Zambia Institute for Policy Analysis & Research

CSO Annex Building, Cnr John Mbita & Nationalist Roads
P.O. Box 50782 Lusaka, Zambia

Tel: +260 211 252559
Fax: +260 211 252566
Email: info@zipar.org.zm
Web: www.zipar.org.zm

Submission on

The Effects of Trade Balance Deficit and High Debt Stock on the Budget Performance in Zambia

by

Zambia Institute for Policy Analysis and Research (ZIPAR)

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1 Introduction

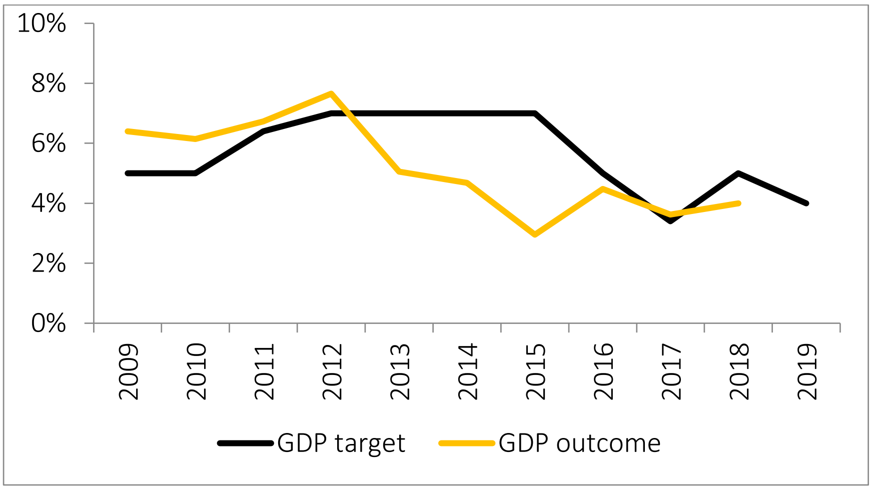
This report is in response to the request made by the Parliamentary Budget Committee to the Zambia Institute for Policy Analysis and Research (ZIPAR) to review the Ramification of Trade Balance Deficit and High Debt Stock on the Budget Performance in Zambia.

The growth and size of any economy are rooted in its financial and macroeconomic conditions. Macroeconomic aggregates are measured through summary indicators or variables such as the Gross Domestic Product (GDP) and GDP growth rate, inflation rate, exchange rate, overall unemployment rates and the trade balance to mention but a few.

Zambia has set herself on an ambitious venture of attaining the status of prosperous middle-income status by 2030. However, budget performance has been worrying in the past 4-5 years, showing persistent deterioration in the economy's fiscal position. Specifically, as fiscal spending has grown and fiscal revenues have remained relatively flat, the fiscal deficit and the debt stock have mounted, adding new debt service pressures on the already constrained public resources.

Moreover, with the continued slowdown of Zambia's economic growth over the years, from a real GDP growth rate of 6.1% per year on average over 2009-2014 to 3.8% per year during 2015-2018 (Figure 1.1), restoring both robust economic growth and fiscal stability are the two biggest challenge the country faces. The inability of the Zambian economy to sustain the robust economic growth it experienced from 2000 to 2014 stems from a lack of fundamental diversification, sophistication and structural transformation.

Figure 1.1: Real GDP growth rate targets and outcomes



Source: Authors' construction

On the other hand, the fiscal instability that has persisted since around 2015 stems from the imbalance between persistently high fiscal spending and relatively flat fiscal revenue at a lower level of output than spending. This has caused persistent fiscal deficits that have been financed through increased borrowing, thus contributing immensely to the increase in the total public debt from a low of 18.8% of GPD in 2010 to 62.2% of GDP in 2017. The negative ramifications of debt accumulation on the national budget are therefore worth considering.

On the external economy front, the Balance of Payments (BOP) – international inflows and outflows of capital and current account items (goods and services) among other items – has a major indirect macroeconomic bearing on Zambia's fiscal performance. Of particularly interest in the context of this paper is the relationship between budget performance and the trade deficit. To understand this less obvious relationship it is instructive to first consider international trade and trade deficits more broadly.

International trade is big business around the world. In 2017, world exports reached US$17.6 trillion and imports were higher at US$17.8 trillion, implying a total trade volume of US$35.3 trillion. The fact that imports were larger than exports implied a trade deficit of US$ 195 billion. This meant that, structurally, the world generated less in foreign exchange earnings from exports than it required to finance its import bill. In other words global import demand for production and consumption purposes outstripped export earnings.

Formally, the *trade balance* captures a component of the current account in the BOP. It consists of the: *goods trade balance*, which captures monetary transaction on merchandise exports less monetary transaction on merchandise imports; and *goods trade balance*, which captures monetary transaction on merchandise exports less monetary transaction on merchandise imports. The usual reference period for BOP statistics is a year although quarterly and even monthly statistics on the same are also quite uncommon.

By definition, trade can be in perfect balance, where exports are exactly equal to imports during a given year. This is generally an ideal or hypothetical situation that will rarely occur in the real world. Conversely, in practice trade will either be in surplus, meaning that exports are greater than imports or it will be in deficit, implying that exports are less than imports (or net exports are negative). In a sense, a trade deficit reflects that an economy is relatively more dependent on the external economy (or other territories) to satisfy its supply needs for domestic goods and services than the rest of the world depends on that economy to produce and supply goods and services. As a rule of thumb, the larger and more persistent the trade deficit, the weaker will be a country's local currency. A weakening currency has many fundamental implications for budget performance, given the need to meet the public sector import bill, to settle all other import demand transaction and to settle external debt services and amortization obligations.

Zambia has therefore recently experienced twin deficits, in trade account under the current account and in the budget deficit. This implies a dual stifling effect of economic imbalances on the economic growth and development of the country.

This paper looks at the two interrelated but distinct aspects. We consider the implications for Zambia of: a trade deficit on budget performance on the one hand; and high public indebtedness on the budget performance. We must hasten to emphasize that even though the topic was given as “Ramification of Trade Balance Deficit and High Debt Stock on the Budget Performance in Zambia”, the implied suggestion that the trade deficit and debt stock are somewhat co-variates within one conceptual framework of influence on budget performance is not valid. This must be dispelled from the onset. In our treatment, the ramifications of a trade deficit follow vastly different transmission mechanisms in affecting the budget compared to the transmission mechanisms associated with a mounting debt overhang. As such, we treat these two pieces of analysis separately in two separate sections of the paper to avoid any possible confusion.

The rest of this report is structured as follows: Section 2 discusses the consequences of a trade deficit on budget performance; Section 3 examines the ramifications of mounting debt and resultant rising debt service obligations on budget performance; and Section 4 offers our conclusion and recommendations.

2 Consequences of Trade Deficit on Budget Performance

2.1 Drivers of the Trade Deficit

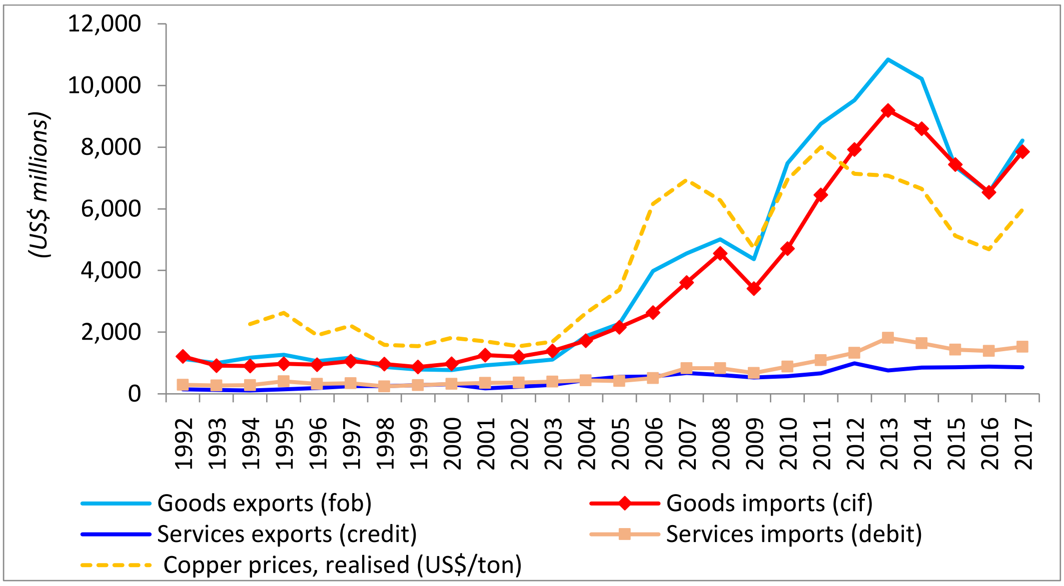
In looking at Zambia’s trade performance the 1990s up to 2017, we see that the level of merchandise (goods) imports were generally almost at parity with goods exports or above them from 1992 to around 2004 (Figure 2.1). After 2004, with the advent of the global commodity price *super-cycle,* goods exports increased sharply. However, because of the heavy import content in the production of export and domestic goods as well as in final consumption, as Zambia export fortunes grew so too did its import bill.

The heavy dependency of export earnings on changes in global copper prices is very evident from Figure 2.1, although the fall in exports did not occur immediately as the commodity price super-cycle ended, around 2011; it came with a considerable 2-year lag with exports starting to fall only after 2013. Interestingly almost throughout the period of the super-cycle, the merchandise trade balance was in surplus. Moreover, even after the super-cycle ended, except in 2015 and 2016 when the country’s goods trade balances stood at modest deficits of US$74 million and US$4 million, respectively, goods export surpluses were recorded. However, as seen later, the overall trade account experienced a notable deficit whose true source was the relatively deep services trade deficits compared to the moderate surplus and deficits on goods trade.

Turning, on the other hand, to services trade, the external balance position was a deficit throughout 1992-2017, except in 2005 when a marginal service trade surplus was recorded.

Figure 2.2 offer a clearer illustration. The persistent services trade deficit, at US$660 million at the close of the reference period in 2017 dominated the goods trade surplus of US$ 364 million. Ultimately, the overall balance on goods and services in 2017 was a deficit of US$296 million. Therefore, the true driver of Zambia's overall trade deficit lies within the services side of international trade.

Figure 2.1: Exports and Imports of goods and services (US$ millions), and copper price changes

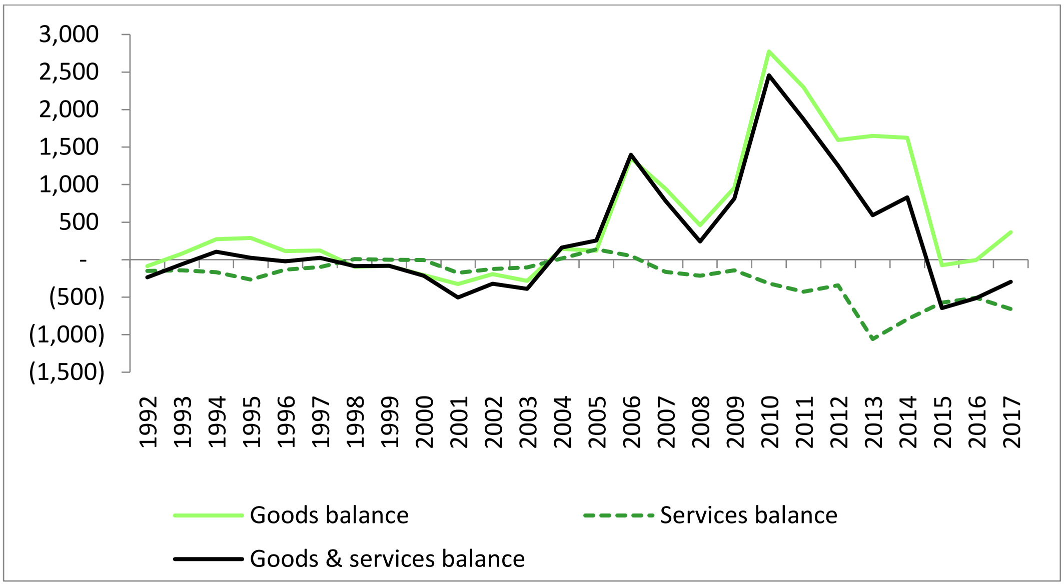


Source: Constructed from BOZ BOP Tables

One way of looking at the deep services trade deficit is that Zambia's domestic services were quite uncompetitive over the period and were therefore readily overtaken by international services operating in the Zambian territory. The most dominant services are shown in Figure 2.3. These included transportation, travel and insurance and pensions. Undoubtedly, service trade is big business in absolute terms in Zambia, with the importation of transportation services of BOP debits (payments to non-resident transportation service providers) accounting for US$888.1 million in 2017, followed by travel (mainly tourism) services exports (credits to Zambia in the BOP) of US$652.6 million.

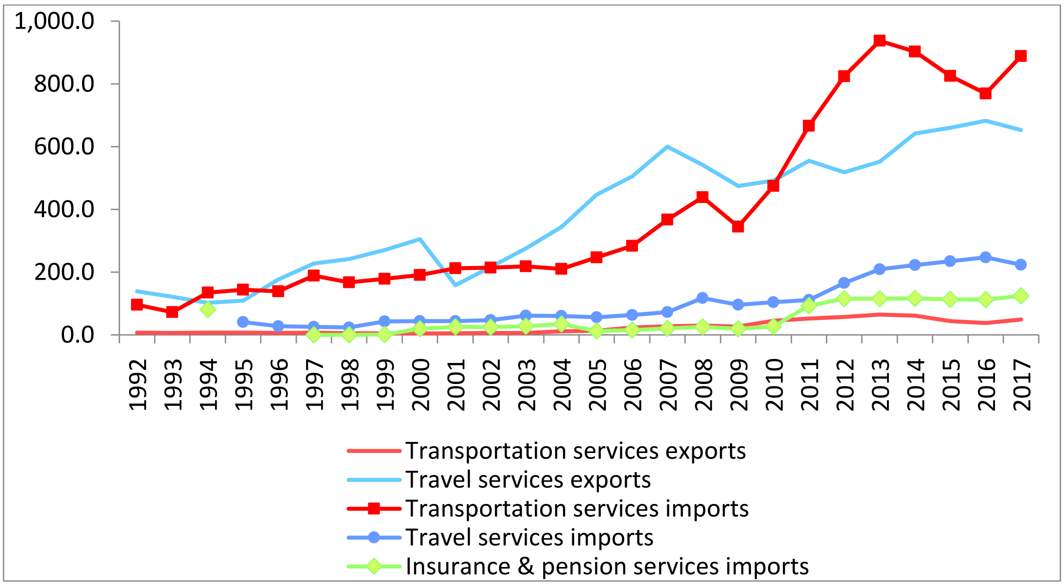
It goes almost without saying that in order to improve the overall trade deficit that has persisted in recent times, considerable attention would have to be given to economic restructuring reforms that give local services providers greater productive capacities and a competitive edge to capture a larger share of the services business, which is currently being lost to foreign transportation, travel and insurance and pensions service providers. Ideas such as reliable local content policies and regulations, special public-private partnerships with State corporations like IDC and ZDA, possible special time-bound subsidy programmes for viable local private sector operators in these strategic services import-substitution areas (transportation, travel and insurance and pensions services).

Figure 2.2: Goods, services and overall trade balances (US$ millions)



Source: Constructed from BOZ BOP Tables

Figure 2.3: Main services trade components (US$ millions)

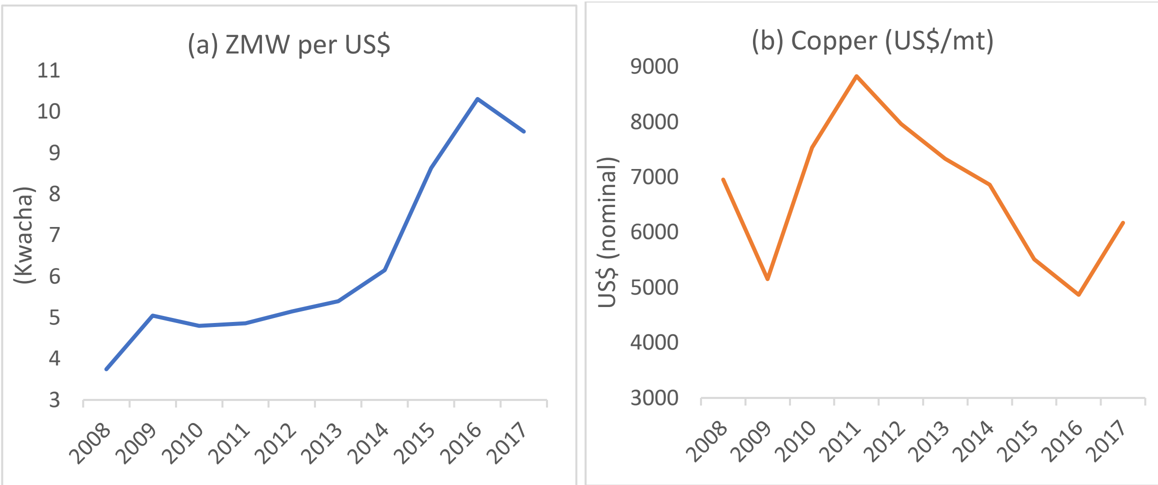


Source: Constructed from BOZ BOP Tables

Of course, macroeconomic variables such as exchange rate shocks, fluctuations in global commodity prices, domestic interest rates, the inflation rate and so on all have various key roles to play as direct or indirect drivers of a trade deficit. In terms of the exchange rate, in a situation in which the value of the Kwacha depreciates, this translates into imports becoming more expensive and directly translates into a deterioration of the overall BOP position.

In Zambia, the exchange rate remained relatively flat in the period up to 2013, but began to rise in 2014 before shooting up by 40% in 2015 (Figure 2.4 (a)). This is the same year in which we see the trade deficit increase by over 150% during the mini-crisis that hit the country. And while the exchange rate is not the only factor that led to the increase in the trade deficit, it was a contributing factor.

Figure 2.4: (a) Exchange Rate and (b) Copper Prices



Source: Bank of Zambia; World Bank Commodity Price Data

In 2015, world trade took a hit across the board. This slump was driven by a combination of factors including falling commodity prices and volatility in emerging Asian economies. Of particular relevance to Zambia was the collapse in copper prices by 20% (Figure 2.4(b)), in part owing to a slowdown in demand from China. With lower copper prices come reduced export earnings for the country given that copper exports account for the vast majority of Zambia's export value. This inevitably widens the gap with imports and increases the budget deficit as more money from the budget has to go towards filling the import-export gap. Moreover, the 2015 slump in copper prices came on the back of a continuous downward trend in prices since 2012 and copper prices did not begin to recover until 2017 when we also see a marked improvement in the trade deficit by 61%.

2.2 Ramifications of the Trade Deficit on Budget Performance

In assessing the consequences of the trade deficit on budget performance, it is important to consider the twin deficit hypothesis. The longstanding macroeconomic theory is that fiscal balances can affect trade balances. That is to say, when the government creates a budget deficit by increasing spending, this increases aggregate demand in the economy, which in turn increases aggregate import demand (for both production and consumption). If imports increase while exports remain unchanged or imports increase faster than exports to the extent of overtaking the total size of the exports, this results in a trade deficit. However, the effect of the trade deficit on budget performance is less obvious.

The primary channel through which the trade balance would affect budget performance is the foreign exchange earning capacity or performance of the economy. If a country continues to run a persistent trade deficit, it is by definition reducing its ability to accumulate foreign reserves as it is earning less foreign currency from its exports than it is spending on imports, bridging the gaps by deteriorating other accounts or areas of the BOP (e.g., running down of reserves). In this case, as reserves reduce, pressure increases on the BOP to finance payments for imports. This imbalance in the BOP can turn into a crisis and put immense pressure on the local currency, causing massive depreciation.

For an import dependent country like Zambia, low levels of foreign reserves and a weak currency create a situation in which government has to find additional money to import all the essential goods that the country needs such as fuel and foodstuffs. However, the government fiscus is generally limited to what can be raised through domestic revenue, with any additional funds coming from either domestic or external borrowing. This increase in debt, particularly external debt, results in increased pressure on the fiscus as a greater portion of the budget is allocated towards interest payments. And where the debt is denominated in foreign currency, exchange rate risks mean that there is the potential for unexpected currency shocks that could increase interest payments even further. The effects of the high debt stock on the budget performance are discussed in greater detail in a subsequent section.

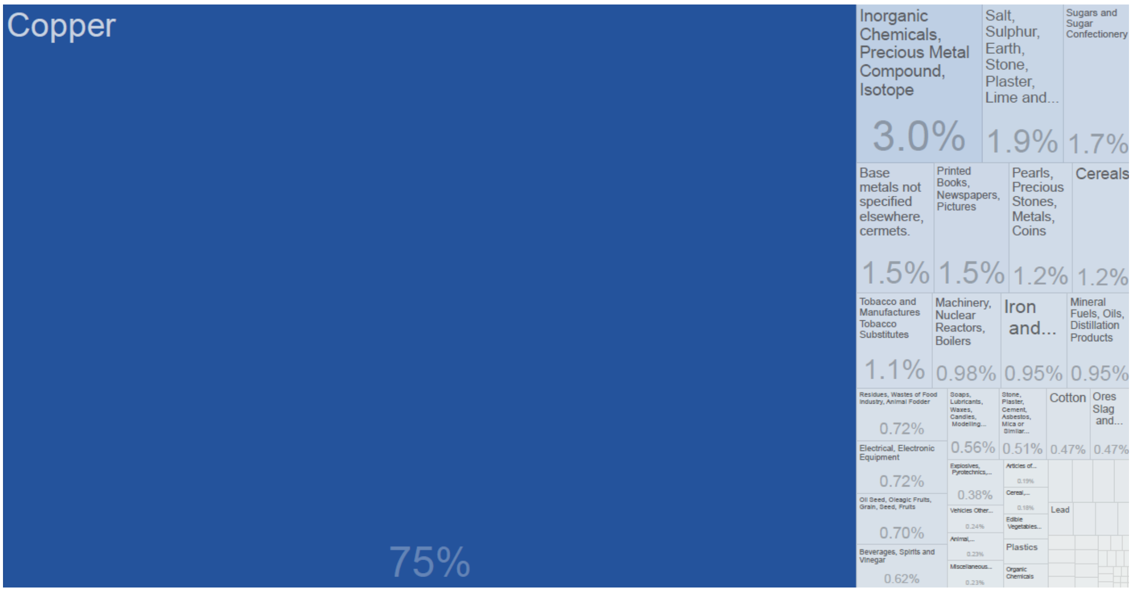
Ultimately, a sustained trade deficit has a negative effect on budget performance by leading to a situation in which government has to find more and more kwachas to finance the budget as reserves are run down and the currency weakens.

2.3 Measures and Challenges of Addressing the Trade Deficit

In Zambia, the trade deficit that currently exists is fundamentally a structural issue. Not only is Zambia highly import dependent on both the goods and services sides, the country also has a fairly narrow (undiversified, unsophisticated and minimal technology) export portfolio. In 2017, 75% of Zambia's export value was in copper (Figure 2.5). Moreover, our import portfolio is made up of goods that cannot be produced locally, nor do they have a close substitute. 40% of Zambia's goods imports in 2017 were made up of mineral fuels, machinery, and ores slag. This means that, given Zambia's high commodity dependence, the economy is left vulnerable to external shocks such as global commodity price fluctuations and exchange rate shocks.

Given the foregoing, there are therefore no easy, short term solutions – that are within the country's control – to the persistent trade deficit that Zambia has experienced in recent years. In the medium to long run, however, there is a need to plan for a fundamental restructuring of the economy. There is a need to diversify the economy away from being so heavily dependent on copper so that, even when there is an external shock to copper prices, for example, the economy has other growth sectors to fall back on. This means developing new areas of production and export. While agriculture has been named as one of the sectors with the greatest growth potential given Zambia's endowment with natural resources and arable land, there may be a need to look even beyond this as agriculture would still leave us exposed to commodity price fluctuations at export.

Figure 2.5: Zambia Exports by Category, 2017



Source: Trading Economics, 2018

This calls for a robust diversification agenda which is aligned to the National Industrial Policy (NIP) (2018) which seeks to enhance sectoral linkages. The NIP seeks to promote the diversification of production, facilitate creation of inter-sectoral and inter-industry linkages, and facilitate a shift towards higher value-added activities in the economy. Sectoral linkages are fundamental to stimulate industrialisation by way of value addition to raw materials such as agricultural products. This in turn will boost economic related activities in other sectors.

3 Debt and Debt Service

3.1 Public External Debt

As at end-June, the total external public debt stood at US$9.37 billion, up from US$3.18 billion five and half years ago, an increase of 195%. Back in 2012, commercial debt was inconsequential, accounting for only 31% of the external debt. Five years on, commercial debt is the single largest item on external debt accounting for 53% of total external debt, an increase of 400% to US$4.9 billion by June 2018. Exports and suppliers' credit have also increased by nearly 300% in the last five and half years. On the other hand, multilateral debt has shrunk as a share of total external debt to 19% in June 2018 from 43% in 2012. Similarly, bilateral debt has reduced from 8% of the total external debt stock in 2012 to 4% in June 2018.

Commercial debt and exports and suppliers’ credit are obviously more expensive than multilateral and bilateral debt. Between 2012 and 2018, interest payments have risen by 201% and increased to 60% as a share of external debt service in 2018 from 23% in 2012.

Table 3.1: Stock and structure of public external debt, 2012-2018

	2012	2015	2018 (June)	% increase 2018/2012
Multilateral	1,382.8	1,509.5	1,824.2	32%
% share	*43%*	*24%*	*19%*	
Bilateral	239.0	209.6	355.0	49%
% share	*8%*	*3%*	*4%*	
Exports & Suppliers' credit	565.8	1,345.6	2,236.9	295%
% share	*18%*	*21%*	*24%*	
Commercial debt	992.2	3,346.0	4,953.9	399%
% share	*31%*	*52%*	*53%*	
Total public external debt	3,179.8	6,410.7	9,370.0	195%
External debt service	296.6	309.4	341.8	15%
Principal	228.9	136.8	138.2	-40%
% share	77%	44%	40%	
Interest	67.7	172.6	203.6	201%
% share	23%	56%	60%	

Source: Annual Economic Reports, Ministry of Finance

3.2 Public Domestic Debt

The domestic debt narrative is no different: it nearly doubled from K15.0 billion in 2012 to K27.5 billion in 2015. During this period, the Government accumulated substantial payment arrears which became a significant part of domestic debt. As a result, domestic debt increased to K51.8 billion in 2016 from K27.5 billion in 2015. Arrears accounted for 36% of the total domestic debt in 2016, up from barely 10% in 2015. In 2017, Government instituted measures to reduce these arrears and managed to curtail the arrears to K12.7 billion from K18.8 billion in 2016. However, during the first half of 2018, arrears increased to K13.9 billion.

Government stepped up the issuing of government securities in 2017 when securities increased to K48 billion from K33 billion in 2016. This resulted in reductions in credit to the private sector as the Government outcompeted businesses for credit. Private sector credit growth contracted in real terms as a result of tightened credit conditions, resulting in constrained growth.

Table 3.2: Stock of domestic debt, K'million

	Total domestic debt	*of which: Govt securities*
2008	8,495	8,022
2009	10,341	9,502
2010	10,867	9,961
2011	14,175	13,122
2012	15,046	14,331
2013	19,745	18,882
2014	23,518	22,312
2015	27,508	24,703
2016	51,821	32,984
2017	61,059	48,359
2018 (June)	65,766	51,866

Source: Annual Economic Reports, Ministry of Finance

4 Consequences of Debt (Servicing) on Budget Performance

4.1 Debt Servicing Payments Crowding Out Critical Sectors

As part of Zambia's macroeconomic objectives for 2019, the Government set out to limit the overall fiscal deficit to 6.5% of GDP, as stated in the 2019 Budget Speech. However, this deficit is still considerably high compared to levels seen in years past. For example, between 2010 and 2012, the fiscal deficit averaged 2.4% of GDP. A higher fiscal deficit target is also an indication that the country's borrowing appetite is still high, leading to accumulation of debt. A high debt stock leaves the country with little room to free-up or generate more resources and widen its fiscal space as the country's revenue is channelled towards debt servicing, particularly foreign debt interest payments and the principal debt repayment.

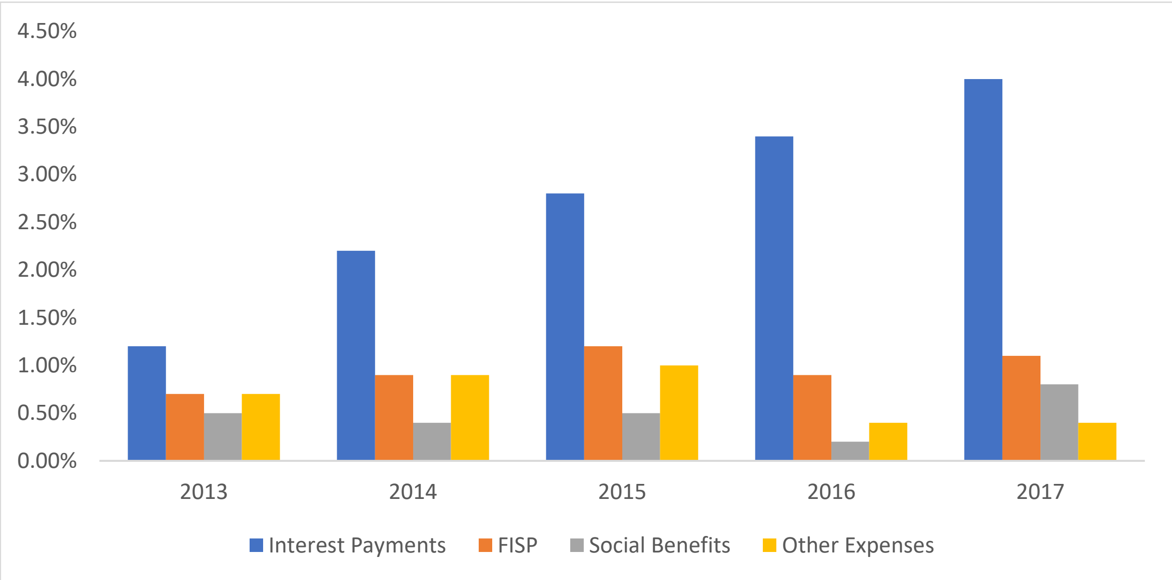
The immediate effect of this accumulation of debt has been crowding out social sector spending in favour of interest payments on debt. Sectors that have been crowded out by debt servicing include the public service pension fund, social cash transfers and the economic empowerment programmes (together represented as social benefits in Figure 4.1). This inherently means that efforts aimed at poverty reduction are hampered and represents a direct effect of debt servicing on budget performance. Approximately 27% of the total K86.8 billion budget announced for 2019 was allocated to debt-servicing costs.

Figure 4.1 illustrates how interest payments have become a significant proportion of GDP compared to social sectors over the years. By 2017, interest payments had increased to 4%

of GDP while social sectors spending remained fairly flat or had even reduced, in some cases.

In as much as a high stock of debt is concerning, the fiscal deficit is largely driven by debt service costs (interest payments and amortisation). At end-June 2018, Zambia's external debt stock was US$9.4 billion or 34.5% of GDP, an increase of K700 million (8%) over the level recorded at end-December 2017 (US$8.7 billion). A decomposition of the fiscal deficit shows that interest payments will take up 73% of the total deficit in 2019. If the kwacha continues to depreciate against the major trading currencies, we can expect an upward adjustment on the costs of interest payments. The growth in expenditure due to higher than planned interest payments on debt would result in a higher than projected fiscal deficit. With gross international reserves which are used in interest payments falling to a low of US$1.63 billion by end September 2018, this poses a threat on the country's ability to sustain interest payments.

Figure 3.1: The evolution of interest payments vs selected items (as % of GDP), 2013-2017



Source: Ministry of Finance and ZIPAR own calculations

In the first half of 2018, interest payments on debt increased to 29.5%, compared to 22.7% in 2017 H1 and are among the main drivers of the Government's spending overruns (Table 4.1). In the first half of 2018 alone, out of the total approved allocation for interest payments in the budget, 67% had already been used up. And given the depreciation of the kwacha that has manifested in 2018, it is likely that the cost of these interest repayments will continue to be overbudget even at year end. These spending overruns inevitably threaten budget credibility as funds to meet the increased demands of debt financing have to be sourced from other areas of the budget.

According to the IMF, Zambia's foreign debt service costs are likely to double by 2020 as its concessional loans as well as the Eurobonds start falling due. As Zambia's debt sustainability falls into question, future borrowing is likely to become riskier and much more expensive, limiting opportunities to borrow and invest going forward. In recent years, GDP growth has fallen, averaging 3.8% in the period 2014-2017 compared to 7.2% in 2010-2013. With the economy expected to grow at 4% in 2019 according to the 2019 Budget Speech, it is clear that interest payments on debt will have to keep drawing on scarce financial resources.

Table 4.1: Recurrent spending as a percentage of domestic revenues, 2010 H1 – 2018 H1

	Personal emoluments	Use of goods and services	Interest payments	Grants & other payments	Social benefits	Other expenses
2010 H1	24.2%	11.9%	3.9%	5.3%	0.4%	3.4%
2011 H1	37.3%	21.1%	5.5%	13.9%	5.2%	2.2%
2012 H1	41.2%	20.4%	6.0%	11.9%	2.4%	9.1%
2013 H1	46.9%	21.5%	10.2%	27.6%	3.4%	0.6%
2014 H1	50.7%	13.6%	9.5%	16.1%	2.7%	0.7%
2015 H1	53.4%	14.2%	12.0%	21.6%	2.8%	3.2%
2016 H1	42.0%	9.4%	16.6%	24.9%	1.1%	1.1%
2017 H1	52.6%	12.6%	22.7%	20.6%	5.4%	1.5%
2018 H1	42.0%	11.5%	29.5%	15.7%	2.4%	0.8%

Source: Ministry of Finance and ZIPAR's own calculations

4.2 Other Effects of Increasing Interest Payments

Different components of debt affect the budget differently. Interest payments come out of the recurrent budget, and in effect from domestic revenue. The interest burden by June this year took up 25.9% of domestic revenue, up from 8.6% in 2012. In fact, interest costs are now equivalent to 61.8% of the wage bill as compared to 20.3% five and half years ago. Interest on debt is crowding out non-interest spending such as the use of goods and services, as well as grants and other payments. This is the spending that makes government work. It is the money that enables the police to move around, and health facilities to buy drugs and treat patients, and educational facilities to buy reading materials, and so on.

Going forward, exchange rate risks remain heightened and are likely to increase debt service costs. Though the 2019-2021 Medium Term Expenditure Framework (MTEF) projects a reduction in debt service payments as a percentage of domestic revenues (i.e. 27%, 26% and 25% of domestic revenues in 2019, 2020 and 2021, respectively), this is unlikely to be the case due to heightened exchange rate risks and the problem of domestic arrears, which have been exacerbated by the reduction in non-interest expenditure.

Table 1.2: Trends in interest payments as a percentage of domestic revenues, 2012-2018

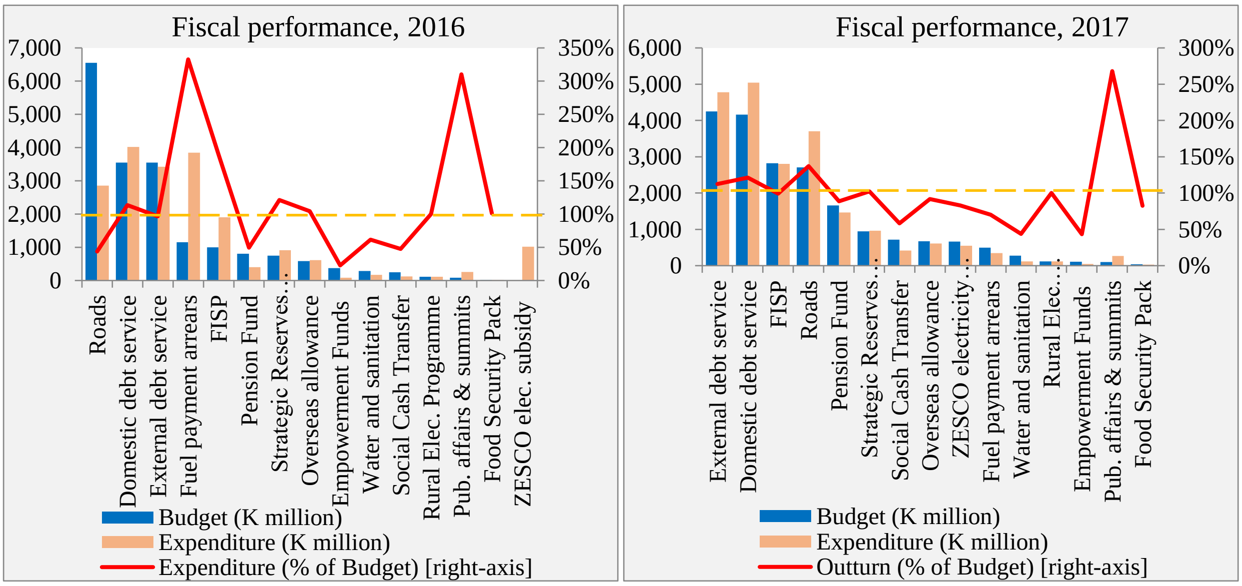
	2012	2015	2018 (June)
Interest payments	1,903	5,224	6,441
% of domestic revenue	8.6%	15.3%	25.9%
Domestic	1,636	3,265	3,575
% of domestic revenue	7.4%	9.6%	14.4%
External	267	1,959	2,866
% of domestic revenue	1.2%	5.8%	11.5%

Source: Annual Economic Reports, Ministry of Finance

4.3 Measures and Challenges of Addressing the Debt Problem

The rapid accumulation of public debt has caused an escalation of debt service interest payments, which in turn has become a major cause of Government spending over-runs and of crowding out of the social benefits sector (Figure 4.2).

Figure 4.2: Fiscal targets and outcomes 2016 and 2017



Source: Adapted from Cheelo (2018)[1]

The planned debt servicing for 2018 is estimated at K14.1 billion. During January-June 2018, Government spent two thirds of the planned Budget to service its debt – that amounts to K9.1 billion. In order to address the issue of expenditure-driven fiscal slippages and the

[1] Cheelo, C. (2018) "Financing the Economic Stabilization and Growth Programme (Zambia Plus) in the Shadow of the IMF". ZIPAR Working Paper No.29, April

resultant mounting debt overhang and escalation of debt service obligations, we propose, in line with previous ZIPAR proposals, that Zambia adopts long-term binding fiscal rules that operationalize the Public Finance Management Act (2018) more fully than the short and medium term policy instruments like the National Budget, the Medium Term Expenditure Framework (MTEF) and the Medium Term Debt Strategy (MTDS). It will be important to ensure that legally binding numerical or quantitative limits (on fiscal spending, fiscal deficits, public debt contraction, etc.) are set upon which Parliamentary approval is granted and highest (ministerial level) sanctions are applied for any breaches to the limits. This will help to promote fiscal discipline, budget credibility and specifically, over time, reductions in the debt servicing burden. In turn, this will free up some resources for critical spending on social sectors, social protection and key infrastructure.

In an attempt to address the heightened risks of debt distress, which the IMF pointed out in 2017 and which persist to date, it will be important for the Government to undertake expenditure rationalization and reduction reforms, particularly in relation to recurrent expenditure. Leading on fiscal rules and other fiscal consolidation measures, the Government must be vigilant in applying key debt management strategies and measures (such as those in the MTDS); the excessive borrowing of the past 6-7 years must be curbed.

Given the current circumstances, to finance fiscal deficits, the Government should only obtain grants or concessional loans from its cooperating partners at lower costs. But borrowing at reasonably low cost depends on the lender's perception of the borrower's ability to repay and the recent Fitch Ratings downgrade of Zambia's credit rating from B to B- with a negative economic outlook is exactly what we need to avoid if we are to access cheap funds.

Going forward, we urge the Government to earnestly implement the measures pronounced in the 2019 Budget and to also avoid deviating from the MTEF (2019-2021) lest spending overruns creep in, which jeopardise budget credibility and fiscal fitness.

5 Debt Distress and Pipeline Debt

To assess debt sustainability, debt burden indicators are compared to indicative thresholds over a projection period.

Debt Burden Thresholds and Benchmarks Under the DSF

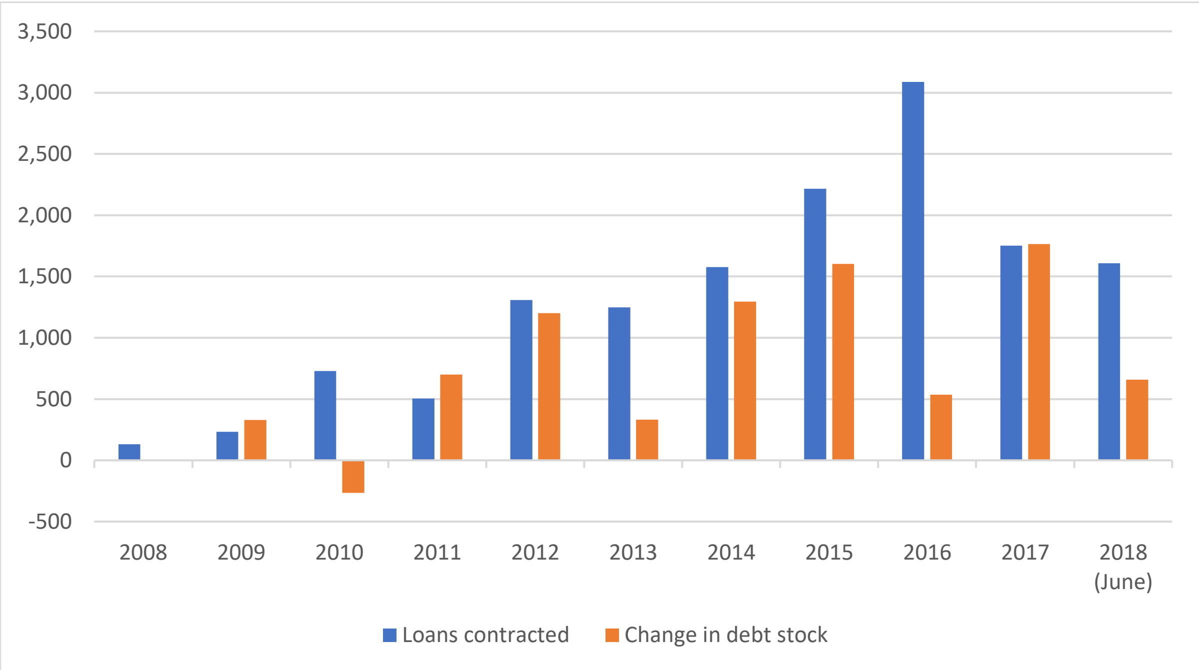
	PV of external debt in percent of		External Debt service in percent of		PV of total public debt in percent of
	GDP	Exports	Export	Revenue	GDP
Weak	30	140	10	14	35
Medium	**40**	**180**	**15**	**18**	**55**

Strong	50	240	21	23	70

On the basis of these thresholds and benchmark, Debt Sustainability Analyses (DSAs) include an assessment of the risk of external and overall debt distress based on four categories: low risk (when there are no breaches of thresholds); moderate risk (when thresholds are breached in risk scenarios); high risk (when thresholds are breached in the baseline scenario); and in debt distress (when a distress event, like arrears or a restructuring, has occurred or is considered imminent). In 2017, the IMF classified Zambia as one of the countries at high risk of debt distress, driven by projected high borrowing requirements over the medium term.

Which brings us to the issue of pipeline debt. Based on information from the IMF's 2017 Debt Sustainability Analysis on loans in the pipeline, Government will disburse approximately US$3.5 billion in new non-concessional loans over the next five years, on top of the US$3.3 billion in already contracted loans[2], mainly to support capital projects. That could easily take the external debt stock to over US$16 billion in the next five years if all the pipeline debt and the already contracted loans are disbursed, which will make the external debt breach the 40% threshold as well as public debt breach the 55% threshold.

Figure 5.1: Loans contracted against changes in debt stock, 2008-2018



Source: Estimated from Annual Economic Reports

As part of the austerity measures announced in June 2018, Government has committed itself to the indefinite postponement of the contraction of all pipeline debt until the debt is

[2] Estimated as the difference between the sum of contracted loans in the last five years and the total debt stock.

brought back to moderate risk of distress, cancelling some of the current contracted loans that are yet to be disbursed to reduce the debt service outlays. If the Government actualizes these pronouncements, the level of pipeline debt as well as the disbursement of already contracted loans are likely to slow down, thereby further reducing the pace of debt accumulation as has been the case in 2018. In the absence of fiscal consolidation and the implementation of the austerity measures, Zambia is likely to face debt distress.

6 Conclusion and Recommendations

In conclusion, we find that both the trade balance and debt have consequences for budget performance. For the trade balance, the persistent trade deficit that has existed since 2013 has resulted in a reduced ability to earn foreign exchange, which directly impacts on the country's stock of foreign reserves. This also in turn affects our ability to meet our interest payments on external debt. Furthermore, the fact that Zambia is a relatively small open economy leaves the country exposed to exchange rate risks, which also affect our ability to build up reserve earnings, as well as impacts on foreign debt interest payments. These factors feed into budget performance by requiring Government to find more and more kwachas to meet foreign currency obligations, thus putting pressure on the budget funds.

As for debt, as debt servicing obligations increase, this crowds out spending in other areas of the budget, including social sector spending and the use of goods and services. These are aspects that directly affect not only budget performance, but also the functioning of the Government. Moreover, as the Government attempts to move from external to domestic borrowing in its debt management strategy and to reduce the threat of exchange rate risks, for example, this also crowds out credit to the private sector, further reducing economic activity and growth.

While there are no easy solutions to these issues that affect budget performance, what emerges is the explicit need for extensive planning for solutions. For the trade deficit, there is a fundamental need for structural change in the economy, including a comprehensive plan for diversification. As for debt, certain well-intentioned pronouncements have already been made in the past to curtail debt accumulation, but these must be followed through in earnest. Ultimately, however, it comes down to an earnest application of restraint on the country's appetite for debt. Only then can we start steering clear of the risk of debt distress.

6.1 Recommendations

A. Effective implementation of a robust diversification agenda aligned to the National Industrial Policy (NIP) (2018) to enhance sectoral linkages and promote diversification of production. This will move the economy towards diversifying away from copper dependency and reduce exposure to external shocks.

B. Implementation of economic restructuring reforms to promote services import substitution. For example, local content policy and regulation, coupled with serious local service provider productive capacity building interventions, including PPP.

C. Establishing legally binding, long-term numerical fiscal rules on fiscal aggregates like expenditure, fiscal deficit and new debt contraction, to curb excessive spending and borrowing.