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Premier Consult Limited

"Zambia's Economic Outlook"

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Zambia's Economic Outlook

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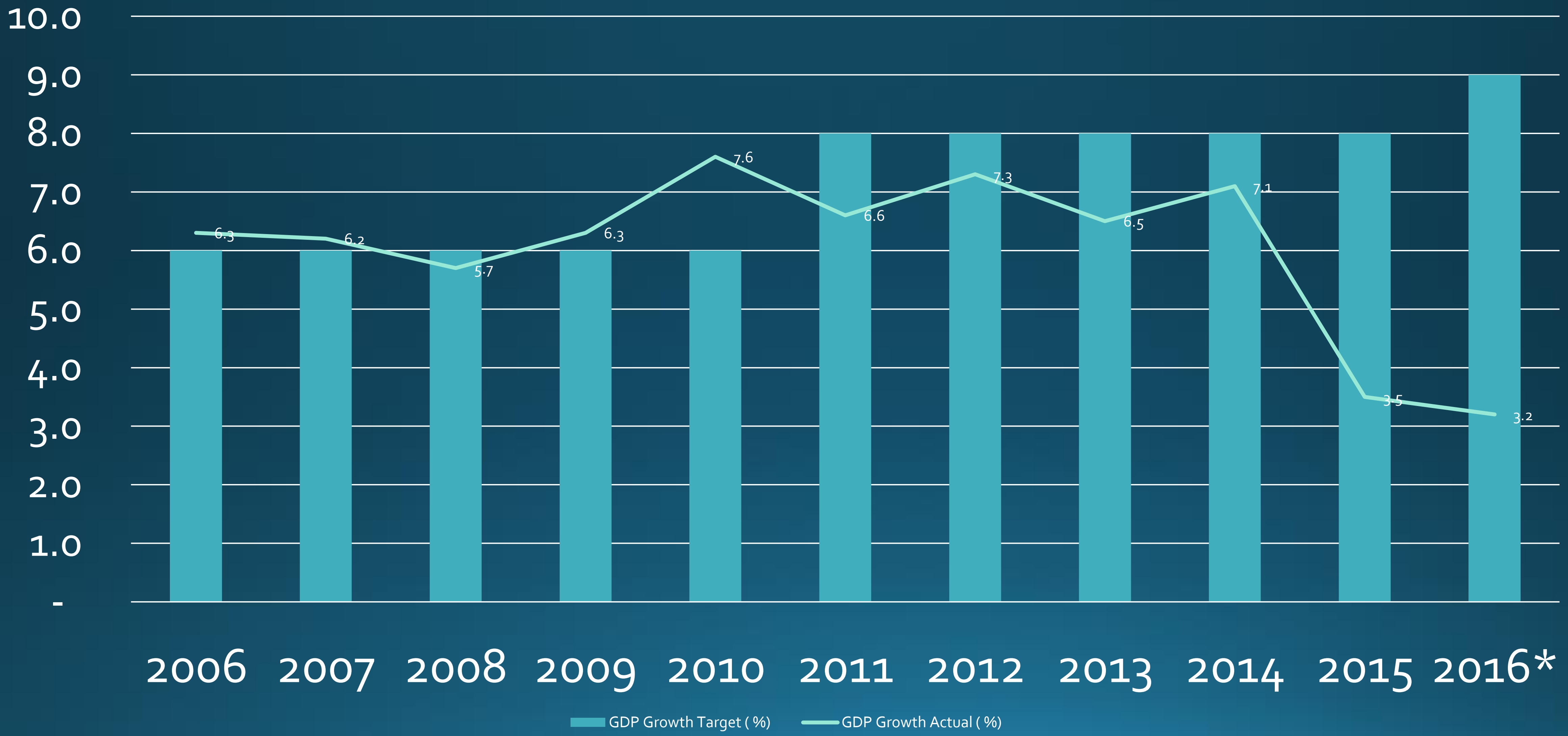
Macro-level Background

- GDP growth during the FNDP (2006-2010) was above the targeted 6%.
  - The only year where growth was below 6% was in 2008 as a result of global financial crises. However, growth was still high, at 5.7%.
- As a result of the sustained economic growth exhibited over these years and the attainment of per capita income of above US$ 1,600 in 2011, the World Bank reclassified Zambia as a Lower Middle Income Country in 2011.
- But ugly things began to happen from 2011…

GDP growth: Actual Vs Target



Important messages…

- Large fiscal imbalances and rapid increase in government's debt since 2011 have raised concerns about the sustainability of fiscal policies in Zambia
- loose fiscal policies in the form of excessive spending in the face of relatively low and flat revenues began emerging in 2012, and by 2013 the fiscal deficit on a cash basis reached 6.4 percent of GDP.
- Lack of adequate policy response to external and domestic shocks weakened government revenues and led to significant spending overruns and wider fiscal deficits up to now

Important messages…

- Fiscal challenges worsened since the second half of 2015 amid negative market sentiment abroad and tighter liquidity conditions domestically
  - Liquidity challenges following tightening of monetary policy by BoZ in 2015/Q4
  - Abroad, GRZ was unable to access financing in the international capital markets
  - These factors worsened the fiscal deficits amidst widening payments arrears

- Fueled by the rapid exchange rate depreciation in 2014-15 and the heavy reliance on external sources to finance the growing fiscal imbalances, public external debt doubled in 2015 compared to 2014
  - The Zambia kwacha lost over 40 percent of its value in 2015
  - external debt increased from 20 percent of GDP at end-2014 to 43 percent of GDP at end-2015 mainly on account of exchange rate risk)

- In 2016, all major credit rating agencies downgraded Zambia’s sovereign rating mainly due to widening fiscal deficits and weaker debt dynamics
- By 2017, Zambia’s risk of debt distress has increased to high driven projected high borrowing requirements over the medium term

Declining foreign grants/aid

- Since 2012, foreign grants have declined sharply affecting Zambia's overall resource envelope.
  - The reduction in foreign grants reflects consolidation efforts by major donors as well as the somewhat limited progress made by government in strengthening public financial management

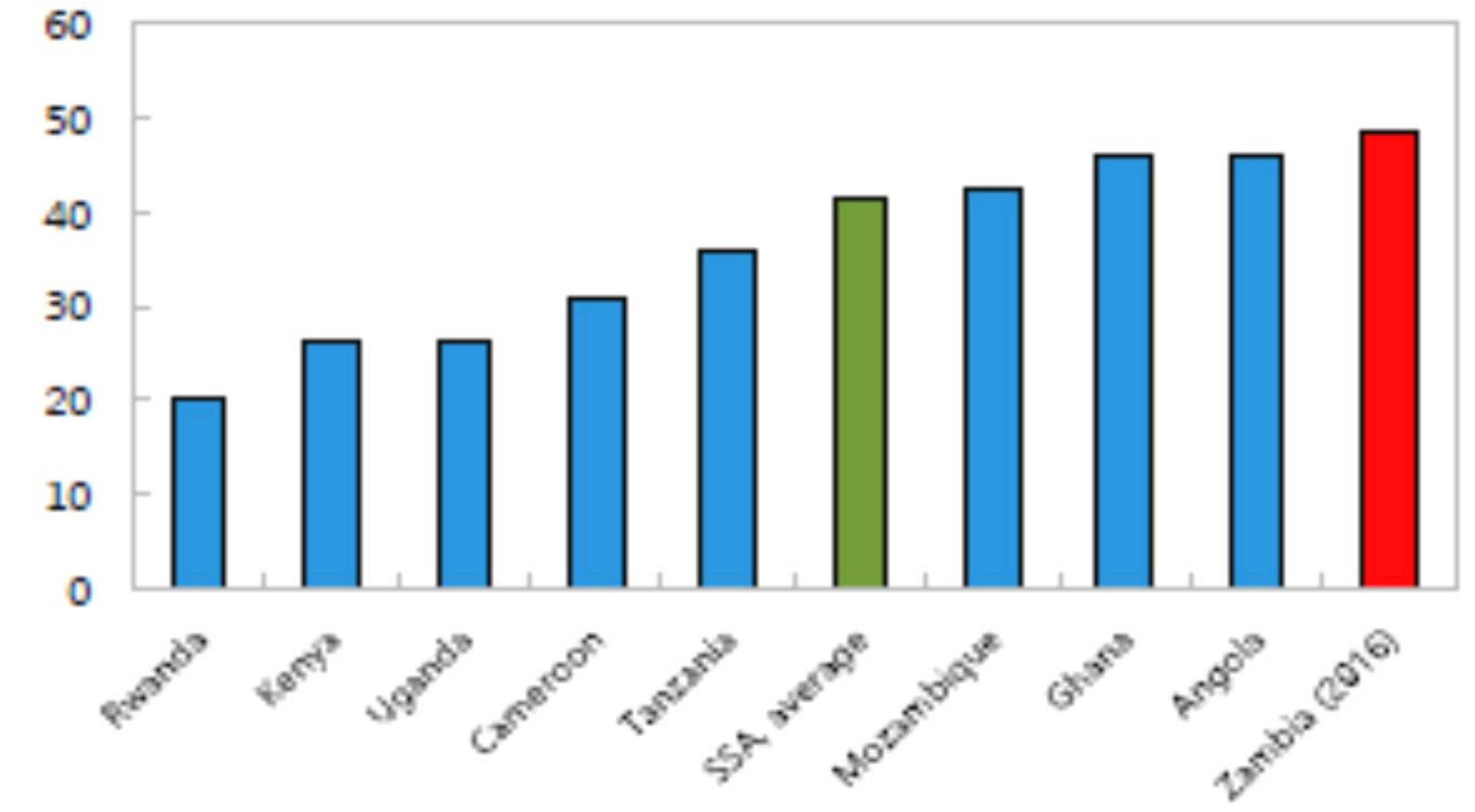
Unsustainable Expenditure Levels

- Recurrent expenditure has continued to outpace domestic revenue mobilization
  - Starting in 2016, the wage bill (took 48.4 percent of domestic revenues), energy and agriculture subsidies (29.9 percent), and debt service (24.2 percent), absorbed over 100 percent of the budget's domestic revenues
    - This left no room for operational and other priority spending, including social cash transfers, but also called for more borrowing

Ballooning wage bill

- Zambia's wage bill is high relative to peer countries in the SADC region It increased rapidly from less than 38 percent of domestic revenues in 2011 to nearly 52 percent in 2014.
  - This represents one of the main sources of pressure on public finances in Zambia.

Wages in Percent of Revenues (Excluding Grants), 2016



Sources: World Economic Outlook database.

Recurrent expenditures exceed domestic revenues

Source: Ministry of Finance and ZIPAR's own calculations

	2011	2012	2013	2014	2015	2016	2017
Recurrent expenditure, % of domestic revenue	**92%**	**94%**	**97%**	**103%**	**112%**	**111%**	**110%**
Personal emoluments	38%	42%	45%	52%	47%	48%	47%
Interest payments	6%	9%	7%	12%	15%	19%	23%
Other recurrent, including subsidies	49%	43%	45%	39%	49%	44%	40%
o/w Social Benefits	5%	4%	3%	2%	2%	1%	4%
Capital expenditure, % of domestic revenue	**20%**	**19%**	**29%**	**20%**	**38%**	**21%**	**20%**
Social Benefits per capita (Kwacha)	**70.1**	**58.4**	**48.3**	**48.9**	**53.5**	**33.4**	**115.0**

Large and not well targeted subsidies

- Energy and agriculture are among the main sources of spending overruns.
    - They soared from 21 percent of 2015 domestic revenues to nearly 30 percent of 2016 domestic revenues.

The threat of Debt Crisis

A load of unsustainable debt hangs heavy over Zambia

- Zambia is part of a list of 25 low income countries considered by the IMF to be at high risk of debt distress in 2018
- Zambian debt reached 59% of GDP as at end of 2017, which is in the territory of unsustainable debt levels. It is now around 73% of GDP
- In October 2017, the IMF issued a red flag that Zambia was at high risk of debt distress, implying that the country was likely to breach the thresholds for debt and debt service indicators and, should it continue on the same trajectory, it would likely default on its debt service obligations.

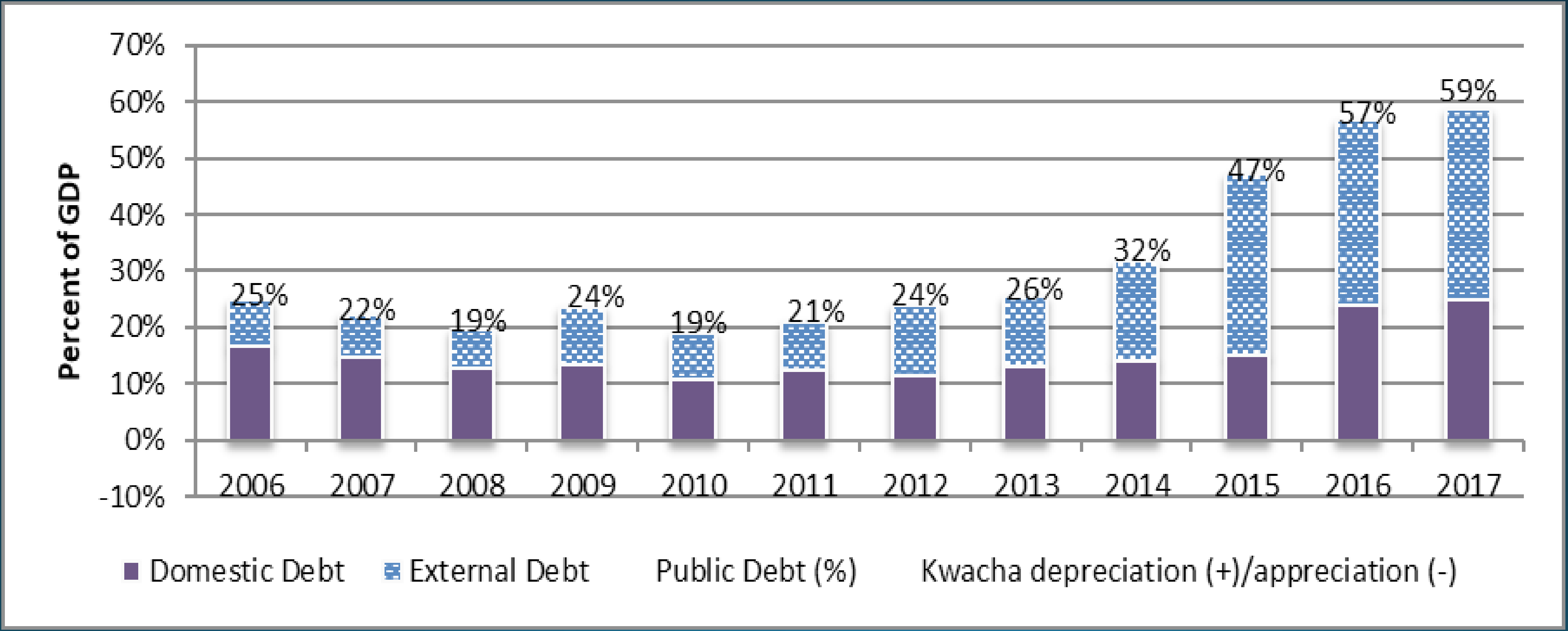
- Exchange rate weakness has contributed to the increase in interest payments in recent years.
  - When the kwacha weakens, as was the case in 2015, external debt increases in kwacha terms, as do the required debt service payments.
  - The foreign currency risk of external borrowing is, thus, increasingly becoming a source of concern

- There is a market concern that official figures for public debt could understate the true amount outstanding, possibly to a considerable degree
  - There is fear, for example, that debt from China has not been fully captured in the computation of official statistics.
  - The government's measures of debt do not include payment arrears, which increased rapidly between 2013 and the end of 2018
    - At the end of 2017, for example, arrears were K12.9 billion, or 5.2 percent of GDP.
  - Arrears adversely affect the private sector, reducing its contribution to GDP growth. The government's debt figures are also said not to include fully guaranteed borrowing by parastatals

This high debt has consequences for growth and poverty reduction efforts

- Increased domestic borrowing by Government from October 2015 resulted in reduced lending to the private sector as businesses and Government competed for credit, and thereby hampered economic growth.
- Further, with interest payments reaching 23% of domestic revenues and personal emoluments as high as 54% of domestic revenues in 2017, other priority spending as well as spending on social protection were crowded out, thereby hampering efforts to reduce poverty.
- Additionally, the high debt has made future borrowing more risky and more expensive, limiting opportunities to borrow, to invest or restructure debt going forward.

Zambia's growing Public Debt to GDP ratios, 2006-2017



Zambia's surging public debt is largely skewed towards costly commercial external debt due to issuing Eurobonds and increased export and suppliers' credit.

- This poses significant repayment and currency risks.
  - The bullet repayment structure of the first two Eurobonds means that the principal will have to be repaid at the end of the term of each loan in 2022 and 2024.
  - Further, interest payments are payable in US dollars, so when the local currency depreciates substantially, the cost of servicing this debt increases.
  - Moreover, while average interest rates on Eurobonds seem low at around 8%, the effective borrowing costs (interest rate *plus* average annual rate of depreciation) averaged 26% in 2016.

Governments attempts to scale down debt…

- In June 2018, Minister of Finance announced measures to bring the country ‘back on a more sustainable debt trajectory.’
  - postpone indefinitely the contraction of all ‘pipeline debt’ until debt distress is moderated
  - cancel some loans
  - renegotiate some bilateral loans in order to extend their maturity
  - cease issuance of guarantees for commercially viable projects
  - stop the issuance of letters of credit and guarantees to technically insolvent parastatals
  - only fund projects that are at least 80 percent complete

…but little progress recorded

- Trial run for 2022 when the first Eurobond falls due suggested that:
  - Increase in debt servicing costs (K9.4bn) is higher than the increase in domestic revenues (K7bn), which means that all the gains in revenues will be channeled to debt servicing costs
  - debt servicing costs will gobble 42% of domestic revenues
  - At 7.9% of GDP, debt servicing costs will be comparable to 8% of GDP usually spent on personal emoluments

Clearly, debt is the Elephant in the Room

- **Solution:**
  - Limit the fiscal deficit, on a cash basis, to 6.5% of GDP
    - Develop a medium term expenditure framework
  - Curtail domestic borrowing from 4% of GDP to 1.4% of GDP
    - Indefinitely postpone the contraction of all pipeline debt cancel some debts; undertake some refinancing
    - Prioritise the dismantling of arrears and curtail its accumulation
  - Reduce the pace of debt accumulation and ensure debt sustainability

Getting to the root causes of debt

- Unsustainable infrastructure spending in the face of low and flat revenues
- Low economic growth

- Reduce the appetite for unsustainable infrastructure spending
- Conditions for growth have to be put in place, including reducing debt accumulation through fiscal consolidation, letting the private sector take centre-stage, and implementing fiscal reforms

2019 Budget targets are unlikely to be met

- **Growth projected at 4%:** Likely to post 2.3-2.5% GDP growth according to the IMF and (yesterday) the new Minister of Finance
- **Inflation projected at 6-8%**: It soured to 8.6 last month June) from 8.1 in May)
- **International reserves at 3 months of imports**: It currently stands at only 1.6 months of import cover (US$1.41 billion) as reported by the new Minister of Finance yesterday

Hon Ng'andu's stated commitment

"**Indefinitely postpone the contraction of all pipeline debt:** The Ministry of Finance has engaged different Ministries to agree on projects to be slowed down, rescoped, cancelled or postponed. The target is to free at least US$500 million annually over the medium term. This is a complex exercise that has legal implications. The process has however taken a little longer to complete."

Update on Economic Developments in the second quarter of 2019, 17 July 2019

Outlook

Managing Zambia's debt requires a return to fiscal sustainability

- Fiscal sustainability indicates a point in time when the country is able to cover its recurrent expenditures within its domestic revenues.
  - This will ensure that borrowing is undertaken only for capital expenditure.

- Reducing the risk of debt distress requires strong and sustained fiscal consolidation
  - Limiting spending overruns
  - Improving domestic resource mobilisation (by removing hurdles to growth mostly faced by the private sector)
  - Exercising restraint on commercial debt and obtaining only concessional and semi-concessional borrowing as outlined in the debt strategy.
  - Debt should be utilised on high-return capital projects.

Government should reduce the crowding-out effect

- Government borrowing from commercial banks is one of the main reasons behind the crowding-out of private credit, coupled with Government's rapid accumulation of arrears which contribute to high interest rates.
- Illiquid suppliers may try to bridge the delays in payment from Government by borrowing from banks and other financial institutions.

- As banks and other financial institutions provide credit to companies owed by the Government, they bear the brunt of non-payment leading to a rise in non-performing loans (NPL).
  - This has left banks unable to extend credit to new customers.
- Credit growth to the private sector is likely to contract in real terms because of tightened credit conditions arising from the rise in NPLs.
- To offset the risks of non-recovery, banks are likely to pass the cost of arrears onto other private borrowers by adding a premium to their lending rate

Government should help reduce information asymmetries between lenders and borrowers

- Small and Medium Enterprises (SMEs) and other private sector players are faced with reduced commercial bank lending.
- Government's incorporation of the Credit Guarantee Scheme Limited, designed to diminish the risk associated with lending to SMEs and planned to be operationalised by September 2018, is commendable.
    - If the scheme works, it will enhance the growth of the financially-marginalised SME sector which has been a key known source of employment and income, and may work to spur growth in the economy.

Debt remains essential to the Zambian economy, but proper management is a must

- Usage of debt financing is still with us as Government revenues remain stagnated. Debt should therefore be obtained strictly for capital expenditure and not to fund recurrent expenditures.

Lastly, with a track record of half-hearted implementation of reforms, public debt management needs to be backed by legislation

- Government should use legal tools to support debt management
- Don't remove Parliament from approving debt commitments

The End