was used to calculate the amount of debt relief that a particular HIPC country needed to reach debt sustainability was unrealistic.

In the case of Zambia, the country continued to be vulnerable to the long-term volatility of its exports, mainly copper which accounted for more than 80 per cent of its export earnings and whose prices were controlled by foreign cartels. Furthermore, the debt sustainability analysis was inherently flawed in that by using a three year backward looking average export earnings as the main indicator for determining future debt sustainability, it could not provide accurate medium to long term predictions. And furthermore, the 150 per cent debt to export ratio as a threshold was not only arbitrary but

totally unrelated to Zambia's conditions. The threshold which was derived from Latin American case studies was not only subjective but at variance with the Zambian situation.

Furthermore, the debt sustainability analysis was wrongly premised by linking debt sustainability to export earnings. By doing so, the analysis assumed that the primary constraints to debt sustainability were the inability of Zambia to export, to receive sufficient export receipts. This was an incomplete assumption as, apart from export revenue, Zambia's external public debt sustainability was a function of many other factors such as the magnitude of the debt and the cost of servicing it, the debt burden and the extent of support that the country obtained from co operating partners.

The third and more telling criticism of the IMF/World Bank debt sustainability model was that it overly defined debt sustainability very narrowly ignoring the reality that a country could have a sustainable debt while the majority of its citizens were wallowing in poverty, hunger, disease and backwardness.

Debt sustainability for both external and domestic debt as conceptualized by the models of the IMF and World Bank had been criticized by many other scholars. Hjerthon (2000)[33] noted that the Fund and the Bank adopted HIPC targets in an ad-hoc manner without systematic analytical basis and that they merely reflected a particular IMF and World Bank style of "common sense". The problem of these ratios suggested by the proponents of the HIPC Initiative was that they were all static. They related to one

[33] Hjerthon P 2000, *"Analytical History of Heavily Indebted Poor Countries (HIPC) Debt Sustainability Targets,* University of Copenhagen, Institute of Economics, and Discussion Paper: 00/03

period in time and not over time. This was a major weakness of the model. Furthermore, the threshold levels to measure debt sustainability were arbitrary and too high. And to cap it all, debt sustainability was defined in financial terms and not in human and social development.

Three other pitfalls could be identified in the IMF and World Bank's standard debt sustainability analysis. First, as was amply argued by AFRODAD[34], the standard ignored the foreign exchange constraint in poor countries. It assumed that production could easily be shifted to exports to generate the foreign exchange needed for debt service. But such a re-orientation was difficult in countries with a history of import substitution policies such as Zambia has had. The foreign exchange constraint was particularly relevant when borrower's domestic obligations were denominated in foreign exchange but their revenues whether government taxes or private sector receipts were in domestic currency. The country would default on servicing its debt.

Secondly, in a country such as Zambia, the standard analysis did not acknowledge the difficulty of changing the variables that affected debt sustainability. The sustainability analysis and projections were therefore not based on, and excluded the interest rate a country would have to pay without official support.

[34] AFRODAD 2005 *The Loan Contraction Process in Africa : The Case of Zambia* ,AFRODAD, London, UK.

Thirdly, as was observed by Cohen D (2000)[35] it was important for the sustainability analysis to consider that changes in the exchange rate had a significant impact on debt sustainability. A devaluation of the currency could quickly worsen a country's debt – GDP ratio in domestic currency. Projections needed to take into account the impact of exchange rate changes not only on foreign currency debt but also on debt denominated in domestic currency that was foreign currency indexed.

An improvement suggested by Johnson (2001)[36] was that there was need for a dynamic external public debt sustainability model that recognized movement of debt ratios over time. According to Johnson, this dynamic approach should involve the relationship between the rate of interest and the rate of growth of exports, in the case of external debt, and rate of growth of budget revenue, for total debt. This dynamic analysis of public debt would tell whether the relationship between these variables was increasing, decreasing or remaining constant over time. For example, if the interest rate was higher than the growth in government revenue, this would mean that there was a growing debt servicing burden. Similarly, if interest rates on domestic borrowing were less than the rate of growth of revenue, this would mean that debt service was declining. In this model, countries with debt ratios at or near the top of the threshold range would normally be countries that had already accumulated payment arrears and were facing an unsustainably high domestic burden and could therefore be considered to have

[35] Cohen D ,2000 "*The HIPC Initiative: True and False Promises,*" CEPR Discussion Papers, Number 2632

[36] Johnson A, 2001 *Key Issues for Analyzing Domestic Debt Sustainability,* Debt Relief International, London.

unsustainable domestic debt. Countries below the range would be considered to have public domestic debt that was sustainable.

The major pitfall of Johnson's model was the weakness in or failure recognizing the human rights dimension. This study contends that there is need to have a debt sustainability model or conceptualization that takes into account the necessity for the debt burden to be such that it leaves a country with sufficient funds to meet their human rights obligations. In this study, whereas the maximum benchmark is to end poverty and backwardness for the majority of the citizens, for the sake of realism, the minimum benchmark of these obligations was taken to be the internationally agreed Millennium Development Goals (MDGs) formulated in 1999. On the basis of the MDG's, this study contends that it is possible to configure the amount of national savings, rate of capital formation,, the level of good governance and other factors needed to determine the extent of public debt that would be considered sustainable for each country distressed by suffocating public debt. An attempt to compute these assumptions is another challenge for future research.

It is apparent that the classical mathematical models, where debt is normally considered "sustainable" if its discounted value was less than two to two and half times annual exports, and if the payments on principle and interest are in the range 20 to 25 percent of exports, were not very useful in addressing Zambia's capacity to redeem its public debts. These approaches only took into account what was practical in terms of paying back loans. A more useful model must be one that captures the need for Zambia to eliminate

poverty and underdevelopment, and takes into account the broader economic and human context. Sustainability of the domestic and external public debt should therefore, be defined not in narrow accounting terms, but in terms of what is needed to eradicate poverty and underdevelopment.

Several approaches as argued above have been developed to assess external debt sustainability. Firstly, it was possible to determine a country's debt sustainability by analyzing its balance sheet, as is the tradition in private corporations. This could be a very good indicator to show whether a country's current and future assets are sufficient to cover all liabilities that may fall through. An attempt to arrive at a reasonable balance sheet for Zambia for the year 2004 could not be made by this study on account of the lack of adequate information both on the asset side as well as on the liabilities side of government accounts. The reasons for this were not far to get. It is not possible to know with exactitude the value of all assets of a government because some of them have as yet to be discovered and exploited. Secondly, it is possible to measure public debt sustainability by calculating ratio relationships such as the following: Debt to GDP ratio which was used to monitor and measure the sustainability of the debt; External debt service to Exports which measured the ability of the economy to generate foreign currency needed to service foreign debt; Debt service to revenue; Debt service to GDP; Exports to GDP; Interest to GDP; Development Expenditure to GDP and so on. The study analyzed some of these other ratios within the Zambian context.

There are two ways in which the Debt to GDP ratio, the Debt to GDP ratio could increase. First, when the real interest rate exceeded the real growth rate. In this case, rising interest payments would cause the debt ratio to rise. Secondly, when a country run a primary deficit and the nominal interest rate was greater than nominal GDP growth rate. In this case, the debt ratio would also rise. The primary deficit of the country's budget can be expressed as in the following arithmetic formula: PD=(Rg+Ge – (Eg-Lg) where PD represents the primary deficit, Rg represents the total revenue, Ge represents grants, Eg represents expenditure and Lg represents interest payments. This measure can be used to assess the growth of debt attributable to non-interest debt. If the growth rate was higher than the prevailing interest rate, existing debt could be serviced by sale of new debt. On the other hand, if the real interest rate exceeded the growth rate, to contain the debt ratio, the government had to use its own resources to service the debt. A government running a primary deficit often did this.

In ending this conceptual framework, it can be said that while there is general agreement by debt management practitioners on the conceptions of what constitutes domestic public debt and external public debt; what public debt management entails; the nature of public policies relevant to debt management; and the conception of public debt sustainability, there is still need to contextualize these concepts to countries specific.

LITERATURE REVIEW

This literature review discusses the work done in the areas of state borrowing, the emergence of a public debt crisis, the issue of public debt policy, the legal and

institutional framework, the need for effective and efficient public debt management, and the effect of foreign aid on public debt management. These dimensions are the areas this study examined in its research.

State Borrowing

The management of the public debt, its growth and its historical emergence has been a controversial issue in the debate over responsible fiscal policy. The work of Smith and Cuddington (1984)[37] provided a summary of the issues. Some critics have not only faulted state borrowing especially deficit financing for being inflationary, but also contended that it overburdened future generations. David Hume (1771-1776)[38] was one of the first scholars to address the subject and criticized the idea of deficit financing. Adam Smith (1937)[39] devoted forty pages of his work "The Wealth of Nations" criticizing the principle of deficit financing. David Ricardo (1951)[40] also condemned public debt creation by governments and noted that this principle tended to destroy capital. This criticism was extended further by J.S. Mill (1915)[41] who viewed the public debt as a double burden which had to be opposed. Generally, all these classical scholars opposed the idea of public debt creation and subscribed to the need for states to adhere to balanced budgets. These protagonists based their approach on the principle of strictly controlling growth in the money supply and argued that this approach was the one sufficient and essential condition for the control of inflation. The basic flaw of this monetarism was revealed in practice, not because it was ineffective in bringing down

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[37] Smith, W and Cuddington, J.T. (eds)1984 *International Debt and the Developing countries,*. A World Bank Symposeum.

[38] Quoted (in) Buchanan, M J. 1958 ***Public Principles of Public Debt*** ,Richard D Irwin, Inc, Homewood, Illinois, USA.

[39] Smith, Adam ,1957, ***The Wealth of Nations*** (Morden Library Edition, New York) pp859-900

[40] Ricardo, David ,1951, ***Funding System : Works and Correspondence,*** Volume IV, London, p187

[41] Mill, J. S. 1915 ***Principles of Political Economy,*** Ashley , London, p873

inflation, but because it could only do so by means of strangling the real productive economy, and then could not prevent a recurrence of inflation in the event of a sustained revival of growth.[42]

The above view differed sharply from those who advocated the administrative control of prices and wages as the most appropriate means of controlling inflation. John Maynard Keynes (1936)[43] in his seminal work "The General Theory of Employment, Interest, and Money" debunked the classical view that low levels of demand in an economy were self-correcting. Keynes advocated that when an economy was in or likely to go into recession, the central government must engage in deficit spending. This doctrine meant that a government could borrow money to spend on public works and other public goods. In so doing, the government would expand overall demand. Keynes further advocated expansionary monetary and fiscal policies, meaning, the use of expanding money supply and lowering taxes to stimulate economic activity. Broadly speaking, Keynes advocated the management of demand to maintain full employment in the economy.

The Keynesian advocacy of deficit financing has however been opposed by the so called neo-monetarists who take the view that the control of inflation in an economy is more important than reducing unemployment. These criticisms are closely identified with the ideas of the Nobel Prize-winning Professor Milton Friedman[44]. The neo-monetarists advocate tight monetary and fiscal policies and the balancing of state budgets. They warn

[42] Mistry, Percy 1991, *African Debt Revisited*, FONDAD, Helsinki.

[43] Keynes, J.M. 1936, The General Theory of Employment, Interest and Money, McMillan, London, UK

[44] Friedman, M. 1958, *Foreign Economic Aid: Means and Objectives* , Yale Review, summer, pp24-38

of the future consequences of debt accumulation and its burden upon later generations. Neo-monetarists contend that debt finance places an unfair burden on future generations, firstly, by reduced capital formation when resources shift from the private sector to the public as occurs when the state borrows domestically, and secondly, by sadling future generations with an obligation to service the foreign debt.

The weakness of the neo-monetarist conception is that they confuse the tasks at hand. The question is not whether a government can repay the debt, because public debt and the economic management are a continuing undertaking. When a debt issue matures, it is paid off as the necessary funds are obtained by issuing new obligations. The issue rather is how interest service will affect the economy and how outstanding debt enters into the liquidity structure of the economy.

The reality on the ground which this study is agreeable with is that all countries incur public debt of one type or another purely on the basis of necessity. For instance, over 80 per cent of Organization of Economic Cooperation and Development (OECD) governments borrowing was in the form of marketable instruments such as government bonds and treasury bills.[45] On average, since the year 2000, OECD countries have been running budget deficits of around 4 per cent of GDP. Even prudent Asian governments, including Japan, have been running budget deficits of an estimated 3 per cent per annum during the decade 1980-90. The OECD predicted that by 2008, its members would be sitting on central government debts totalling 86 per cent of their combined Gross

[45] Mellon, J and Chalabi, A.L 2005), ***Wake Up! Survive and Prosper in the Coming Economic Turmoil*** ,Capstone Publishing, London, UK.

Domestic Product (GDP)[46]. This situation repeats itself in almost all developing countries.

In relation to this study, the above experience of other countries is important as it will show whether the contraction of the public debt in Zambia was consistent or not consistent with conventional practice of public debt management. In other words, how did deficit financing affect public debt management in Zambia? The position of this study is that deficit financing is sustainable if it is directed towards wealth creation. It becomes unsustainable if it is used in consumption related public expenditure.

The Public Debt Crisis

There is generally no single definition of what should constitute a public debt crisis. Many studies have taken a case study approach compiling the difficulties specific countries are subjected to. Bears, David and Bhatia (1999)[47] in their study published in Standard and Poor's "Credit Week" of December 22, 1999 was a case in point. It simply indicated the difficulties countries with huge public debts faced with respect to macro economic stability indicators. For instance, a huge debt overhang may force trading partners to stop providing additional supplies of goods and services giving the condition that supplies would only be made after only earlier debts are settled, This can adversely affect a country's macro-economic stability

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[46] Mellon, J and Chalabi, A.L.2005, ***Wake Up! Survive and Prosper in the Coming Economic Turmoil,*** Capstone Publishing, London, UK

[47] Bears, David T and Ashok Bhatia ,1999, " Sovereign Defaults: History" (in) ***Standard and Poor credit week,*** December 22

Other studies take a quantitative approach. Such is the approach that was taken by Detragianche et al (2001)[48]. They defined a country to be in a debt crisis if the country had arrears on external obligations towards commercial creditors in excess of five percent (5%) of commercial debt outstanding or had a rescheduling or restructuring agreement with commercial creditors. This quantitative definition can also be criticized. Firstly, it does not differentiate between sovereign or private sector arrears and or rescheduling due to data limitations. Secondly, the definition might exclude some debt difficulties that could have been avoided by large-scale support from donors.

Another quantitative method suggested by Manasse and Roubini (2005)[49] is the use of the Binary Recursive Tree Methodology (BRT) for classification and prediction of a public debt crisis occurring in a country. This model is a quantitative approach which searches for patterns and relationships in the data. The methodology is highly statistical and further amplification of it can be found on www.salford-systems.com/. Manasse and Roubini applied the methodology to Colombia for the year 2004 in order to evaluate default in risks. The following questions and answers were used to establish Colombia's debt situation:

a) "Does total external debt exceed 49.7 percent of GDP?" No. Columbia's total debt was 48.6 percent of GDP.

b) Is short-term debt over reserves above 130 percent? No. Its value was 98 percent.

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[48] Detragianche, Enrica and Antonio Spilimbergo ,2001, "Crises and liquidity: Evidence and Interpretation" *IMF working paper 01/2* ,Washington DC.

[49] Manasse, Paul and Roubini, Nouriel "Rules of Thumb for Sovereign Debt Crises", *IMF working paper, WP/05/42, Washington D.C., IMF, 2005*

c) Is "public external debt above 215 percent of revenue? No. It was 100 percent.

d) Is the economy growth rate above -5.45 percent? No. It was 3.13 percent.

The result according to this model was that Columbia in 2004 was not crisis prone. It had a crisis probability of 2.3 percent.

Using the same methodology, they argued that one could classify countries into four typologies, namely; relatively safe, liquidity crisis-prone, unsustainable debt path (solvency) crisis prone and exchange rate and macro crisis-prone type.

In respect to this study on Zambia, the typologies if applied for the year 2004 which is the baseline year of this study would have put Zambia's public debt in an unsustainable position for two thresholds (a) and (b) but would be sustainable in (c) and (d). This methodology was therefore not very helpful in providing a total picture of public debt sustainability for a country such as Zambia as it failed on two of the four measures.

With respect to literature on Zambia, the only published study that attempted to discuss the debt crisis was that by Fernholz, F.R. (2004)[50] in which he discussed approaches which the Zambian government used to deal with the massive debt problem in the early 1990s and its failure to expand and sustain the strategies. The study correctly concurred with Easterly W (2000)[51] that focusing on debt relief without altering the basic structure

[50]Fernholz,F.R, Debt Management and Debt Relief during the 1990s in Zambia (in) Hill, C.B and McPherson, M.F. 2004, *Promoting and Sustaining Economic Reform in Zambia* , Harvard University, USA.

[51] Easterly, W, 2000, "How did Highly Indebted Poor Countries Become Highly Indebted? Reviewing Two Decades of Debt Relief" ,World Bank, Development Research Group, *Working Paper , no. 2225,* June

of an economy and its policies would only lead to another round of external debt accumulation after the effects of debt relief fade.

In concluding this section on the debt crisis, in general, many studies and methodologies do provide plausible explanations of what caused the debt crisis in each country studied as well as models for explaining features that may lead to rise of debt problems. Jonathan and Fernandez (1995)[52] summarize the various solvency and liquidity measures. As earlier indicated, using solvency measures such as the debt to GDP ratio, measures of liquidity such as short-term debt over reserves or exports and debt service over reserves or exports. In addition, there are other macro-economic factors used to analyze the debt crisis such as real economic growth, inflation, exchange rate over-valuation, and the fiscal balance and exchange rate volatility. Taken together, the literature suggested several factors that were at the core of empirical modes that attempted to predict the possibility of public debt crisis happening in countries. This study will apply some of these models to the case study on Zambia to determine their use value.

Strategies against the Debt Crisis

At a global level, many suggestions to the solution of the debt crisis have been made. Several suggestions dealt only with part of the problem while others are flawed intrinsically for various reasons. Lomax (1986)[53] for instance identified 29 proposals that

[52] Eaton, Jonathan and Raquel Fernandez 1995," Sovereign Debt" NBER Working Paper 5131 prepared for Handbook of International Economies for a Systematic Survey of Literature on Sovereign Debt, Hemming, Richard

[53] Lomax F.D. ., 1986, *The Developing Country Debt Crisis*, McMillan Press, London.

had been suggested between 1980 and 1986. Later on, other suggestions were added and ranged from radical alternatives suggested by President Fidel Castro[54] to simply repudiate the debts to moderate alternatives. Morris Miller (1989)[55] listed 14 compilations and more than 80 proposals. The early international response after the 1978 global debt crisis emphasized case – by – case marked based approaches to resolving balance of payments of developing countries[56]. The drive was centred on the principles of debt rescheduling aimed at preserving the contractual present value of the debt and structural adjustment to increase the present value of the debt. It was assumed that debtor countries such Zambia were illiquid temporarily but not insolvent. The challenge was to re capacitate a debtor country to enable it service its debts in the long run. In other words, the objective was to return a debtor country to budgetary solvency. This strategy failed as the adjustment in reality meant high costs in terms of reduced investment and output and compressed domestic consumption.

Against this failure of Structural Adjustment Programmes (SAPS) which was apparent by 1985, the creditor nations and institutions pioneered other initiatives to address the debt problems of developing countries.

The first of the initiatives included those suggested by United States Treasury Secretaries beginning with James Baker[57] who at a meeting of the IMF/World Bank held in Seoul,

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[54] Castro, Fidel, 1992, *Grandmal* op cit

[55] IDRC ,1992, ***The Global Cash Crunch ; An Examination of Debt and Development*** , (DRC: Ottawa, Canada, p24

[56] Miller M ,!989), ***Resolving the Global Debt Crisis*** (UNDP, New York). See also: Obadan, M.I. ,2003, ***The External Debt Crisis; Strategies and Policies*** ,Zed Press, London, pp140-163

[57] Statement of the Honourable James A. Baker 111, before the Joint Annual Meeting of the IMF/World Bank, 8 October, 1985, Seoul, Korea .(in) "*Treasury News*" Mimeo.

Korea presented a plan which was aimed at assisting the debt crisis of middle income countries. The plan involved disbursing US$20 billion to 15 countries. After the money was provided, the countries that benefited from the loans did not become credit worthy as much of the lending instead of increasing economic growth, was used to finance interest and principal repayments to the financial institutions.

After observing this inadequacy that new lending and adjustment policies alone were insufficient to reduce the debt overhang, another American Treasury Secretary Nicholas Brady[58] in 1989 reformulated the Baker Plan and stressed debt reduction. However, the Brady Plan also did not go far enough and also failed to solve the problems of the debt-distressed countries.

The last attempt by the United States was the initiative so called the Houston Terms which were jointly proposed with France at the G7 meeting in July 1990. This initiative was directed at lower middle-income countries and included debt rescheduling of all types. This initiative also failed.

On the bilateral front, many initiatives were suggested under the Paris Club protocols to address the debt problems of developing countries. These initiatives included, firstly, the Venice Terms proposed in June, 1987 in which poor adjusting countries were to pay lower interest rates on their debts and be given longer repayment period with longer grace periods. Secondly, were the Toronto Terms proposed in June 1988 and adopted by the World Bank/IMF in October 1988. The terms called for partial debt write-off, lower

[58] Senator Bill Bradley, *A Proposal for Third World Debt Management*, Zurich, 29 June, 1986. Mimeo

interest rates and extension of maturities. Thirdly, there were the Trinidad Terms proposed by the Commonwealth Finance Ministers in late 1990. The proposals included cancelling by creditors two thirds of the stock of debt, rescheduling of the remaining debt over 25 years including five years of grace period.

Fourthly, there were the Enhanced Toronto Terms also called the London Terms adopted in December 1991. These terms provided for additional debt relief of up to 50 per cent of eligible debt in net present value terms. The fifth initiative was the Naples Terms also known as the "exit rescheduling" which were adopted by the Paris Club in December 1994 following the G7 summit in Naples, Italy. The proposals tied a country benefiting to several conditional ties to be supervised by the IMF.

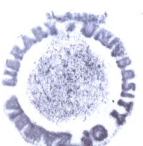
All these initiatives proved to be inadequate and all failed to resolve problems of the debt overhang of developing countries. Reduction of debt did not go far enough. This was particularly apparent as debt reduction did not include multi lateral debt from institutions like the IMF and the World Bank as they claimed that their debts could neither be rescheduled nor cancelled.

The last initiative was the Highly Indebted Poor Counties (HIPC) initiative proposed by the IMF and the World Bank in 1996 did not drastically differ from earlier failed initiatives aimed at resolving the debt problems of developing countries. The HIPC initiative covered 41 countries of which 33 were in Africa. The aim of the initiative was to reduce the debt burden of these countries to levels that would enable them service their

debts from their own resources and donations. Sustainable debt was defined in 1996 as a stock of debt with a net present value of 200-250 per cent of annual exports and a debt-to-government revenue ratio of 280 per cent. These thresholds were obviously unrealistically too high and after criticism, were reduced in 1999 to a debt to export ratio of 150 per cent and a debt-to-revenue ratio of 250 per cent. This adjustment boosted the net present value of potential debt reduction from US$12.5 billion to US$27 billion.

For a country to qualify for assistance under the HIPC initiative, several conditional ties were imposed. A country had to adopt a Structural Adjustment Programme (SAP) and policies supported by the IMF/World Bank. A country had also to be Enhanced Structural Adjustment Facility (ESAF)-eligible, IDA only and facing an unsustainable debt. A country wishing to benefit had therefore to first conduct a debt sustainability analysis (DSA) study and establish a track record of performance criteria for a minimum period of six years (3 years to decision point and another 3 years or more to completion point).

The weaknesses of the HIPC initiative have already been apparent in many countries. The initiative was neither complete nor effective. Firstly, the lack of inclusion of domestic debt in calculating the debt service burden condemned the initiative to failure from the very beginning. Secondly, the debt sustainability analysis conducted to determine eligibility and the basic assumptions made, were subjective and not consistent with reality. Thirdly, the performance criteria under the mandatory Structural Adjustment Programmes (SAPs) were too stringent and not only destabilized the political unity of HIPC countries but also adversely affected the social sector performance. And lastly, the



performance period of a minimum six years before a country could obtain debt relief was too long. Because of these flaws, many HIPC countries even after attaining completion point were bound to fail to meet their external resource requirements, including debt servicing without debt rescheduling or accumulation of arrears on unpaid debt. In other words, they would continue to face the problem of external viability.

With respect to Zambia, which was the subject of this study, its policy environment between 1964 and 1991 was based on import substitution industrialization as opposed to export led growth[59]. This development approach did not help Zambia establish the capacity to export and earn foreign exchange to support debt service. The Zambian government together with the International Monetary Fund (IMF) and the World Bank assumed that the price of copper would pick up and thereby make Zambia be in a position to service the public debt. This did not happen. When the debt crisis began, the government was compelled to seek assistance from elsewhere.

Zambia began implementing various economic programs supported by the IMF and World Bank after the 1973/74 when it began experiencing balance of payments problems. These economic programs, which had several name designations, such as, Standby Agreement, Structural Adjustment Facility, Enhanced Structural Adjustment Facility, Policy Framework Paper, Rights Accumulation Program, and the Poverty Reduction and Growth Facility (PRGF) were all aimed at making Zambia be credit worthy and be able to service its external debts.

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[59] Chitala D, 1988, "Zambia's Import Substitution Industrialization Policy and its Role in The International Division of Labour (in) , Moroney, Sean (Ed) ***Industrial Development in Africa,*** Africa File Limited, London ,UK.

In spite of all these programmes, Zambia still remained poor and highly indebted both externally and domestically. All these IMF initiatives presented several inherent weaknesses. The ESAF loans did not solve Zambia's debt problems. In fact, as Grusky[60] showed, ESAF loans contributed to the debt treadmill and worsened the country's debts.

Similarly, the HIPC initiative under the IMF supervised Poverty Reduction and Growth Facility (PRGF) as noted earlier did not actually amounting to much relief in real terms. A publication of the Focus on the Global South published in October 2000 observed the following. "The most glaring problem with the HIPC initiative for debt relief is that it will not provide lasting relief from debt for the HIPC countries of the South. The HIPC process is aimed not at cancelling debts, but at ensuring that they can be repaid. It has little to do with enhancing human development, reducing poverty or even increasing economic growth to the debtor countries. Rather, it is designed to massage debt figures down to a level where they would be deemed "sustainable" again according to the criteria of the IMF"[61].

Furthermore, for most HIPC countries, the debt reduction on offer was too small[62]. Zambia, for instance will actually pay more after the initiative than it paid before the initiative. The following observation explicitly defines Zambia's predicament. "Zambia's diligence in pursuing World Bank and IMF – led reforms has resulted in an

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[60] Grusky, S, April, 2000, "The IMF and the World Bank : A New Reform Package; The Poverty Reduction Strategy Papers: An Initial NGO Assessment "(in) *Jubilee 2000*, London, UK, page 9.

[61] Broker, S ,December, 2000,The Myth of HIPC Debt (in) ***The Mail and Guardian*** ,December, 2000. p6

[62] Hjertholm. P ,2000, ***Analytical History of Heavily Indebted Poor Countries (HIPC) Debt Sustainability Targets,"*** University of Copenhagen, Institute of Economics Discussion Paper : 00/03.

increase in the poverty gap and the weakening of the country's social services. Its debt burden has fundamentally undermined its efforts to tackle the HIV/AIDS crisis, and the numbers infected continue to rise above one million. Zambia has been forced to strain its resources to the limit in seeking to meet its huge debt service obligations... As Africa debt service obligations grow each year, and as Africa's people are forced to repay these debts by mortgaging their health, their education and their future, it is time to acknowledge that the cancellation of Africa's debts represents the only just solution"[63].

Even the World Bank's Chief Economist, the Nobel Award winner Joseph Stiglitz in 1998 condemned the HIPC initiative as being misguided and called for a more humble approach to macroeconomics and a commitment to honour promises made in social sectors[64].

In looking at solutions to the debt problem of developing countries, another report of the Executive Committee on Economic and Social Affairs of the United Nations[65] contended that beyond the immediate task of reducing the excessive debt burden of developing countries through the HIPC initiative and other initiatives, thought should be given to the adoption of preventive measures to avoid unsustainable public and private debt in the future. Those measures must aim at ensuring responsible lending and borrowing habits notably through increasing the accountability and transparency of borrowing and lending

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63 Focus on the Global South , October, 2001 "The Transfer of Wealth: Debt and the Making of a Global South" (Chapter 4).

64 Stiglitz,J , 2004, **Globalization** ,Harvard University, Mass. USA.

65 United Nations Organization ,May, 1999 **"Report of the Executive Committee on Economic and Social Affairs** ,UNO, New York, page 3.

activities undertaken by public and private economic agents. The debt management capacity in debtor countries should also be strengthened.

Other debt relief campaigners notably Jubilee 2000 and AFRODAD[66] have been calling for complete cancellation of all HIPC debts. Generally, in most developing countries, this appears to be the inevitable conclusion. If the debt is not drastically reduced, adjustment itself cannot be on a sustainable basis to enable these HIPC countries resume growth.

On the other hand, the IMF and World Bank staffs[67] while conceding that debt reduction is necessary argued that it was insufficient for a return to creditworthiness of HIPC countries. In reducing the debt stock and debt servicing, it was important at the same time to address or restore the economic policies and management practices that were prudent. The IMF/World Bank argued that by making suitable changes in relative prices, policies and institutions, by reconnecting public investment and by bringing about other structural changes in the economy while freeing the domestic resources from being transferred to external creditors, a country's debt servicing obligations would become commensurate with its debt servicing capacity and it would eventually be able to restore creditworthiness.

Whereas the IMF and World Bank view appears to be logical, the test is in its application. The adjustment programs that are uniformly recommended are long and difficult

[66] Jubilee 2000 (2000) An Emerging Scandal: Debt Cancellation and the Broken Promise of Cologne ,Jubilee 2000, UK

[67] IMF and World Bank Staffs, (July, 2001) 100 Percent Debt Cancellation? A Response from the IMF and the World Bank Washington D.C. USA, PP1-6

processes. Liberalization often causes the collapse of local industries. Globalization often reduces these countries into dumping grounds for cheap imports and impedes the objective of industrialization.

Public Debt Policy

Scholarly work on the effect of public policy on public debt management has a long history. As already shown above, the pioneering work of Maynard Keynes[68] perhaps more than any other provided the justification for governments to contract public debt including by way of deficit financing to support growth and development of a country. However, while appreciating the necessity of deficit financing, Keynes also noted the problems the public debt may bring about. Keynes (1963) discussed the problem of debt burden when he analyzed the fate of German reparations. He noted correctly that heavy debt payments may divert national savings from investment in the export oriented activities required to generate the balance of payments surplus needed to service the debt. In other words, a heavily indebted country cannot generate the surplus needed to grow rapidly enough to service the debt.

In most post-colonial African countries, the development paradigm that was followed in the 1960s and 1970s centred on emphasis on Central Planning and Physical target setting, administrative and discretionary controls on the allocation of scarce resources and the establishment of state enterprises for production. Husain(1993)[69] noted then that

[68] Keynes, M, 1963, *Essays in Persuasion* , Noton and Company, New York,

[69] Husain, Ishrat,1993, External Debt and the Development Process (in) *UNITAR, Document Series No.3 – **Good management Pays***, UNITAR, Geneva.

Development policy emphasized (a) distribution and trade in all economic sectors, (b) expansionary fiscal policies with budgetary deficits supported by external borrowing, and (c) import – substitution strategy of industrialization under protective tariff and non tariff barriers. This policy approach inevitably led to the expansion of public debts in these countries which in due course became unsustainable.

A major contributing factor to poor public debt management was the public policy constraints which were reflected in apparent neglect of debt management. A report by the United Nations Development Program (UNDP)[70] identified the following four functions of debt management that had been neglected.

1. Having accurate and up-to-date records of all external loans;
2. Being fully aware of the timing and amounts of debt servicing obligations;
3. Being able to project the impact of borrowing decisions of various entities on the country's overall debt profile and balance of payments, and;
4. Ability to benefit from various innovations and instruments available in the international financial markets and designed to reduce costs or risks to the debtor.

Having identified these factors, the UNDP report recommended two possible areas for international intervention regarding debt policy. First, to reduce, in an orderly fashion, the debt overhang and debt service payments to levels which were commensurate with the economic capacity of debtor countries. Secondly, to prevent the renewed build-up of

[70] UNDP, 1997, ***Debt Management***, magnet.undp.org/Docs/efa/DEBT.HTM

debt beyond prudent levels, a danger which might present itself once creditworthiness had been restrained.

However, whereas these recommendations appear reasonable, there were major factors that impeded effective public debt management in many developing countries which if not addressed, any attempts by the international community to assist would prove futile. Husain (1993)[71] identified five scenarios. Firstly, there were countries that had pursued rapid expansion of exports and had experienced favourable terms of trade such as those in East Asia. These countries largely avoided debt problems as the growth of their exports were higher than the growth of interest payments which factor enabled them to reduce their debt burdens relative to exports. Secondly, there were those countries that pursued import –substitution industrialization policies instead of export led growth. These countries stagnated. Thirdly, there were countries that immediately took measures to adjust in the face of the oil crisis, curtailing consumption in the public sector and refused to resort to excessive foreign borrowing. These countries did not face severe payment difficulties. Fourthly, there were countries that made prudent investment and efficient use of resources – investing in infrastructure, human capital and expanded productive bases. These did not suffer a debt crisis. And lastly, there were countries that emphasized more effective decentralized economic institutions and more diversified production systems. These did better than mono–economies and those that had central control over all economic activities.

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[71] Husain, I , 1993, External Debt and the Development Process (in) *UNITAR, Document Series No.3 – **Good management Pays***, UNITAR, Geneva.

Furthermore, Husain (1993)[72] in showing the difference between East Asia and Sub Saharan Africa showed how Asian countries had to use five strategies in a successful effort to transform their countries. Firstly, leadership was the key factor. The leaders forged national visions that were sensitive to national aspirations and captured the imagination of all sectors. Secondly, their economic policies were based on competitive advantage as opposed to mere comparative advantage. Thirdly, there was political will and integrity. Fourthly, there was a dynamic and incorruptible private sector that worked with government. And fifthly, the challenge was to become a centre of excellence rather than be a market for imported goods. Following these policy perspectives, Asian countries were able to become the magnet of global investments and come out of the debt trap.

In respect of the above five strategies in the context of Sub Sahara African countries; the opposite of the proposed results was generally the norm. Leadership of the countries was weak with many counties being administered by authoritarian dictators. Economic policies were based on import substitution strategies as opposed to export growth strategies. Many countries had no political will to break with neo colonialism. Corruption in both the public and private sector was rampant. Lastly, the countries remained raw material producers and exporters and net importers of manufactured goods.

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[72] Husain, I , 1993, External Debt and the Development Process (in) *UNITAR, Document Series No.3 – **Good management Pays***, UNITAR, Geneva.

With respect to Africa's public debt crisis, Rugumamu (2005:101)[73] observed that the huge indebtedness had crushed all possibilities for economic growth by diverting scarce resources needed for health, education and infrastructure as well as contributing to the continent's further marginalization from the global system. The Southern Commission (1990:227)[74] observed that "debt had become a form of bondage, and the indebted economies had become indentured economies – a clear manifestation of neo-colonialism".

It is from the above perspective that this study is of the view that repayment of Africa's external debt cannot and should not be met given the structural, political and economic constraints imposed by the global economy. Rugumanu (2005)[75] even went further to insist that even if all debt was cancelled, many problems which led to the debt crisis would continue to exist. Therefore, major policy changes in both the creditor and debtor nations were required in order to generate long-term economic prosperity in Africa. Walter Rodney (1972) had shown how sub-Saharan Africa suffered a drain of wealth. "The question as to whom and what is responsible for African underdevelopment can be answered at two levels. Firstly, the answer is that the operation of the imperialist system bears major responsibility for African economic retardation by draining African wealth and by making it impossible to develop more rapidly the resources of the continent"[76]. In other words, as Patrick Bond (2006) put it, "the central process was associated with exploitative debt and finance, phantom aid, capital flight, the brain drain, unfair trade,

[73] Rugumamu, S ,2005, ***Globalization Demystified*** (Dar es salam University Press, Tanzania, p102
[74] South Commission ,1990, ***The Challenge to the South*** ,Oxford University Press, Oxford, p227
[75] Rugumamu, S.M. ,2005, ***Globalization Demystified*** ,Dar es salam University Press, Tanzania, p106
[76] Rodney, Walter ,1972, *How Europe Underdevelopment Africa*,(Dar es Salaam Publishing House, Dar es Salaam Tanzania

distorted investment and the ecological debt the North owes the South, in the context of profoundly undemocratic global power relations"[77]. The above points attested to the need to have a public policy regime that was anchored on production of goods and services as opposed to consumption based public policies.

A discussant's paper presented to the Annual Bank Conference on Development Economics (ABCDE), World Bank in Paris, in May 15 – 16, 2003 by Seshamani[78] argued that creditor countries and institutions are not wholly responsible for the debt burden reaching crisis proportions or the poor state of development in the poor countries. This assertion appears to partially contradict the arguments of other academicians who entirely place the blame on structural adjustment programs forced on poor countries by the creditor nations and multi-lateral institutions[79]. In defence of his stand that even poor countries themselves contribute to the public debt crisis in their countries, Seshamani asserted that "irresponsible governments (through wrong policy regimes, reckless profligacy in spending patterns, corruption and personal enrichment by leaders, lack of genuine commitment to development) and uncontrollable external factors (such as adverse terms of trade, transmission of economic contagion, changes in weather patterns resulting in droughts and floods) have also played their roles"[80]. These assertions or assumptions can only be confirmed if subjected to a case study of a specific country.

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[77] Bond, Patrick, 2006, *Looting Africa* ,The University of Natal Press, Pietermaridzburg, South Africa, p5

[78] Seshamani, V ,1990, *Towards a Human Development Approach to Debt Sustainability*, Discussant Paper to the Annual Bank Conference on Development Economics, World Bank, Paris, May 15-16, 2003

[79] Bond, Patrick, 2006, *Looting Africa* , AED Press, London.

[80] Seshamani V ,1990, *Towards a Human Development Approach to Debt Sustainability*, Discussant Paper to the Annual Bank Conference on Development Economics, World Bank, Paris, May 15-16, 2003

In concluding this section, it is apparent that it is important to adopt public policies that are aimed at job and wealth creation and which insure that the public debt is sustainable, namely, that the rate of growth of the public debt is lower than the rate of growth of real GDP and which would enable a country meet its human rights obligations to its nationals. The public debt and any problems arising there of any country is largely a creation of the public policies that it follows. While there are several strategies that can be used to resolve the problems of the public debt overhang such as debt rescheduling and cancellation, this study holds the view that there is need to adopt public policies that aim at avoiding wastage and which help to advance growth and development. The structural adjustment policies that the Zambia government practiced between 1991 and 2004 tended not to advance efficient public debt management as the debt overhang continued to be high and unsustainable.

In relation to the literature on Zambia, apart from the work of Fernholz, (2004)[81] no analysis of Zambia's debt policies were available to this study in published forms that could be reviewed.

The Legal and Institutional Framework

The literature on the legal, institutional and management framework of public debt management is quite varied. Researchers have attempted to create models which they contend best define a good institutional and management framework. The World Bank's

[81] Fernholz, F,R, Debt Management and Debt Relief during the 1990s in Zambia (in) Hill, C.B and McPherson, M.F. (2004) *Promoting and Sustaining Economic Reform in Zambia* ,Harvard University, USA.

Country Policy and Institutional Assessment (CPIA) index is probably the most widely used measure of, policy and institutional frameworks[82]. The index is supplemented by the governance indicators developed by the work of Kaufman, Kraay and Mastruzzi (2003) (KKM)[83].

The CPIA index assesses the quality of a country's present policy and institutional framework. It has 20 indicators in four broad categories: economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions. Countries are rated on their status with scores from one (lowest) to six (highest) to determine the efficiency and effectiveness levels of the institutional and management framework. Using this index, the closer the country is to six, the closer it is to the ideal international standard. As at the end of June, 2004, Zambia was among the 25 other HIPC countries who still had not reached Completion Point and was ranked one, meaning that its policy and institutional framework was still poor.

With respect to the KKM governance indicators, they cover about 200 countries in six areas: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. A country's estimate is presented as a point between -2.5 (lowest) and 2.5 (highest) with the world average at zero. The group average on this indicator for countries with Poverty Reduction and Growth Facility (PRGF) programs and in which Zambia was grouped by the IMF, was shown as 0.6 for

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82 Kappagoda, Nital "Requirements for Effective Debt Management (in) Good ***Debt Management Pays*** ,Document No.3, UNITAR, (Geneva, 1993) pp 17 See also Kaufman,D, Kraay, A, Mastruzzi, M (2003) Governance Matters III: Governance Indicators for 1996-2002, World Bank Policy Research Working Paper 3106 ,Washington DC, USA

83 IMF ,2001, ***Guidelines for debt management*** Prepared by the staffs of the IMF and World Bank ,Washington DC, USA. see also: ***External Debt management in Heavily Indebted Poor Countries*** *(HIPCs)* (Washington DC, March 21, 2002

the years 2000 and 2002. In other words, Zambia rated very poorly on both the CPIA index as well as the KKM governance indicators.

A clear drawback of the above models of quantitatively defining a country's policy and institutional capacity is the fact that the estimates are subjective since they depend on self rating. Furthermore, the CPIA index and the KKM governance indicators may well be correlated but the interpretations can not be stretched too far. One can not draw a conclusion that if one is ranked six in the CPIA index or 2.5 in the KKM governance indicator, then the country has a policy and institutional framework up to international standards.

With respect to the legal framework, it is generally accepted that the regulatory framework for public debt management of any country is essential for a country to successfully manage its finances and repay its debts. A good legal support plays a crucial role in the negotiation and implementation of all financial arrangements. Many studies(2004)[84] have asserted that there were four key questions that a regulatory framework had to answer: the first question was who had authority to borrow on behalf of the state; the second question was who had the authority to issue state guarantees on debts incurred by others, such as state agencies and instrumentalities; the third question was what limits were there on the borrowing and guarantee powers of the state; and the fourth question was what were the procedures that the regulatory framework required the state to follow when incurring debt obligations. In addition to the above four questions,

[84] Husain, I January, 1993,,External Debt and the Development Process (in) *Good **Debt Management Pays*** (UNITAR, Geneva) 39. See also: Kalderen, L ,September, 1997, *Debt Management,* UNDP, New York; IMF/IDA ***External Debt Management in Heavily Indebted Poor Countries***, March, 2002

two more question according to this study can be added. The first is: To what extent did the legal framework clarify the authority to borrow and issue new debt, invest and undertake transactions for a government? The second is: To what extent was the organizational framework specified and able to ensure that mandates and roles were well articulated? In the absence of answering these questions positively, any country would find it very difficult to manage the public debt effectively and efficiently. One of the objectives of this study was determine the extent these factors have constrained Zambia's public debt management.

When the above legal constraints are related to literature on Zambia's pubic debt management, the only published work was the study Jubilee-Zambia sponsored on the loan contraction process in Zambia conducted by Munalula[85]. This study analyzed the legal framework governing the government's power to borrow. The study examined the extent to which Zambia's poor capacity for loan absorption could be attributed to the legal framework governing public external debt. The study discussed the legal provisions and procedures to follow in borrowing, supporting legislation, constitutional and statutory controls on borrowing, and the loan contraction process. The study ended by making recommendations to reform the law, improve oversight by strengthening the office of the Auditor General and Parliament as well as instituting a public awareness campaign on public debt contracting.

[85] Munalula, M,M, 2001, *The Legitimacy of Sovereign Debt* (TSD Thesis, Notre Dame) See also Munalula M M , 2003, *Debt Cancellation for Poverty Reduction: Research Report on the Loan Contraction Process in Zambia* (Jubilee-Zambia, JCTR, Lusaka, Zambia).

Munalula's work was a pioneering work on the legal context of Zambia's public debt management and provided useful suggestions to improve the legal framework on public debt management. The Munalula study argued for good laws to address the public debt. However, the work was overly legalistic and did not analyze the other policy issues that impact on public debt management. Some of these policy issues include macro-economic policy questions, management capacity, sustainability of the public debt, the role of foreign assistance, and the legal and institutional framework- issues of concern to the current study. Our study stresses institutional effectiveness and peoples' capabilities as well as the role of compliance as the anchor for effective and efficient public debt management.

This study's view is that the quantitative approaches are not helpful to countries like Zambia. There is need to suggest a model that deals with real life such as the necessary changes in both the law and the institutions as well as guarantees for compliance and the management capacities of both the institutions and human resources. Arbelaex et el (2003)[86] contended that "an optimal public debt policy depends on the specific conditions of each country such as the starting point of the debt's objective level, the current tax regime, the foreign currency sources and the specific characteristics of each country." This observation in respect to Zambia was correct. The country had special legal and public policy and institutional constraints which had to be taken into account in the design of any public debt strategy aimed at improving public debt management.

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[86] Arbelaez, M. A.,2003, *Interactions between Public Debt Management and Debt Dynamics and Sustainability: Theory and Application to Colombia*, pp3 Mimeo

Public Debt Management

Nihal Kappagoda (1993)[87] argued that effective public debt management required a capacity to monitor and manage a country's debt comprehensively and efficiently. This could be achieved by implementing debt management projects which could include the following country specific components: I) a well defined legal and institutional framework to monitor the contracting of loans, their utilization and repayment; ii) the administrative arrangements for the compilation of data required for debt monitoring and management; iii) facilities for the storage, retrieval and analysis of debt data, either by a manual system or computer software; iv) the organizational arrangements for debt management which involves the creation and staffing of a Debt Management Office (DMO) in an appropriate location; and v) the training in aspects of debt management that are relevant to the needs of the borrowing country. These observations were consistent with the generally agreed requirements for setting up an effective procedural framework for public debt management. However, this formal conditionality in reality is country specific. That is why a case study for each country is necessary to appreciate the extent these components are present or absent in each country's public debt management and to show how they have impacted on a country's public debt management.

[87] Kappagoda, Nihal, 1993, "Requirements for Effective Debt Management" (in) UNITAR, Document No.3 ,***Good Debt Management Pays*** ,UNITAR, Geneva.

Our study agrees with recommendations of the staff of the IMF[88] who in their guidelines for Public Debt Management advised that each country should ensure that it accomplished the following:

i) the legal framework should clarify the authority to borrow and to issue new debt, invest and undertake transactions on government's behalf;

ii) the organizational framework for debt management should be well specified and ensure that mandates and roles are well articulated;

iii) risks of government losses form inadequate operational controls should be managed according to sound business practices, including well articulated responsibilities for staff and clear monitoring and control policies and reporting arrangements;

iv) debt management activities should be supported by an accurate and comprehensive management information system with proper safeguards;

v) staff involved in debt management should be subjected to a code of conduct and conflict of interest guidelines regarding the management of their personal financial affairs; and

vi) sound business recovery procedures should be in place to mitigate the risk that debt management activities might be severely disrupted by natural disasters, social unrest or acts of terrorism.

It will be revealing to see the extent Zambia has performed on these benchmarks in its public debt management. In the literature, there is a general recognition that special skills in human resource management and data management are essential in advancing

[88] IMF and World Bank. 2001, ***Guidelines for Public Debt Management***, IMF/WB, Washington DC, USA.

effective and efficient public debt management. A report on the joint Program of Debt management 1991 to 1996 by the United Nations Development Programme (UNDP) in cooperation with the United Nations Conference on Trade and Development (UNCTAD) and the World Bank argued that countries could learn from four national case studies, namely; Argentina, Bangladesh, Egypt and Uganda on the importance of software development and installation together with extensive training of debt office staff[89]. The report indicated that the four case study countries had remarkably improved on their public debt management. All the countries had installed the Debt Management and Financial Analysis (DMFAS) computer hardware and software which helped them create a solid base for debt data collection, processing and reporting. They also had set up integrated public finance systems and conducted staff training to implant human resource management skills in officials.

The UNDP report further argued that a contributing factor to the debt crisis was the neglect by many developing countries of the basic functions of debt management. These functions according to the UNDP included having accurate and up to date records of all loans; being fully aware of the timing and amounts of debt servicing obligations; being able to project the impact of borrowing decisions of various entities on the country's overall debt profile and balance of payments; and being able to benefit from various innovations and instruments available in the international and financial markets and designed to reduce costs or risks to the debtors.

[89] UNDP, DMFAS 5.0, technical information note. A description of the DMFAS functions designed to support operational debt management and an overview of its functional characteristics. **Ref: UNCTSD/GID/DMFAS/Misc. 4/Rev.2.**

It is therefore agreed in the literature that an effective and efficient public debt management framework can contribute to ensuring and managing long-term public debt sustainability. An effective public debt management system must determine the composition and structure of the debt portfolio a country should have in order for its cost to be low and less vulnerable to market shocks.

In concluding the above sections of the review, it can be said that the public debt management policies, the legal, institutional and management frameworks are areas that require country specific studies. The quantitative approach discussed of defining a country's debt management capacity is not useful on its own. There is need to analyze the policy, legal, and institutional frameworks and the management capacity of each country to be able to advance possible improvements in public debt management.

Foreign Aid and Public Debt Management

Many studies on foreign aid affirm the general proposition that the provision of foreign assistance by the rich countries to the poor countries was initially motivated by the desire to stimulate growth and development and eradicate poverty in these countries. The foreign aid aspect of the public debt problem of Zambia, though variously documented in both official and non-official documents, has not received sufficient analytical attention. A recent study by Fernholz (2004)[90] provided a synopsis of debt management and debt relief in Zambia during the 1990's. The article attempted to show how Zambia had benefited from debt relief efforts and argued that the repayment profile of Zambia's

[90] Fernholz, F.R. ,2004, "Debt Management and Debt Relief During the 1990s in Zambia" in Hill C and McPherson M.F. (Editors) ***Promoting and Sustaining Economic Reform in Zambia*** ,Havard University Press, Boston, USA, pp 263-293

external debt was more favourable as the debt had been contracted on highly concessional terms. This conclusion referred to the period up to the late 1990's but was based on erroneous computation in the HIPC decision point document[91]. As it turned out, the debt up to 2004 has simply remained unsustainable due largely to compounding interest and accumulation of arrears and penalties on late payments[92].

Several studies have shown that particular types of foreign aid have generally been ineffective. Lancaster, C (1999)[93] and Collier, P and Gunning, J.W. (1999)[94] were of this viewpoint. Baur, P.T. (1991)[95] also rejected the notion that foreign aid promotes growth and a country's development potential. Other scholars such as Samir Amin (1977)[96] saw foreign aid as an instrument furthering the goals of neo-colonialism, that aid perpetuated dependency and deepened underdevelopment of the poor countries.

The aid-saving debate, which focused on the two-gap model developed by Chenery and Strout (1966)[97], argued that foreign aid was an engine of growth. Griffin (1970)[98] developed the aid-saving argument and suggested different avenues through which aid could lead to a decline in savings. This was mainly through its effects on government

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91 IMF and IDA ,2000, ***Zambia: Decision Point Document for the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative***, MF, Washington DC, USA.

92 IMF and IDA ,2005, ***Zambia: Enhanced Initiative for Heavily Indebted Poor Countries Completion Point Document*** (IMF, Washington DC, USA)

93 Lancaster C, 1999, ***Aid to Africa: So Much to Do, So Little Done*** ,The University of Chicago Press, Chicago.

94 Collier P, Gunning J.W. ,19999,"Explaining African Economic Performance"(in) ***Journal of Economic Literature*** , Vol. 37, No. 1, pp 64-111

95 Baus, P.T. ,1991, ***Aid, End it or Mend it*** ,Centre for Economic Growth, San Francisco, USA.

96 Amin, Samir ,1998, ***Africa in the Age of Globalization*** ,Zed Press, London.

97 Chenery, H and Strout, A.M. ,1966, "Foreign Assistance and Economic Growth" ***American Economic Review September***, Vol. 56: pp679-733.

98 Heller, P.S. ,1974, Public Investment in LDCs with recurrent cost constraints "in" ***Quarterly Journal of Economics,*** vol. 88, May, pp251-277

expenditure patterns and revenue generation. Heller (1975)[99] in his utility maximization model concluded that foreign loans did not fully increase total expenditure, but reduced borrowing and taxation while increasing government consumption and decreasing government investment.

Many policy practitioners generally agree that aid is supposed to support growth. The problem in developing countries, however, is that the creditors or donors make aid fungible by transferring aid resources from donor aided sectors to non-donor aided sectors. Because of this, many developing countries report less success with aid. A World Bank report[100] published in 1998 argued that countries with good monetary, fiscal and trade policies registered high positive effects of aid.

Critics of the aid-saving model have argued that foreign aid substitutes domestic resources through declined savings, reduced government tax revenue and increased government consumption. Swaroop et al (2000)[101] for instance contended that foreign aid simply substituted for already earmarked government spending. Aid merely softened the government's budgetary constraints.

The work of Nyoni (1997)[102] and many others confirm that huge receipts of foreign aid by developing countries have effects on growth similar to those of the discovery of natural resources like diamonds or oil and therefore may cause the so called Dutch

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99 Heller, P.S. 1974, Public Investment in LDCs with recurrent cost constraints "in" ***Quarterly Journal of Economics,*** vol. 88, May, pp251-277

100 World Bank ,1998, ***Assessing Aid :What works, What Doesn't and Why***, Oxford University Press, UK.

101 Swaroop, V et al ,2000 "Fiscal Effects of Foreign Aid in Federal Systems of Governance: The Case of India" "in" ***Journal of Public Economics***, Vol77, Number 2000 pp307-330.

102 Nyoni, T.S.,1997, Foreign Aid and Economic Performance in Tanzania ***AERC Research Paper Number 61*** ,Nairobi, Kenya.

disease. This disease occurs when huge receipts of foreign aid by a poor country like Zambia bring about disruptive effects on the domestic economy. If the aid is low for instance, the inevitable result would be increased domestic borrowing. If the aid was high, this may lead to the appreciation of the internal currency which in turn would lead to the contraction of the traded exports sector and inflation in the non - traded sectors. However, if an economy was able to deal with the increase in donor aid in a manner that impacted positively on economic growth, this would be a welcome move. Zambia's experience would be revealing to analyze.

The starting point to understand the role of foreign aid is to ask the question why aid is provided. One clear answer which for Zambia was most relevant during the period of this study (1990-2004) was that Zambia had a large external debt which could not be serviced without extraordinary donor support. In a study by McPherson M.E. (2004)[103], it was shown that Zambia between 1975 and 2001 received a lot of external aid. Zambia received in excess of US$16 billion in foreign assistance which was equivalent to more than 20% of GDP. However, much of the assistance provided in the 1990's had little to do with creating the foundation from which Zambia could grow and develop. The fact for Zambia was that the huge aid did not address the growth sector. Most of the aid given was consumption-oriented. The food aid in 1992 prevented a humanitarian disaster. The Paris Club debt relief and donor funded commercial debt buy back were further confirmation that Zambia could not repay its debts. Most of the aid given simply rationalized what were, in fact, sunk costs.

[103] McPherson, M.E. 2004, "Ending Aid Dependence in Zambia" (in) Hill, C. and McPherson M.E. *,Promoting and Sustaining Economic Reform in Zambia* , Harvard, USA , pp445-478

The same applied to the IMF support under the Rights Accumulation Program (RAP). Zambia was required to meet IMF conditions for an extended period so that it could gain the right for the IMF to move US$1.2 billion from its bad debts ledger to its accounts receivables. Zambia still owed the US$1.2 billion, an amount that would only be repaid when and if the creditor donor community provided the necessary finance[104].

Other literature show that debt servicing had resulted in diversion of development assistance, with bilateral aid from the European Union member countries being used to finance the debt owed to the IMF, World Bank and the African Development Bank (ADB). Rugumamu (2005:105)[105] quoting World Bank sources noted that it had been estimated that around 25 per cent of bilateral aid, some US$ 9 billion annually was used directly to finance debt repayments. The UNCTAD (2001:86)[106] noted that if net resource and net resource transfers were combined with leakages, it turned out that in the past two decades Africa had not received any net transfers of real resources from the rest of the world. It estimated that for each dollar of net capital inflow in Sub Saharan Africa from the rest of the world, some 25 cents went back as net interest payments and profit remittances abroad, more than 35 cents leaked into capital outflows and reserve build ups while 51 cents constituted losses. These figures implied that there was a net transfer of real resources from Africa to the rest of the world.

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[104] IMF ,1993 "***Zambia: Staff Report for the 1993 Rights Accumulation Program***" EBS/93/48 , IMF, Washington DC, USA.
[105] Rugumamu, S.M. 2005, ***Globalization Demystified*** ,Dar es salam University Press, Tanzania pp101-125
[106] UNCTAD ,2001:36*), Economic Development in Africa: Performance, Prospects and Policy Analysis* , UNDP, New York, USA

McPherson(2004)[107] concluded that the problem with providing the aid that Zambia received was that "it deflected the attention of African governments from the fundamental changes required to get their countries out of debt and off aid".

The argument advanced by McPherson (2004) that "sustained growth and development are impossible while Zambia remained as dependent on foreign resources as it had been since the early 1970's"[108], had certainly some relevance. Poverty in Zambia had increased despite the aid. The aid did not stimulate a major restructuring of the economy nor address Zambia's debt crisis in a comprehensive manner. Aid appeared to make Zambia complacent and the country appeared to treat aid as an entitlement and in the process it had become hooked on aid. There was need for Zambia to devise an aid exit strategy as well as a debt exit strategy that would allow Zambia to channel aid to productive investment to enable Zambia build capacity to attain economic independence and be able to honour its debt obligations as they fell due.

In concluding this section of the review, the findings from a study by Iyoha(1999)[109] are very revealing about the impact of external debt on economic growth in Sub-Sahara African countries between 1970 and 1994. Iyoha found that debt overhang variables in the investment equation depressed investment through both a "dis-incentive" effect and a "crowding out" effect. When he simulated the impact of alternative debt reduction scenarios (5%, 10%, 20% and 50%), it was found that debt stock reduction would have

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[107] McPherson, M.E ,2004 "Ending Aid Dependence in Zambia" (in) Hill, C. and McPherson M.E. ,*Promoting and Sustaining Economic Reform in Zambia* , Harvard, USA, pp445-478

[108] McPherson, M.E ,2004 "Ending Aid Dependence in Zambia" (in) Hill, C. and McPherson M.E. ,*Promoting and Sustaining Economic Reform in Zambia* , Harvard, USA, pp469

[109] Iyoha, A.M., March 1999, ***"External debt and Economic Growth in Sub-Sahara African Countries: An Econometric Study"***, AERC Research Paper 90, African Economic Research Consortium, Nairobi Kenya pp 264-5

significantly increased investment and growth performance. A 20% debt stock reduction would on average, have increased investment by 18% and increased GDP growth by 1% during the 1987-94 period. The results demonstrated that total debt cancellation could provide a much-needed stimulus to investment recovery and economic growth of Sub Sahara Africa.

Given this finding, it is necessary that in addition to debt cancellation, strong movement towards improving public policy and management capacity on public debt management be made to avoid wastage and enable it impact positively on growth and development.

Summary and Conclusions

The review has defined the conceptual framework of the study and discussed the literature on state borrowing, the public debt crisis, public debt policy, the legal and institutional framework, foreign aid and the strategies of public debt management. All these scenarios were related to Zambia's experience. It is shown in the review that the debt crisis in the 1980s gave a devastating blow to development in many developing countries. Public debt management should therefore target not only the reduction of the public debt overhang and debt service payments to levels which could be commensurate with the economic capacities of debtor countries and also prevent any renewed build up beyond prudent levels.

Furthermore, it was important for debtor countries to devise national debt policies and strategies that ensured that the public debt was sustainable. This should involve the

creation of enforceable regulatory rules training of debt managers in all necessary skills including data management, sourcing of finance and adoption of best practices.

HYPOTHESES AND QUESTIONS

The key issues that emerged from the conceptual framework and literature review can be summarized as follows: Firstly, the magnitude of the debt or the debt overhang for Zambia was huge and its consequences were severe in the context of Zambia trying to fight poverty and underdevelopment. The implication for this was that Zambia had as a matter of necessity to devise a debt exit strategy. Such a debt exit strategy had to be time bound. Secondly, the debt overhang was only a symptom of larger economic problems, the legacy of past and continuing mismanagement of the economy. The implication for this was that Zambia needed to improve on its public policy and good governance record. A strategy to avoid wastage and mismanagement had to be devised. Thirdly, the asymmetric power relations between Zambia and the international financial system, was also partly responsible to Zambia's debt crisis. The implication for this was that if properly administered and effectively used, foreign assistance could boost growth and development. It was important for the country to remove the burden of all past external debts and adopt its own adjustment program.

Having thus narrowed the problem to one that could be reasonably handled, in order to achieve its objectives of investigating the constraints on public debt management in Zambia between 1991 and, the study was guided by the following hypotheses/assumptions and research questions:

a) Zambia's public debt was huge, unsustainable and the consequences were such that it impeded the fight against poverty and underdevelopment.

I) What was the size and impact of Zambia's public debt stock on public debt management?

ii) How did the debt overhang relate to the development challenges of Zambia?

iii) To what extent was the public debt a constraint to the pursuit of effective poverty eradication in Zambia?

iv) How sustainable was Zambia's public debt? What could be considered as the sustainable public debt in Zambia?

b) Zambia's public debt management difficulties are part of the legacy of Structural Adjustment Programmes and Policies.

i) To what extent can structural adjustment policy reforms be said to have impacted on the public debt management?

ii) What public policies were required to improve public debt management?

c) The management of Zambia's public debt was compromised by inadequate management capacity.

i) To what extent can implementation capacity or its lack be said to have affected public debt management?

ii) How could coordination among government agencies be enhanced to ensure coherence?

iii) What management information system would best improve public debt management?

iv) Of what significance was a well trained and motivated staff and institutional capacity building which kept up with developments in international best practices?

d) The management of Zambia's public debt was adversely affected by a poor legal and institutional framework.

i) To what extent did the legal and institutional framework affect public debt management in Zambia?

ii) To what extent did corruption, abuse of office and thefts hamper effective public debt management?

iii) How did the public debt management system especially with respect to management capacity of government institutions affect public debt management in Zambia?

iv) What reforms in the legal and institutional framework in Zambia were needed to ensure effective and efficient public debt management?

v) How could accountability and transparency be enhanced?

e) Uncontrollable external factors, the asymmetric power relations in the global financial architecture affected Zambia's public debt management as the rules of international finance capital tended to encourage odious debt to accumulate, encourage capital flight and condemn a country to foreign aid dependency.

i) How dependent was Zambia on foreign aid and how did this impact on public debt management?

ii) Did Zambia need a foreign aid exit strategy in its public debt management policy to spur creative development? What debt and aid exit strategy would be advisable for Zambia?

f) Effective and efficient public debt management can best be sustained if based on an effective and efficient National Public Debt Management Strategy.

METHODOLOGY AND DATA ANALYSIS

The study used a case study approach. It began with a broad documentary search in order to generalize results on public policy constraints on public debt management in Zambia and then focus in the second phase on detailed qualitative, open – ended interviews to collect details from public debt managers and relevant individuals and organizations. With this methodological approach, it was hoped that the findings would be analyzed to allow the research come up with well-grounded suggestions to improve public debt management in Zambia.

Documentary Method

This involved the analysis of documents and studies held by several institutions. These institutions included the Ministry of Finance and National Planning, the Bank of Zambia, the Ministry of Justice and the Auditor General's Office. Other institutions that hold documents and studies on public debt management in general and Zambia in particular

included the IMF, World Bank, UNDP, UNITAR, MEFMI, Debt Relief International and several websites on the Internet. Desk research was also conducted at the University of Zambia library, the National Assembly library, the National Archives library and libraries of the British Council and the United States Information Service.

Documents held by government departments and parastatal institutions as well as investigative organs such as the Task Force on Corruption, the ACC, the DEC, the Police Service and others were also analyzed. Of particular interest were the audits of external debt and callable guarantees conducted by Audit firms such as the Cobalt Report and the Report on callable guarantees and payments made by the Ministry of Finance and National Planning.

Interviews

Data was obtained by means of questionnaires and interviews. The questions that were asked are as shown in Appendix 14 of this study.

With respect to the questionnaire, questions were presented with the same wording and in the same order to all relevant respondents. The reason for standardization was to ensure that all respondents replied to the same question. The questions were open-ended and were designed to permit free responses from respondents.

Altogether, the following persons were interviewed: the Secretary to the Treasury, Governor of the Bank of Zambia, External debt and internal debt experts and macro-

economic experts from the Ministry of Finance and National Planning, Bank of Zambia, the Attorney General's Chambers and The Treasury Counsel.

In addition, representatives of a sample of multi-lateral agencies such as the IMF, World Bank, UNDP; a sample of Paris Club and London Club representatives notably the European Union and representatives of bilateral countries such as the UK, USA, Canada, Germany and Ireland; and non Paris Club members such as China, Japan, India, Kuwait, France, Italy, Saudi Arabia, and Russia were interviewed. This sample was used because the countries were represented in Zambia through their embassies or offices.

Furthermore, officials from Jubilee-Zambia, the Christian Council of Zambia, the Economic Association of Zambia, Zambia Congress of Trade Unions and other non-governmental organizations working in the area of public debt management such as the Zambia Research Foundation, and the Zambia Chamber of Commerce were interviewed.

In the interviews, the verbal information given was not taken at face value. It had to be interpreted in the light of other knowledge about the subject. The respondents were specially selected for their ability to access information on public debt management and who were sufficiently intelligent to absorb the questions. The reported facts were then evaluated in terms of accuracy and credibility. The reason for adopting this approach was on account of lack of reliable published information on Zambia's public debt, especially, the domestic public debt.

The fieldwork devised open-ended key questions to guide the data collection process. The interview protocol was devised for each interview taking into account their relevance and knowledge of the research area. The interview solicited information presented in the questions in appendix 15

Data Analysis

This study was basically a historical analysis of public debt management in Zambia. In the analysis of the data, the study used the qualitative historical approach. Data from historical records and interviews was collected and analysed in terms of correctness of record.

As is well recognized, every reader of social research publications is familiar that raw data in the form in which it may have been collected, can be used in conjunction with data that have undergone analysis and is on a higher level of abstraction. This study benefited from this approach. The raw data that was analyzed fulfilled two functions, namely, to illustrate the range of meaning attached to public debt management and to stimulate new insights on the public debt management problem.

In terms of statistical analysis, the study used raw data presented in tables to summarize the obtained data.

CHAPTER 3

THE EVOLUTION AND SUSTAINABILITY OF THE PUBLIC DEBT IN ZAMBIA

INTRODUCTION

This chapter outlines the evolution of the public debt overhang in Zambia. The first part of the chapter presents the evolution of the domestic debt problem and relates the debt to its sustainability. The second part presents the evolution of the external debt and relates it to its sustainability. The third part of the chapter is the a conclusion where it is argued that the evolution of Zamia's public debt in terms of quantum, was negatively related to her capacity to undertake effective and efficient public debt management.

ORIGINS OF THE PUBLIC DEBT PROBLEM

The origin of Zambia's public debt problems as alluded in Chapter One dates back to the 1970-80 period. In response to the deterioration in foreign exchange reserves occasioned by the global recession of the 1970's, especially the fall of copper prices, Zambia went into the international financial market to contract debt in order to support its budget. The country also started borrowing internally by way of deficit financing.

The first forty years of the economic background of Zambia up to 2004 is well documented in several studies[110]. Once a middle-income country at the time of independence by 2004 Zambia was ranked as one of the Poorest and Least Developed Countries (LDC) and also a Heavily Indebted Poor Country (HIPC)[111].

It is well established that Zambia's development problems were rooted both in its colonial past as a British Colony prior to independence in 1964 and in the post-colonial era as it continued to be tied unequally to the global economy[112]. From1964 to 1991, Zambia's development policy was characterized by direct state intervention in the economy. The state after the nationalizations and the creation of state enterprises between 1968 and 1970 owned and controlled over 80% of the productive sector. Mining which accounted for over 90% of the country's foreign exchange earnings was in state hands. This state of affairs meant that when any economic crisis fell, the state would be most affected.

Beginning in the mid 1970's, the country experienced sharp deterioration in its terms of trade and declines in Copper and cobalt production.[113] The government attempted to offset the decline in mineral revenues by borrowing heavily or deficit financing. This was the beginning of the accumulation of public debts. Approaches to reform the economy

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[110] Hill, C. B. and McPherson M.F. 2004, *Promoting and Sustaining Economic Reform in Zambia* ,Harvard University Press, Boston, Massachussets, USA). See also: Turok, B. 1989, *Mixed Economy in Focus: Zambia* (Institute of African Alternatives, London.

[111] IMF/IDA, *Zambia, Decision Point Document* Washington D.C USA

[112] Bates, R. H. and Collier P , 1992, *The Politics and Economics of Policy Reform in Zambia* , Duke University Press, Duke, USA

[113] Roberts,A 1968 The Political History of Twentieth Century Zambia. In Ranger T.O (Ed) *Aspects of Central African History.* Heineman, London: Ben Turok,1989, *Mixed Economy in Focus*- Zambia, Institute of African Alternatives, London: Bostock, M 1972, Economic Independence and Zambian Copper, A Case Study of Foreign Investment. Praeger, New York, USA. Mudenda G . 1984 *The Development of the Mining Industry in Zambia,*. PhD Thesis, University of Sussex, UK: Young, A. 1973 Industrial Diversification in Zambia. Praeger, New York, USA

were attempted but largely failed to jump start the economy to growth and the country failed to avoid the debt crisis.

The main causes of the decline of the economy were a combination of several factors. Fernholz[114] identified four shocks. The first shock was political, with economic consequences for Zambia. The country's active support to the liberation wars in Zimbabwe, Angola, Mozambique, Namibia and South Africa led to disruption of trade routes. The disrupting of export and import routes tough never quantified,was at great cost for landlocked Zambia. The closure of the railway trade route through the then Rhodesia controlled by a minority regime under global economic sanctions forced Zambia to divert its trade to pass through Tanzania by road. Similarly, because of the liberation war in Angola, the Benguela Railway Line was permanently closed.

The second shock was a debt overhang which had started building up following the first oil shock of 1973-4 when OPEC increased oil prices.[115] When the tightness of the oil market in 1979 allowed the possibility of increasing its price, there was little buyer resistance and the official price for Saudi light increased from US$ 12.40 in 1978 to over $30 a barrel by October 1978[116]. For Zambia, as was the case for most oil importing countries, the effect was seen in the deterioration of its balance of payments. As an oil importer, Zambia had to pay far more for its oil than previously and this additional import costs had the tendency of increasing Zambia's current account deficit.

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[114] Fernholz, F.R. 2004 Debt Management and Debt Relief during the 1990's in Zambia (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp 263 – 265

[115] Macpherson M.C. 2004 The Historical Context (in) Hill, C.C. and McPerson, M.F., (Ed) ***Promoting and Sustaining Economic Reforms in Zambia.*** (Harvard University Press, Boston, Mass,) pp 32- 38

[116] Lomax, F , 1986 *The Developing Countries Debt Crisis* ,McMillan Press, London, UK.

The third shock was a slump in the world price of copper which declined to uneconomic levels.[117] This was compounded by the fourth shock, namely, production difficulties occasioned by disasters such as the one that occurred at the Mufulira Mine in 1974 which saw the flooding of the mine.[118] The production of copper decreased from about 730,000 tons of copper in 1974 to less than 300,000 in 1979. The low production of copper adversely affected the country's export earnings and caused balance of payments deficits in the country which deteriorated by 55% of Gross Domestic Product (GDP) in 1974/75.

The fifth shock came when interest rates in the world economy increased causing Interest arrears to grow at an alarming rate. In 1980, government interest arrears were US$ 6.3 million while arrears on principal were $33 million[119]. Public and private debt arrears as well as those to the IMF amounted to $500 million in 1980. By 1990, the total arrears position of Zambia was more than $3 billion, almost the size of Zambia's GDP. Furthermore, scheduled external debt service excluding debt relief under the HIPIC initiative increased from US$ 328 million in 1998, US$ 388 million in 2001 US$ 590 million in 2001 reaching US$ 710 million in 2004[120].

Faced with these shocks, instead of implementing a vigorous programme of sustained macroeconomic adjustment and other structural reforms, Zambia turned to external

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[117] IMF 1990-2005 *Zambia: Statiscal Appendices,* Washington D.C. USA

[118] Mudenda, G 1984 *The Development of the Mining Industry in Zambia,* PhD Thesis, University of Sussex, UK

[119] Fernholz, F.R. 2004 Debt Management and Debt Relief during the 1990's in Zambia (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp 266

[120] Zambia, Ministry of Finance and National Planning, *Annual Economic Reports* (Various Issues). See also IMF, Selected Issues and Statistical Appendices (Several Years)

borrowing to finance the budget deficits[121]. The lending and refinancing by creditors was also on predominantly non concessional terms, meaning that the loans advanced to Zambia were provided on commercial terms with onerous interest rates and conditions. The loans had the effect of expanding Zambia's debt portfolio to unsustainable levels.

All these shocks were compounded by the widespread lack of prudent debt management, added to the growth of the debt. As the economy began to experience current account deficits and diminishing foreign exchange resources, the state imposed tight controls over foreign currency transactions[122]. Furthermore, many of the outstanding loans were converted into public sector debts when creditors invoked guarantees given by the government.[123] In 1987 when foreign exchange reserves were practically exhausted, para-statal companies and private sector debtors repaid their obligations to the Bank of Zambia in local currency, while the arrears in foreign exchange mounted. There was a shortfall in the supply of foreign exchange at the fixed exchange rate. A pipeline awaiting foreign exchange allocation built up. Eventually, the government had to pay the shortfall between the official rate and the market clearing rate of exchange. In addition, the unpaid balances guaranteed by the creditor and debtor governments or export agencies of creditor countries were re-scheduled and became public external debt.

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[121] Turok, B 1989 *Mixed Economy in Focus: Zambia, Institute for African Alternatives*, London U, pp213-217

[122] Macpherson M.C. 2004 The Historical Context (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp 38

[123] Fernholz, F.R. 2004 Debt Management and Debt Relief during the 1990's in Zambia (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp 265

EVOLUTION OF THE DOMESTIC PUBLIC DEBT

Zambia's domestic debt problems, in comparison to the external debt problems, are of recent origin. As it has already been shown in the literature review, the domestic public debt overhang becomes a problem if the government's internal borrowing crowds out the private sector and is responsible for high interest rates in the economy. As already shown, the consequences of such a scenario are a tendency to adversely affect economic growth of a country. This state of affairs began to emerge in Zambia after 1978 when the state resorted to deficit financing of its budget. This was as a result of the balance of payments difficulties that emerged following the oil shock which increased import prices of oil, and the falling copper prices and copper production (Copper production for instance which in 1976 stood at 712,000 tonne, fell to 444,000 tonnes by 1990 and continued failing reaching about 300,000 in 2004)[124]. These economic difficulties, which reduced government foreign exchange earnings, are largely responsible for setting in the debt overhang on Zambia and compelling Zambia to rely on deficit financing of its budget.

As a general rule, where as all governments borrow from the public to support the budget, the borrowing or deficit financing can only be considered sustainable if the country can meet or settle both its current and future domestic debt obligations when they fall due without resorting to rescheduling or roll over as became the case for Zambia between 1991 and 2004. The domestic debt in Zambia in the period of study increased and reached high levels mainly because of uncontrolled deficit financing of the fiscal

[124] IMF, 1999 and 2006 *Zambia: Statiscal Appendices* Washington D.C, USA

budget[125]. The difficulties in debt management could be seen in the continued accumulation of government expenditure arrears.

Before January 1993, the Bank of Zambia's monetary policies used government securities to alleviate liquidity problems of government at controlled interest rates[126]. The original stock of government securities before 1990 was below K95 billion on Treasury Bills and K6 billion on government bonds. After 1993, because of hyperinflation, the government adopted two policies. The first policy was the adoption of the policy of cash budgeting and the second was the opening of tender for government securities at freed interest rates.

These two policies were meant to guide government in controlling public spending and liquidity in the market. This, however, did not work. Beginning in May 1993, there was a persistent failure by government to meet the financing of maturing debt and interest due on government securities. Instead of paying the debt as it fell due to creditors, the government unilaterally started rolling over the maturities and interest compounding the liabilities at great cost to the government as these accumulated debts meant that the government was liable to additional interest and penalties. The underlying reason for the government's failure was mainly the poor performance of the economy.

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[125] Zambia, 2003 Draft Zambia Domestic Debt Policy and Reduction Strategy, MoFNP, Lusaka, March p2. See also Macpherson M.C. 2004 The Historical Context (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp 36-37

[126] Zambia, 2004 *Financial Sector Development Plan for Zambia*, MoFNP, Lusaka, Zambia, pp 85-91

Table 7:

Structure and Evolution of Domestic Debt in Zambia

Year	Total Debt (Billion Kwacha)	GRZ Securities (Million Kwacha)	Primary Deficit (Billion Kwacha)	Debt Service (Billion Kwacha)	BankLending (Rates %)	GDP (Rates)
1995	-	-	-	77	66.7	-2.5
1996	-	-	-	122	69.0	6.9
1997	-	-	-	115	37.2	3.3
1998	-	242,654	-485	80	37.9	-1.9
1999	-	327,338	-298	105	44.8	2.2
2000	-	548,579	-708	140	54.9	3.6
2001	3,941.4	1,087,046	-1,056	207	54.6	4.9
2002	4,126.3	3,085,965	-1,031	450	51.5	3.3
2003	4,961.6	4,106,411	-1,349	563	44.4	4.3
2004	**5,186.1**	4,239,003	-442	746	37.1	5.4

Source: Zambia, MoFNP , Annual Economic Reports (Several Years) Lusaka

Table 8:

Level of Domestic Public Debt and Debt/GDP Ratio

Year	Level of Debt (Billion Kwacha)	GDP at constant prices (Billion Kwacha)	Debt/GDP Ratio (%)
1995	-	2,177	-
1996	-	2,328	-
1997	-	2,405	-
1998	-	2,360	-
1999	-	2,413	-
2000	-	2,499	-
2001	3,941.4	2,621	150.4
2002	4,126.3	2,708	152.4
2003	4,961.6	2,825	183.6
2004	5,186.1	3,005	172.6

Source: Source: Zambia, MoFNP , Annual Economic Reports (Several Years) Lusaka

As Tables 7 and 8 above show, the domestic debt had been rising from about four trillion kwacha in 2001 to over five Trillion Kwacha in 2004.[127] Domestic interest payments alone consumed about 10% of the discretionary budget or 3% of the Gross Domestic Product. The primary deficit was consistently high reaching 1.3 Trillion in 2003 Kwacha before dropping to 442 Trillion Kwacha in 2004. The debt/GDP ratio was also

[127] Zambia, MoFNP 2003 *Draft Zambia Domestic Debt Policy and Reduction Strategy*, MoFNP, Lusaka, March

consistently high. It was clear that the rapid growth of the public debt was a potential threat to macroeconomic stability.

By December 1993, the cash budget had completely become dysfunctional and was abandoned in mid 1995.[128] The situation was made worse by donors who also did not provide adequate support to Zambia in terms of balance of payments support. Because of the pressures on its balance of payments as well as on its discretionary budget, the government resorted to borrowing from the Bank of Zambia in order to meet its budget and constitutional expenditures such as debt service obligations through the foreign exchange and Kwacha bridge loans. The report prepared by the Ministry of Finance and National Planning suggesting a strategy to deal with the escalating domestic debt problem provided statistics that showed the growth of Zambia's domestic debt stock for the years 2001 to 2004. These statistics are presented in Table 9.

Table 9 provides a perspective that characterizes Zambia's domestic public debt as consisting of outstanding payments for government securities, parastatal debt, loans and advances from the Bank of Zambia, local government debt and other domestic liabilities.[129]

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[128] The cash budget was a policy adopted matching expenditure to available revenue with the objective of preventing government operations from being an independent source of credit expansion. See Hill, Catherine B 2004 Fiscal Policy and Public Expenditure Control, (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp81-88

[129] Zambia, MoFNP 2003 *Draft Zambia Domestic Debt Policy and Reduction Strategy*, MoFNP, Lusaka, March, p 1

Table 9

Zambia's Domestic Public Debt 2001-2003 (K'Million)

	DECEMBER 31, 2001	DECEMBER 31, 2002	DECEMBER 31,2003	DECEMBER 31, 2004
A) Government Securities	1,078,300,000,000	1,433,891,600,000	3,908,400,000,000	1,340,744,000,000
Treasury Bills	402,600,000,000	841,943,500,000		
GRZ Bonds	676,700,000,000	591,948,100,000		
B) Central Bank Loans &	1,787,900,000,000	1,828,069,700,000	261,000,000,000	2,898,259,000,000
Advances	383,300,000,000	506,321,800,000		
Kwacha Bridging Loans	1,404,600,000,000			
Foreign Exchange Bringing Loan				
C) Parastatal Liabilities	725,800,000,000	56,221,544,191.60		
Parastatal Debt	725,800,000,000			
D) Other Liabilities	378,300,000,000	808,092,000,000	578,900,000,000	
Domestic Arrears	346,200,000,000	458,084,000,000	100,700,000,000	
*Awards and	32,100,000,000	70,000,000,000	322,100,000,000	
Compensation	-	280,008,000,000		
*Unremitted GRZ Pension fund				
E) Local Government	-			
Dues	-			
Salary arrears	-			
Pension	-			
Public works	-			
Total	**3,941,400,000,000**	**4,126,300,000,000**	**4,961,580,000,000**	**5,186,140,000,000**

Source: Zambia, MoFNP, *Draft Domestic Debt Policy and Reduction Strategy*, Lusaka, March 2003 p

With respect to Government Securities[130], these debts included Stocks, Treasury Bills, Bonds, and Promissory Notes. All these, as indicated earlier, started increasing after 1993. Whereas the stock of government securities as at December in 2001 was K101 billion made up of K95 billion in Treasury Bills and K6 billion in bonds, by December 2001, the amount of government securities had increased to about K1.1 Trillion and by December 2004 reached an unsustainable level of K4.2 Trillion.

The main purchasers of Treasury Bills and bonds were Commercial Banks. The bills and bonds did not only yield high returns to commercial banks but were also very secure when compared to other possible borrowers as they had sovereign guarantee. For example, at the end of December 2001, 78 percent of Treasury bills were held by commercial banks, 17 percent by the non-bank public such as individuals, private companies, pension funds and insurance companies.

With respect to the bonds, the stock of government bonds showed similar trends as in treasury bills recording increases since 1999[131]. The increase in the bonds could be explained by the fact that they had high interest rates which attracted investors including private pension funds.

With the increased treasury bills and bond stock, Zambia suffered the burden of increasing interest payments.[132] The total interest cost of treasury bills increased from

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[130] Zambia, MoFNP 2003 Draft Zambia Domestic Debt Policy and Reduction Strategy, MoFNP, Lusaka, March, p 1

[131] Zambia, MoFNP *2003 Draft Zambia 2003 DSA for Completion Report*, Livingstone, 19-30 May, pp24-26

[132] Zambia, MoFNP 2004 *Zambia Debt Sustainability Analysis Report*, Livingstone,Zambia, November, p15

K82.7 billion in 1999 to K258.6 billion in 2003. The interest cost on bonds also rose from K71.8 billion in 1999 to K169.1 billion in 2003 largely on account of fiscal and monetary policy financing and the restructuring of government debt to Bank of Zambia at the beginning of 2003. All together the interest costs on Government securities increased from K66.7 billion in 1995 to close at K375.0 billion in 2002 representing a 462.2 percent increase in costs.

As regards Loans, advances and bridge loans, these were stocks by the government from the Central Bank[133]. The government had been obtaining bridge loans from the Bank of Zambia to finance the budget deficit using the Kwacha bridge loan and to finance the foreign debt service shortfall using the foreign exchange Bridge loan. The Kwacha bridge loan was obtained at zero interest charge while the foreign exchange loan was borrowed at 4.5 percent per annum. During the period of study, the latest amount would be calculated at the end of each month and then be converted into local currency and the Bank of Zambia would issue itself Treasury Bills at the current market rates.

The Foreign exchange bridge loan was closed in 2003 by the issuance of a 10-year bond.[134] The Kwacha bridge loan has been decreasing from K506.3 billion in 2002 to K261 billion in 2003 mainly on account of the restructuring of government debt to Bank of Zambia and reduced use of these loans by government.

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[133] Zambia, MoFNP 2004 *Zambia Debt Sustainability Analysis Report*, Livingstone,Zambia, November, p14

[134] Zambia, MoFNP 2003 *Draft Zambia 2003 DSA for Completion Report, Livingstone*, 19-30 May, pp22

As regards Government Arrears (Expenditure arrears), these debts included those debts created by suppliers of services and goods to government institutions[135]. The practice of government had been to procure on credit. The suppliers usually overpriced their goods or services to cover delayed payments. Furthermore, controlling officers usually over committed government to un budgeted expenditures disregarding any budget limitations. All these factors resulted in domestic arrears increasing from K346.2 billion in December 2001 to K458.1 billion by end December 2002 representing a 32 percent increase.

With respect to Compensation which presents salaries and Awards which are a result of litigation against government, these too could not be paid in full by government and as a result of this failure, arrears also increased from K32.1 billion in December 2001 to K70 billion in December 2002 representing a 180.9 percent increase. Concerning un remitted statutory contribution arrears such as outstanding debt to pension funds, these too also increased over the period of study. In 2001 for instance, these debts were K168 billion and rose to K280.6 billion in December 2002 and reached K322.1 billion in 2003. As concerning contingent liabilities or government guarantees, these increased from K6.2 billion in 2002 to K15 billion in 2003.

All these changes in the public domestic debt situation in Zambia occurred following the financial sector reforms that were introduced after 1991.[136] Among the reforms that were introduced included the liberalization of interest rates and the introduction of trade in government securities in 1993. The securities included treasury bills of 28, 91, 182 and

[135] Zambia, MoFNP 2003 *Draft Zambia 2003 DSA for Completion Report*, Livingstone, 19-30 May, pp22
[136] Zambia, 2004 *Financial Sector Development Plan for Zambia*, MoFNP, Lusaka, Zambia

273 duration and Government of Zambia bonds of 12, 18, and 24 month's duration. The Bank of Zambia used securities auctions both for liquidity management purposes and to influence interest rates since the Treasury bill rate was used by the Commercial Banks as the benchmark for determining the price of their loans. Furthermore, the Bank of Zambia started open market operations in 1995 and repurchace (repo) operations in 2002. In 1998, the Bank of Zambia also listed government bonds on the Lusaka Stock Exchange for secondary trading.

With these policy reforms, what could be observed was the gradual rise of the public domestic debt. In general, the domestic debt of Zambia has been increasing to unsustainable levels since 1993[137]. As at December 2003 the domestic debt was K5, 186.4 billion or roughly US$ 1.04 billion and accounted for 14 percent of the total national debt of Zambia. This public domestic debt overhang became a constraining factor in Zambia's monetary policy. Table 10 summarises the status of Zambia's public domestic debt and interest payments.

As can be observed from the Table 10, in 2003, public domestic debt interest payments alone consumed about three percent of the country's gross domestic product (GDP). This was more than ten percent of the government's budget. Zambia's domestic debt had been growing since 1990 which resulted in many debilitating consequences. Firstly, the crowding out effect of private investment was very prominent. Most investable surpluses held by financial houses instead of being lent to the private sector to invest in productive ventures were invested in secure government securities thus adversely affecting growth

[137] Zambia, Bank of Zambia, *Main Economic Indicators*(Various Dates)

of the economy. Because of this many developing countries were prevented from expanding their export bases necessary to earn foreign exchange, which in turn was, necessary to dismantle the external debt.

Table 10

Zambia's Domestic Public Debt and Interest payments Selected Indicators

Year	Central Govt. Expenditure % GDP	T-Bills and Bonds outstanding %GDP	Interest (% Exports)	Interest (%GDP)
1990	32.9		4.3	1.4
1991	40.2		4.2	1.7
1992	37.2		7.4	1.7
1993	35.8		13.5	4.8
1994	38.1		12.0	4.6
1995	32.1	7.9	7.8	2.6
1996	27.1	6.5	11.2	3.1
1997	26.1	5.9	8.6	2.2
1998	30.6	4.0	4.3	1.3
1999	29.3	4.4	4.8	1.4
2000	31.0	5.4	4.5	1.4
2001	32.1	8.3	4.9	1.6
2002	31.9	19.0	8.7	2.8
2003	32.6	21.1	8.9	2.9

Source: Compiled from Bank of Zambia, Main Economic Indicators(Various Dates)

Secondly, interest rates during the period of this study were consistently high caused largely by the government's excessive borrowing from the money markets to finance its budget deficits.[138] Between 1991 and 2004, real interest rates on the 91-day treasury bills and overdrafts by Commercial banks were relatively high. The bank rates, which had reached 122.5 per cent in 1993, dropped to 69.8 per cent 1996 and levelled between 40 and 60 per cent there after, making the cost of capital to be very high in Zambia.

[138] Bank of Zambia, Main Economic Indicators(Various Dates)

Furthermore, about 80% of Zambia's public debt was external and only the remaining 20% was domestic debt of short maturity. However, domestic interest payments constituted over 70 per cent of total interest payable.[139] In 2004 for instance, total domestic debt service was Kwacha 927.5 billion while external debt service was Kwacha 660.4 billion – an indicator that the government was financing current spending at a very high cost.

EVOLUTION OF THE EXTERNAL PUBLIC DEBT

With respect to the external public debt, analysis of the debt stock over the period 1991 to 2004 reveals that Zambia's external debt had been increasing.[140] For instance in 1970, Zambia's external debt was about US$ 700 million. The debt rose to over US$ 3.2 billion at the end of 1980 and almost doubled reaching US$6.6 billion in 1990 before peaking at about US$7.2 billion in 2004. The rise in the stock of debt over the period was mainly due to arrears accumulation in the IMF and the World Bank after Zambia unilaterally imposed a ten per cent debt service moratorium in May, 1987. This action by Zambia meant that the country's debt was left to expand as all donors stopped supporting Zambia in its debt service efforts.

In 1980, Zambia's total arrears, principal and interest of her external debt amounted to US$ 3.9 million[141]. By the end of 1986, arrears stood at US$ 466.1 million rising to US$ 1.164 billion by the end of 1987. By the end of 1991, arrears accounted for about 24.9 per

[139] IMF, Selected Issues and Statistical Index, IMF Country Report Numbers 04/160 and 06/118

[140] IMF, 1990- 2004, Statistical Appendices, Washington, USA

[141] Fernholz, F.R. 2004 Debt Management and Debt Relief during the 1990's in Zambia (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) p267 see also World Bank, Global Development Finance (various Issues); Zambia, MoFNP, Macro-economic Indicators, (Various Issues, Lusaka, Zambia.

cent of the debt stock which was about US$ 1.813 billion. This was the beginning of the debt overhang in Zambia.

In the period between 1992 and 1995, the debt stock was considerably reduced by using several policy options which included actual debt service by Zambia, negotiating for debt write offs, rescheduling arrangements with bilateral creditors in both the Paris Club and non Paris Club members[142]. For example, under the 1992 rescheduling agreement with the Paris Club creditor countries, Zambia's external debt stock was reduced from US$ 6.943 billion to US$ 6.853 billion and over the next three years, a decline of eight per cent was recorded. Table 8 below which presents Zambia's external debt stock shows that by 2004 however, the external debt had risen to over US $7 billion meaning that the country had not decisively addressed the problem of its huge debt overhang.

Following the normalization of relations between Zambia and the IMF and World Bank, Zambia's access to their resources improved.[143] As Table 11 shows, Zambia's debt to the multi-lateral institutions grew quickly. By 1996, multi lateral debt had increased to US$ 3.269 billion representing over 50 percent of the country's total external debt exposure. Of this, about 21 per cent was debt owed to the World Bank and about 19 per cent was owed to the IMF. The share of bilateral credit stood at about 46 per cent or about US$ 2.677 billion.

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[142] Fernholz, F.R. 2004 Debt Management and Debt Relief during the 1990's in Zambia (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,) pp 269-281

[143] Ministry of Finance and national Planning *Annual Economic Reports* various issues, 1991-2004

Table 11 shows that Zambia's total external debt stock stood at US $ 7.1 billion in 2004 and the stock of external debt disbursed and outstanding payments inclusive of arrears between 1996 and 2004. It is clear from Table 11 that Zambia's external public debt stock was high at almost US$700 per capita debt in Zambia.. Most of the debt was owed to multi lateral institutions whose debt could not be rescheduled. This was according to their rules. In 2004, US$3.9 billion out of the total external debt of about US$7.2 billion was owed to multi lateral institutions. As it has been shown earlier, the conditionalities were such that if Zambia defaulted on any of the multi-lateral debt repayments, all the donors grouped in the Paris Club also would freeze any bilateral support they had with Zambia. It is obvious that Zambia was in a very difficult situation and that it needed to not only exit this debt trap but also make improvements to its public debt management capacity.

Table 11

External Debt Stock of Zambia 1992-2004 (US $ Million)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
edium/Long erm ub. arranteed					5,946.1	6,171.0	6.650.5	6,051.5	5,837.0	6,437.9	6,470.0	
ultilateral	1,471.8	154.2	1688	3,201.2	3,268.7	3.314.6	3,172.7	3,375.1	3,404.3	3.346.1	3.855.2	3,703.0
DB/ADF					176.4	169.7	257.0	320.7	328.4	318.7	296.0	217.2
orld Bank					1,402.1	1,482.1	1,547.6	1,668.3	1,788.7	1,837.1	2,491.2	217.2
MF					1,205.5	1,205.5	1,205.2	1,219.2	1,128.5	992.0	965.9	2,294.4
hers					484.7	456.5	162.9	166.9	158.7	198.3	102.0	1,065.1
lateral					2,677.4	2,856.4	3,477.8	2,676.4	2,438.5	3,091.8	2,614.8	126.3
ris Club	1,583.4	1,674	1,833.1	2,152.6	2,246.4	2,427.3	2,998.5	2,405.0	2,179.2	2,713.9	2,343.1	2,245.4
n Paris Club	433.7	432.9	435.2	452	431.2	429.1	479.3	271.4	259.3	377.9	271.7	2,000.0
ed/lt/pvt					260.0	231.3	278.2	455.9	410.3	832.3	670.4	245.4
mmercial	243.4	244.1	231.3	236.3								
ivate	11.8	41.4	42.3	56.8								546.6
otal Stock	3,744.10	3,913.60	4,229.90	6.098.90	6,206.1	6,402.3	6,928.7	6,507.4	6,253.1	7,270.2	7,140.4	6,495.0

Source: Compiled from: Ministry of Finance and national Planning *Annual Economic Reports* 1991-2004

A detailed perspective giving calculations for the estimated external debt stock as at June 2003 per identified creditor or activity is highlighted in Appendix 8. The Appendix clearly distinguishes the principal owing, the interest and arrears as well as the specific creditors. Analysis of the debt by type of activity shows that over 54% of the debt was multilateral debt, and 36.6 percent was bilateral debt showing that Zambia had a severe liquidity problem.

In terms of currency composition, Table 12 summarizes the status in 1997 and 2002. Most of the external debt (51.7% in 2002) was denominated in Special Drawing Rights (SDR) indicating that the IMF was the single most important creditor and most influential. Zambia's debt liability to the IMF by way of Special Drawing Rights constituted 44.1 percent and 51.7 percent of all the foreign debt of Zambia in 1997 and 2002, respectively. This fact meant that, in relation to the Zambian Kwacha which was weak, Zambia suffered immeasurably on account of exchange losses. Between 1995 and 2004 the official exchange rate between the Kwacha and the United States Dollar depreciated from ZMK759.3 in the first quarter of 1995 toZMK 4,781.1 in the fourth quarter of 2004.[144]

[144] IMF (March, 2006) Zambia: Selected Issues and Statistical Appendix

Table 12

Zambia's External Debt by Currency Composition 1997 and 2002*

	1997	1997	2002	2002
Currency	AMOUNT	% of Total Debt	AMOUNT	% of Total Debt
French Franc	139.8	2.3	93.5	1.3
Deutche Mark	508.7	8.6	348.6	4.9
Pound Sterling	399.3	6.7	386.0	5.5
US Dollar	692.2	12.4	952.2	13.5
Japanese Yen	692.2	11.6	748.6	10.6
Special Drawing Rights	2,622.6	44.1	3,653.0	51.7
Other	840.4	14.3	884.4	12.5
TOTAL	5,941.4	100.0	7,066.3	100.0

Source: Zambia,Ministry of Finance and National Planning, 2003 Zambia 2003 *DSA for Completion Point Report*, Livingstone,19-30 Mayp15

- The later years 2003 and 2004 could not be provided by either the Bank of Zambia or the Ministry of Finance and National Planning as the data had not been computed for the years in question at the time of this study..

With regard to the composition of the debt stock by interest rate structure, Table 13 provides details for the year 1997 and 2002.

Table 13

Zambia's Debt Stock by Interest Rate Structure in 1997 and 2002

	1997	1997	2002	2002
	AMOUNT	RATE	AMOUNT	RATE
Canada Prime Rate	37.7	0.6	39.6	0.6
UK Prime Rate	144.5	2.5	156.3	2.2
LIBOR 6 MONTHS DEPOSIT	87.3	1.5	108.3	1.5
FF Deposit in London (3 M)	28.8	0.5	16.7	0.2
Taux Du Marche Obligatoire	58.2	1.0	68.9	1.0
0 to 4.99%	2,388.7	42.3	3,480.7	49.2
10%	2,506.5	0.7	218.7	3.1
TOTAL	5,653.2	100.0	7,066.3	100.0

Source: MoFNP, Investment and Debt Management Department, 2003 *DSA for Completion Point Report*, Livingstone, p 17

The interest rate structure of the debt stock in 2002 was mainly in the 0 to 4.99 per cent where the bulk of the debt was affected as opposed to 1997 where the stock was concentrated in the 5 to 10 per cent category. This can be explained by Zambia's shift from borrowing from commercial sources where the debts were non concessional to borrowing the bulk of the loan portfolio from the International Development Agency (IDA) whose terms were concessional as the interest terms were pegged at only 0.75 percent and over longer repayment periods. The Table shows that between 1997 and 2002, average interest rates grew from 5.7% to about 7.1%. All this additional cost was borne by debtor nations on compound rates. This was very onerous for Zambia as the added cost of the debt meant additional distress on its foreign exchange earnings which in turn adversely affected its budget.

With respect to the maturity of the external debt, Table 14 provides the situation for 1997 and 2002, which range adequately covers the way the external public debt was maturing.

Table 14

Maturity Structure of Zambia's External Debt in 1997 and 2002

	1997		2002	
MATURITY	AMOUNT	%	AMOUNT	%
0 TO 4.99 years	61.2	1.0	96.6	1.4
10 years or more	5,448.8	91.7	6.545.4	92.6
TOTAL	5,941.4	100.0	7,066.3	100.0

Source: MoFNP, Investment and Debt Department, 2003 DSA *DSA for Completion Point Report*, Livingstone page p17

The profile of the stock shows that more than 90% of Zambia's external debt had a relatively long maturity structure of 10 years or more. This reflected the concessional nature of the loans contracted. However, in spite of this, when the debts fell due, the

country was still obligated to redeem them. In this way, it impacted on the type of improvement in debt management one wished to introduce.

With respect to debt service, this has been the one onerous and costly factor in Zambian's public debt management between 1990 and 2004. As shown in Table 15, in 1991, debt service payment was US $ 655 million, which was very onerous for Zambia. This was because there were a lot of maturities that fell due on the IMF loans as a result of the previous Kaunda government breaking off with the IMF programme in 1987. In order to service the IMF maturities, Zambia was forced to contract more loans and this in turn simply added to its external public debt obligations. Table 15 shows that the hump between 1992 and 1995 was due to repayment of arrears to the IMF. The Table further shows that debt service after 1998 began to generally decline. In 2000, the debt service before applying for HIPC assistance would have been US $ 434 million on average and more than US $ 630 million afterwards due to the IMF maturities that were falling due after the rescheduling in the early 1990s.[145] But because of Zambia being under an IMF supervised programme, the debt service obligations were reduced as Table 15 shows.

[145] IMF, 1999, Zambia Statistical Appendix, IMF Staff Country Report Number 99/43, Washington D.C, USA

Table 15

Zambia's Actual External Debt service 1990-2002 (US$ million)

	1990	91	93	94	95	96	97	98	99	2000	2001	2002
Creditor												
Bilateral							48.4	42.5	66.9	55.0	39.1	29.1
Paris Club							33.9	29.7	51.1	34.4	39.0	28.5
Non-Paris Club							14.5	12.8	15.6	20.6	0.1	0.5
Multilateral							111.7	89.4	86.9	90.1	90.1	96.1
IMF							8.7	8.0	9.1	8.3	46.6	75.2
IDA/IBRD							60.2	38.7	27.6	27.8	16.8	9.1
ADB/F							27.6	30.1	30.1	29.8	12.7	3.4
Others							14.6	12.6	20.1	18.2	14.0	8.4
Financial Institution							-	-	-	-	-	-
Other	,										0.4	
Total	290	655	275.	315.9	324.4	348.7	256.4	160.1	131.9	153.8	139.1	129.2

Source: Compiled from Data provided by IDM Department, MOFNP *Annual Budget Speeches* and IDA and IMF ,Statistical Appendices, various issues

The debt burden of Zambia has over the years been made a little easier by debt relief in terms of the rescheduling forgiveness that creditors have given to a country. Table 15 above shows that Zamia's annual debt service reduced from a high of US$655 million in 1991 to about US$129.2 million in 2002. This debt service was still onerous as Zambia had to forgo social sector investments to service the debt.

Table 16

Selected Features of Zambia's External Public Debt

Year	Total Debt		Scheduled Debt Service		Debt/GDP Ratio	Debt/Exp. Ratio	Debt/Rev. Ratio	Debt Service Interest Paid (K Billion)
	US$ Million	% of Exp. Ratio	US$ Million	% of Exp. Ratio				
1990	6, 898	505	647	47.4	-	-	-	-
1991	6, 827	576	718	60.6	-	-	-	-
1992	4, 981	413	678	56.3	-	-	-	-
1993	5, 102	483	522	49.4	-	-	-	-
1994	6, 397	542	541	46.2	-	-	-	-
1995	7, 041	550	590	44.9	68.7	-	-	182
1996	7, 085	620	453	41.6	52.8	-	-	200
1997	6, 971	534	399	32.7	27.2	-	-	211
1998	6, 613	720	328	35.7	19.0	810	584	123
1999	6, 407	761	318	37.8	14.9	848	483	107
2000	6, 253	717	388	44.5	13.5	838	320	164
2001	7, 270	689	590	55.9	15.7	822	289	124
2002	6, 488	601	593	54.9	12.8	708	223	210
2003	6, 468	519	616	49.4	10.6	615	175	229
2004	7, 080	347	710	34.8	9.6	398	149	152

Source: Compiled from IMF, Statistical Appendices, various issues

Table 16 further shows that Zambia's external debt was relatively high. If compared to the statistics computed from World Bank Tables,[146] Zambia's debt burden averaged US$ 900 per capita while for the other Sub Saharan African countries, it was about US$ 450.Additionally, Zambia's debt service as share of GDP averaged 9 percent , double the ratio of other Sub Sahara African countries. While the debt service during the period of study was reducing on account of repeated rescheduling, the debt/export ratio was way above the 150% threshold accepted by the IMF/World Bank as being sustainable. As

[146] Computed from World Bank, World Bank Tables (Various Issues)

Table 16 shows, Zambia's debt/export ratio was at a high 810% and even though it reduced and reached 378% in 2004, it was still unacceptably too high.

Furthermore, in terms of sustainability, between the period 1991 and 2004, following the liberalization of the financial sector, the real growth rate of Zambia's economy was consistently lower than the real interest rates. GDP growth between 1990 and 1999 averaged -0.5 percent per annum while UK prime rate was 2.5 percent. The economic growth rate of the country declined further in later years but was not matched by a reduction in deficit financing. This situation shows that a country with such statistics would sooner rather than later be subjected to unsustainable debt overhang.

In order to fill its expenditure programme, the state run uncontrollable primary deficits. Table 17 below shows that Zambia's revenue to GDP ratio was very high rising from 40 per cent in 1995 to 206 per cent in 2004. This symbolised that the country had severe budget funding problems and deficit financing was one open option to fund the budget gaps. This factor was the crucial one responsible for the development of the domestic public debt overhang.

Zambia's situation can be compared to the findings of a study by Yan Sun (2004)[147] on HIPC Completion Point countries during the period 1992-2002. The maximum and minimum ratios for the thirteen countries ranged between 38 percent and 6 percent to Zambia's range of between 206 percent and 40 percent showing that the debt service was unsustainable if Zambia desired to defeat poverty and underdevelopment.

[147] Yan Sun ,2004, External Debt Sustainability in HIPC Completion Point Countries, *IMF Working Paper* WP/04/160

Table 17
Zambia: Central Government Revenue to GDP Ratios 1995-2004

Year	Revenue (in ZMKb)	GDP (in ZMKb)	Revenue/GDPRatio
1995	871	2177	40
1996	1958	2328	45
1997	1283	2405	53
1998	1529	2360	65
1999	1921	2414	80
2000	2528	2499	101
2001	3262	2621	125
2002	4259	2708	157
2003	5104	2847	179
2004	6173	3001	206

Source: Compiled from IMF, Statistical Appendices, various issues.

The other measure of external debt sustainability was the debt service to revenue ratio. This ratio measured the capacity of the economy to service the current debt. For Zambia, between 1995 and 2004, the ratio hovered between 271 percent and 46 percent respectively as Table 18 below shows.

In other words, in 2004, without fresh donor inflows or other relief, 46 percent of the Zambian government's revenues would have been used for debt service. Table 19 below further shows some indicators of debt distress that Zambia was subjected to.

Table: 18

Zambia: Debt service to revenue Ratios 1995-2004

Year	Schedule Debt Service		Revenue	Debt Service/Ratio
	(in US$ millions)	(in ZMK billions)*	(in ZMK Billions)	
1995	590	2360	871	271
1996	453	1812	1058	171
1997	399	1596	1283	124
1998	228	912	1529	60
1999	318	1272	1921	66
2000	388	1552	2528	61
2001	590	2360	3162	72
2002	593	2372	4259	55
2003	609	2436	5194	48
2004	710	2840	6173	46

* Exchanged rate is taken as ZMK 4,000 = US$ 1
Source: IMF ,2004, 2006, *Selected Issues and Statistical Appendices*

Table 19:

Indicators of Zambia's Debt Distress

Debt Distress	1990	1995	1999
EPD as % of exports	506	550	691
Sched DS as % Exp	47	46	63
Net Debt S as % exp	6	30	20
Net Debt S as% GDP	2	10	5

Source: Hendrick van der Heijden ,June, 2000, *The Ineffectiveness of Economic Policy Reform, Foreign Aid and External Debt Relief in Zambia,* , Economic Association of Zambia, Lusaka.

Zambia was greatly debt distressed as Table 19 attests. The level of external dent averaged US$ 7 Billion during the study period. Per capita debt burden averaged US$ 720 for Zambia while for Sub Sahara African countries; it was US$466 during the same period. Interest payments absorbed a large proportion of revenue. Debt service as a percent of exports was relatively high. Rising from 6 per cent in 1990 and reaching 30 per cent in 1995 before slightly falling to 20 per cent in 1999.

Zambia's public debt problems can be explained variously. The first and arguably the most profound argument for Zambia's economic woes, which was worsened by its relatively huge public debt overhang ,was Zambia's failure to sustain the development of the copper mines. The neglect of copper mine development manifested itself in, first, Zambia failing to recapitalize the nationalized mining companies to the extent that there was gross under investment in ZCCM.[148] Secondly, the holding company ZCCM suffered inadequate supervision and poor management as political rather than business interests were considered more important. This neglect to recapitalizing the copper mining companies led to a decline in copper production which, as already observed in Chapter Two declined drastically. The consequence of this declining copper production exacerbated by low metal prices, resulted in Zambia suffering balance of payment problems. With the reduced export earnings, it increasingly became difficult for the country to service its external debts. In other words, it became increasingly difficult to manage the external debt as Zambia did not have sufficient foreign exchange when payments fell due.

[148] Gray, Clive 2004 Critical Review: Lessons from Zambia for Sub-Saharan Africa (in) Hill, C.C. and McPerson, M.F., (Ed) *Promoting and Sustaining Economic Reforms in Zambia.* (Harvard University Press, Boston, Mass,)

Table 20

Zambia's Merchandise Exports 1995-2003 fob.

(In Millions US Dollars)

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Exports	1066	1198	995	1110	816	755	746	884	916	1117
Metal Exports	910	984	760	807	520	467	497	590	560	710
Copper										
Value		851	569	621	365	372	425	507	510349	601
Volume		327	302	256	240	234	297	330		
Price*1		1.12	0.79	0.93	0.65	0.70	0.82	0.77	0.70	0.78
Cobalt										
Value		134	193	187	157	95	72	83	50	109
Volume										
Price*1		3.9	4.6	4.9	3.7	3.4	4.7	4.2	6.6	
		24.5	22.6	18.3	14.4	11.6	9.6	8.0	5.4	7.5
Non-Metal Exports	157	235	304	296	288	249	295	357	407	

Source: BOZ, Main Economic Indicators (Compiled from Various Reports) *1 US $ per pound

Table 19 above summarizes the statistics in Zambia's merchandise exports between 1995 and 2003. Whereas copper production averaged 300,000 metric tons, the total value of income received dropped from US $ 851 million in 1995 to US $ 372 million in 1999 before rising to US $ 601 million in 2003. The low earnings from copper exports was because the international prices of copper were generally depressed and were generally below the break-even point of profitable copper production which was around US $1.20 per pound. Instead the price of copper dropped from US$1.12 in 1995 to US $0.65 in 1998 before marginally rising to US $ 0.78 in 2003.

It was this fall in copper earnings as a result of low production and low international copper prices that led to the decline in export earnings from copper. This decline of copper production and income continued into the 1990's as ZCCM continued with its serious production costs and efficiency problems. This situation negatively affected Zambia's economy as a whole.

The second error Zambia made was to allow the country's savings, investment and fiscal efforts to weaken while at the same time, the policy makers allowed unproductive consumption to expand or rise. Table 21 below summarizes the pertinent indicators of macro economic performance of the country. This fall in investment meant that Zambia was unable to earn sufficient foreign exchange to enable it meet its debt service obligations when they fell due.

Table 21

Zambia: Indicators of Macro-Economic performance 1980-2004

	1980	1990	1995	1999
Cooper Exports ('000 tonnes)	682	440	341	352
% of GDP				
Government Revenue	25.5	20.3	19.9	17.5
- Tax Revenue	22.9	19.9	18.7	17.1
- Non-Tax Revenue	2.6	0.2	1.7	
Public savings	-	5.5	3.6	0.4
Gross Domestic Savings	19.3	16.5	7.3	4.7
Consumption	80.7	83.5	82.7	94.6
Gross Domestic Investment	23.3	17.3	13.1	13.8

Source: Ministry of Finance and national Planning, *Economic Reports*, (Various Years)

Table 21 shows that the gross domestic savings in 1980 were quite low at 19.3 percent of GDP which by 1999 had dropped to 4.7 percent as compared to Sub-Sahara African

countries average of 26 per cent[149] at the time. The savings dropped further to 16.5 percent in 1990, 7.3 percent in 1995 reaching 4.7 percent in 1999. This situation was very bad for Zambia when compared to the savings rate of low-income countries as a whole, which averaged 32 percent of GDP in 1998. It was obvious that such policies that neglected mobilization of domestic resources was bound to drive Zambia into donor dependency.

In his study,Hendrick Van der Heijden (June 2000)[150] noted that in Zambia, failure to adopt an economic growth-oriented diversification strategy that required a determined programme to raise internal savings to finance an expanding investment level in the non-copper sector, must be seen as a strategic error of the Zambian government. Whereas it was generally acknowledged that without a minimally adequate level of net investment, Zambia's economy could not grow, the policy makers in their actions failed to realise this objective.

Table 22 shows the fall of gross domestic investment and compares it with projected growth in various programs that Zambia took between 1990 and 2004.

[149] Heijden, H. 2000, *The Ineffectiveness of Economic Policy Reform, Foreign Aid and External Debt Relief in Zambia,* , Economic Association of Zambia, Lusaka p10-13

[150] Heijden, H. 2000, *The Ineffectiveness of Economic Policy Reform, Foreign Aid and External Debt Relief in Zambia,* , Economic Association of Zambia, Lusaka

Table 22

Zamia: Gross Domestic Investment (% of GDP)

Actual Vs Projections

	1990	1991	1992	1993	1994	1995	1996	1907	1908	1999	2000	2001
Actual	17.3	11	11.9	15.0	12.7	13.1	14.8	13.6	14.4	13.8		
Projections												
1989-93		22.5	24.9	27.4								
PFP 1992-1994			19.5	20.0	20.5		14.5	15.5	19.5			
ESAF 1995-98												
ESAF 1996-2001										17.6	20.3	20.0

Source: Ministry of Finance and National Planning, *Economic Reports*, (Compiled from Various Years)

Public investment was not only low as compared to policy objectives with the programme objectives but also showed rather disturbing features of dependence on external assistance.

On account of the devastating unstable external debt problems, the IMF and the World Bank in December, 2000, allowed Zambia to be considered for debt relief under the HIPC initiative. However, before Zambia could reach the floating completion point and enjoy debt relief, it had to conduct a Debt Sustainability Analysis (DSA)[151]. The Ministry of Finance and National Planning conducted this study in 2004 under the supervision of the two institutions, the IMF and the World Bank.. The report is reviewed in Chapter Four of this study.

[151] Ministry of Finance and National Planning , 2004, *Debt Sustainability Assessment Report* , Lusaka, Zambia.

CONCLUSION

In concluding this chapter, it is clear from the data adduced that the domestic and external public debt of Zambia grew rapidly and posed a potential threat to macroeconomic stability of the country during the period 1991-2004. With respect to the domestic debt, it grew to very high levels that it caused major distortions in the economy. These distortions which included high interest rates, the crowding out of the private sector, and the perception that Zambia was un-creditworthy, meant that the huge magnitude of Zambia's domestic debt would continue to be a major constraint on the country's desire to eradicate poverty. What was most unfortunate during the period of the study was that the country had no strategy to manage the growth of the domestic debt or to address the accumulation of arrears other than to seek for fiscal restraint by way of moral suasion which, was not however adhered to. The domestic debt was unacceptably unsustainable.

With respect to the external debt of Zambia between 1991-2004, the study revealed that the country was compelled to service annually external debts in the range that was one third above the country's total export earnings. This meant that the country was left with hardly anything to invest in the growth sector to enable it eradicate poverty and underdevelopment. The fact that the country resorted to borrowing from the domestic market further worsened the distortions in the economy.

In the history of humanity, there were several examples where debt payments owed to richer creditors were either cancelled or reduced so much to allow recipient nations to

catch up.[152] After World War Two for instance, British repayments to the United States were capped at four percent debt-service to export ratio. In 1953, defeated Germany was allowed to limit its payments to only 3.5 percent. Further examples were even more recent. In the 1960s, Western countries capped Indonesia's repayments to six percent to reward the Suharto regime for the overthrow of the Communist regime. After the 1991 Gulf War, the United States forgave US$7 billion in military debts owed by Egypt. In other words, cancelling Zambia's external debts would not be an impossible burden for creditors who had taken losses in other parts of the world in the past by writing off these debts or allowing huge discounts. All what was required was political will.

[152] Korner P., Mass G.,Siebold T., Tetzlaff., 1984 *The IMF and The Debt Crisis*, Third World Books, Zed Books, London .