Lessons from a Zambian standoff*

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The recent collapse of the protracted negotiations to restructure Zambia's external debt, following a default in November 2020, underlines the failure of the prevailing international financial architecture to address global challenges. Not only has the structure not been adapted to the realities of a changing international order, but it binds the less developed countries into accepting the IMF as the principal agent to manage balance of payments difficulties and address debt stress, on behalf of both creditors and debtors. But the claim of the IMF to being a neutral arbitrator has long been in question. The Zambian experience suggests that the prevailing structure aims to get bilateral creditors, in this case principally China, to carry the burden of a restructuring process which protects the interests of and even favours private creditors, who leveraged cheap capital and rushed into less developed country market in search of high yields.

The fact that the prevailing international financial architecture (IFA) is not fit for the purpose of ensuring fairness and stability in global economic relationships was once again revealed when Zambia's strenuous efforts to resolve its external debt crisis fell apart recently. Zambia, in November 2020, was the first country to default on external debt payments after the pandemic. Following that, the government began negotiations with the IMF to discuss and accept conditions and a programme the latter defined as necessary for a successful process of restructuring. The perception was and is that once an IMF designed restructuring process is accepted by the debtor government and put in place, all creditors would fall in line.

At the end of 2022 Zambia external debt (including arrears on principal and interest) stood at $18.3 billion.[i] Around 34 per cent of that ($6.3 billion) was owed to bilateral creditors (with the Paris Club accounting for just 8 per cent or $1.5 billion and China for $4.2 billion or 23 per cent). Multilateral creditors (especially the World Bank accounted for $3.6 billion or 18 per cent and Eurobond holders and commercial creditors accounted for $3.5 billion and $3.2 billion respectively (19 and 18 per cent).

Eligible to be considered under the G20's Common Framework for debt treatment, Zambia was the first country that chose to opt for that route in which the restructuring of debt from creditors, along the lines laid out in a debt sustainability analysis (DSA) from the IMF, would reflect comparable or equal treatment of different creditors. This required obtaining financing assurances from the bilateral creditors to obtain emergency credit from the IMF, negotiating a detailed restructuring deal with these bilateral creditors that met the IMF's DSA standards, and then making private creditors accept a comparable restructuring arrangement. The fact that this process, which took almost three years after the initial default to complete, fell apart, points to the inadequacy of the IFA to resolve one among the most pressing challenges facing the international community today.

The delay arose in each of the stages that the process had to go through. To start with, it was only at the end of August 2022, 21 months after default, that Zambia 'won' International Monetary Fund approval for its 38-month loan program. The Extended Credit Facility (ECF) arrangement promised to provide total funding equivalent to about $1.3 billion (100% of Zambia's quota, or shareholding in the Fund), and $185 million as a first instalment. At that time, Zambia's total public debt stood at around $16 billion. What the Common Framework and the small ECF loan did was that they legitimised temporary suspension of external debt servicing by Zambia and provided a small amount of new money to begin repayments.

To obtain that temporary reprieve, Zambia (as has been true of other stressed debtors) had to pass two tests: it had to persuade its official bilateral creditors (accounting for around 32 per cent of public debt) to promise to negotiate a deal to restructure debt along the lines the IMF recommends; and, it had to begin implementing a set of measures that the IMF believed would strengthen the debt carrying and repayment capacity of the government. In earlier IMF programmes, the focus when providing emergency finance to debt-stressed countries, was trade and financial liberalisation. The "adjustment" involved diluting or dismantling restrictions on foreign trade and investment that many of these countries had imposed as a way of ensuring domestic policy space. This liberalisation was justified on grounds that it would not only increase capital inflows, but also create conditions for export expansion, and help ensure balance of payments sustainability. The consequence was the prising open of goods, services and financial markets in the less developed countries for international capital.

By the 2010s, however, economic borders in almost all less developed countries had been thrown wide open. It was this, especially the liberalisation of explicit and implicit rules governing the inflow of foreign finance, that had allowed for the accumulation of large volumes of public debt by less-developed country governments that either desperately needed the foreign finance to cover current account deficits, or were putting available foreign capital to questionable uses. On the other side, in creditor countries, liberalisation had allowed yield-seeking investors and governments cementing strategic alliances, to access abundant cheap capital to provide credit to the less developed countries at high interest rates, without due diligence. This trend gathered momentum with the massive injection of cheap liquidity by advanced country central banks. In Zambia's case the easy availability of international liquidity led to three issue of Eurobonds in 2012 ($750 million), 2014 ($ 1 billion) and 2015 ($1.25 billion), amounting to a total liability of $3 billion maturing in 2022, 2024 and over 2025-2027. Yet in 2015, before Zambia was hit by a serious drought, the IMF and World Bank categorised the country was characterised as being subject to "moderate risk" of debt distress.

In the new circumstances, therefore, the investor-side problem was not to prise open new markets, but to ensure that debt stressed governments would have the capacity to repay much, if not all, of the debt provided. That was interpreted as being equivalent to the debtor government having enough domestic resources to repay past debt without incurring new debt for that purpose or to meet committed or desired expenditures. This partly shifted the focus from just external debt that was the immediate problem, to aggregate debt, which had to be reduced to generate resources to service foreign debt. The fact that those domestic resources had to be converted into the 'hard' currencies in which external currency debt had been incurred, was underplayed. So besides getting bilateral creditors to agree to restructure outstanding debt owed to them to improve the debt carrying capacity of the stressed debtor, the IMF required evidence that the debtor government was adopting policies that reduced its borrowing needs and released adequate resources to repay past and future debt. So even to persuade the IMF to agree to an ECF loan arrangement, Zambia's government had to show intent to eliminate fuel subsidies, slash agricultural subsidies, privatise and reduce "inefficient" public investments and increase tax revenues, normally by raising (regressive) indirect taxes. In addition, the agreement imposed new conditions implying more austerity, which the government had to agree to. Negotiating all these requirements takes time and explains the delay between default and completion of even the first stage of the process.

But in keeping with these requirements, the IMF agreement was preceded by policy decisions that showed intent, and came immediately after bilateral creditors arrived at a preliminary restructuring agreement with the Zambian government in June 2022. "Very pleased the Official

Creditor Committee for Zambia has provided its financial assurances clearing the way for a Fund program," IMF managing director Kristalina Georgieva tweeted after the event. "The delivery of these financing assurances will enable the IMF Executive Board to consider approval of a Fund-supported program for Zambia and unlock much needed financing from Zambia's development partners," said a subsequent official statement from her.[ii] Following the agreement creditor governments established an “official sector” creditor committee (OCC) to work out the details.

Getting the bilateral creditor agreement was not an easy task. The Zambian experiment with debt restructuring follows major changes in the structure of what was an unequal order, which the dominant players refuse to recognise and adjust to. For a few decades after the Bretton Woods conference, the international financial architecture that had two developed market economy-backed and US-dominated institutions, the IMF and the World Bank, at the apex, was seen as fit enough to ensure global stability. In normal times these institutions facilitated the “recycling” of hard currency from the balance of payments surplus countries to the deficit countries. In times of balance of a payments crises, resulting from inadequate access to foreign capital to finance the deficit in a particular country, the IMF served as a lender of last resort, providing the bridge finance necessary to keep the country afloat, overseeing a process of debt restructuring that provides relief, and imposing policies that were (incorrectly) assumed to be adequate to restore medium-term balance of payments sustainability.

The architecture worked because for long, besides foreign direct investment, the main source of cross-border capital flows to the less developed countries were “official”, bilateral or multilateral, flows, from governments or government-backed entities in the developed market economies. This architecture was supported by an informal cartel of these developed-economy creditor governments, the Paris Club, which contributed to the IMF-supervised balance of payment “adjustment” exercises with debt relief or write-off, besides an additional dose of new capital.

The consequences of these actions that gained strength after the 1960s, as well as other changes in the international financial system, upset this arrangement. To start with, trade and financial liberalisation widened the trade and current account deficits in most less developed countries, and sharply so after the oil shocks in countries that were dependent on oil imports. Second, the oil price hikes shifted surpluses from trade away from the developed countries to the oil exporters, reducing the control exerted by developed economy governments on the recycling process. Third, with much of the extra surpluses earned by the oil exporters being deposited in the leading global commercial banks located in the developed market economies, the private sector had control over a larger share of these surpluses as well as the credit that was being created by leveraging those surplus deposits. A part of that surplus found its way to low- and middle-income country markets, where risk-adjusted returns were higher and not to where these surpluses were needed to support vulnerable balance of payments.

Zambia, being a less preferred target among these countries, had to wait for the years after 2008 for access to private flows, when the response to the financial crisis in the form of quantitative easing and low interest rates increased hugely the availability of global liquidity at low interest rates. Between 2012 and 2019, the share of private creditors in the country’s long term external debt rose from 17.7 per cent to 52.1 per cent. It did help that Zambia had been one of the countries that benefited from the HIPC and MDR initiatives. Having reached completion point under the MDRI in 2005, Zambia was granted debt cancellation to the tune of $5.2 billion which reduced its public and publicly guaranteed debt to less than a billion dollars. But the new surge in borrowing was not only because of this. It was substantially the result of a supply side-push of capital from the North to the South. Exploiting that push, for example, the Zambian government successfully issued sovereign bonds in international markets in 2012, 2014, and 2015, to finance large infrastructural projects. The result was the growing importance of private creditors—commercial banks and bondholders—in total external borrowing.

The other shift in the international debt scenario was that, following the debt relief initiatives of the 1990s and early 2000s, governments in the developed market economies, the members of the Paris Club, were overcome with "aid" fatigue. Their presence in bilateral credit markets diminished. On the other hand, a rising China, with an appetite for food and raw material supplies from less developed countries, was willing to provide credit to finance the infrastructure needed to build an adequate supply chain for these commodities. The result was that as the stock of bilateral creditor debt in countries such as Zambia rose once again, China's share in Zambia's bilateral credit stock rose to at 80.6 per cent in 2012 and stood at 77.6 per cent in 2021.

Given these developments, it was clear that there could be no successful restructuring of debt if China does not join a bilateral deal, or private creditors don't agree to restructuring based on comparable treatment. Hence, once the IMF loan was approved, attention shifted to pushing China into joining the far less exposed Paris Club in restructuring bilateral debt. There were two reasons why China was reticent. The first was that, since the restructuring was occurring under the auspices of and on terms dictated by the IMF, which was controlled by the US and EU, there was no reason to expect that the exercise would safeguard China's (let alone Zambia's) interests. In fact, there were adequate reasons to believe that the IMF policy package was not the best suited to putting Zambia's balance of payments and debt on a sustainable track to ensure repayments of China's credits. Second, besides the fact that the Paris Club countries were now minor bilateral players, the World Bank and other multilateral development banks, insisted that they be excluded from any debt restructuring exercise. Any reduction in the net present value of the outstanding debt of these creditors, it was argued, would erode their preferred creditor status, which underlay their AAA ratings and easy access to international debt markets. That in turn would undermine their important role as agents facilitating the development of the less developed countries. China was unwilling to see these institutions as independent, technocratic and altruistic, and therefore deserving of special treatment. Moreover, these institutions mediated much of the flows of whatever credit came from the developed market economies and the developing world. So, excluding these institutions from the restructuring exercise would put most of the burden on China, for the advance of a restructuring strategy it had little role in designing.

But contrary to assessments in the international media, perhaps sensing its importance in determining whether restructuring would occur on not, China relented. In June 2023, the Zambian government announced that the OCC, which included China and the "Paris Club" of creditor nations, had agreed to restructure their combined $6.3 billion worth of loans. Of those loans, over $4 billion was owed to the Export-Import Bank of China.[iii] The deal which involved no write off in nominal value, extended maturities by an average of 12 years (going up to 20 years) and reduced the coupon rate to as low as 1 per cent, with increases to a maximum of 2.5 per cent after 14 years.[iv] This amounted to a reduction of 40 per cent in the net present value of restructured debt. But, given the higher interest rates that commercial lenders and bondholders had obtained on their loans and the fact that many bondholders were not original lenders but had acquired these loans cheap in the secondary market, support for the agreement in the OCC was linked to an understanding that private creditors would accept restructuring terms that implied cuts on the present value of their loans up to 10 percentage points higher than that imposed on sovereign lenders. Meanwhile, China chose to treat loans from two large publicly owned financial institutions—China Development Bank and Industrial and Commercial Bank of China—as private lenders. This was perhaps a move to prevent it from losing out on any parallel deal that gives private creditors better terms.

Not long after the OCC deal, the Zambian government announced in November that it had arrived at a restructuring agreement with private bondholders (holding the $750mn 2022 bond, the $1bn 2024 bond and the $1.25bn 2027 bond) and sent the terms on to the OCC for approval. The 'agreement in principle' that was to exchange historical bond debt for two new bonds, was assessed by the Zambian finance ministry as involving a nominal haircut of $700 million, a new average maturity of 15 years and the overall cash flow relief of $2.5 billion over the period of the IMF programme.[v] The agreement included a provision of "upside" treatment, with one of the bonds delivering enhanced repayment terms in the form of faster repayment and higher interest rates if either Zambia's debt carrying capacity, as assessed by the IMF and World Bank's Composite Indicator, moves to medium from weak, or if exports of goods and services and fiscal revenues measured in US dollars exceed IMF projections.

The agreement clearly had the silent support of the IMF. OCC approval would have resulted in completion of the restructuring process, making it the first success for the Common Framework. But, instead, the process broke down when the bilateral creditors, rejected the agreement with bondholders as unsatisfactory and not reflective of comparable treatment. This was because, as opposed to expectations of up to an extra 10 percentage points cut in net present value relative to official creditors, the bondholder deal involved private creditors not only being subjected to net present value reductions comparable to official creditors, but also obtaining larger repayments sooner than the official lenders.[vi] The cash available in the initial stage of the restructuring was to be diverted disproportionately to the private creditors. This benefits the private sector also because the uncertainty as to whether repayments can be sustained over the programme increases with time. Following the rejection by bilateral creditors, the IMF pretended to be neutral, with a spokesperson stating that the institution is "supportive of debtors and creditors finding a solution and has continued to provide technical analysis to help inform the negotiation."[vii] This amounted an institution that was dictating the size of sectoral haircuts sidestepping the question as to how comparable treatment was to be assessed. That favoured the private sector.

Interestingly, following the OCC rejection the Zambia External Bondholder Steering Committee issued a statement expressing 'disappointment' and 'concern' about the OCC's stand, despite "(i) the IMF's position that the revised proposal meets IMF program parameters and DSA targets; and (ii) the fact that the Government views the Revised AIP (as it did the original AIP) as comparable with the OCC's concessions under the MOU." Moreover, it held that it is frustrated with "the current process which requires reliance on the OCC's assessment of comparability in circumstances where a lack of transparency prohibits discussion or independent assessment of comparability by bondholders."[viii]

As a result, the G20's Common Framework, applicable to countries that are either least developed countries or eligible for lending by the International Development Association, is turning out to be an instrument being used to force China, now a major lender, to accept an IMF-led and dictated restructuring process. The international community is unable to impose it on the private creditors. The stepwise process that the IMF instituted was also clearly aimed at generating through austerity the cash required to pay off creditors, thereby ensuring that private creditors who have already earned high returns from high interest rates, are in a position to recoup their capital even if not at their full present value. But the question as to how domestic resources released through austerity would be transformed into foreign currency to service external debt remains unanswered. The financial architecture that has precipitated this new crisis in Zambia is clearly not fit for purpose.

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[i] Figures from, International Monetary Fund (2023), *Zambia: 2023 Article IV Consultation, First Review Under the Extended Credit Facility Arrangement, and Financing Assurances Review*, Washington D C: IMF.

[ii] See https://www.reuters.com/world/africa/g20-chair-says-zambias-creditors-commit-negotiate-restructuring-terms-2022-07-30/.

[iii] Unlike the Industrial and Commercial Bank of China and the China Development Bank, which were categorised as private lenders, China's Exim Bank was treated as an official arm.

[iv] According to Bloomberg (https://www.bloomberg.com/news/articles/2023-06-24/zambia-to-pay-1-interest-after-mission-impossible-debt-deal), *Debt Justice* estimates the average interest rate on bilateral loans from China at 3.9 per cent. The deal includes a clause stating that if Zambia is upgraded to a "medium" debt carrying capacity status, interest rates rise to a maximum 4 per cent. Principal repayments begin in 2026, and amount to 0.5 per cent or around $30 million a year, until 2035.

[v] https://www.londonstockexchange.com/news-article/32BT/announcement-of-agreement-in-principle/16183195.

[vi] According to Bloomberg, this was recommended by "a working paper prepared in June for Zambia's official creditor committee, led by China and France," and "China's Exim Bank got approval from authorities in Beijing to agree to a deal based on those assumptions in June." See https://www.bloomberg.com/news/articles/2023-12-20/china-snarls-zambia-debt-deal-after-mix-up-on-bondholder-losses?sref=ZF339egI.

[vii] https://www.bloomberg.com/news/articles/2023-12-20/china-snarls-zambia-debt-deal-after-mix-up-on-bondholder-losses?sref=ZF339egI.

[viii] https://www.ft.com/content/83252adc-f83f-473e-892a-559f3258f3f2.

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