The KWACHA ARBITRAGEUR

Budget Analysis and Debt Note

'V' shaped recovery for Zambia in the labyrinth of creditor engagements and debt management

7 October 2020

Executive Summary

Zambia in the week beginning September 20 was flooded with a confluence of events that caught the markets unawares. Starting the week with a cabinet meeting that approved a Medium-Term Expenditure Framework (MTEF) dubbed the Economic Recovery Plan – ERP for 2021 replacing the 2017-2019 Economic Growth and Stabilization - EGS Plan. This was approved in tandem with the Minister of Finance's presentation of the 2021 estimates of revenues and expenditures, which would set the tone for the economic rebound which Republican President Edgar Chagwa Lungu had alluded to in his opening speech to parliament on September 11. Growth in 2020, is forecast to shrivel by 4.2% as disease pandemic risks persistently weigh business fabric tracked for 18 months in negative territory as measured by Purchasing Managers Index[1] – PMI. Food security risks were top on the agenda as Zambia's cabinet addressed the need to curb the spread of locusts that could damage crops offsetting the effects of a bumper harvest this year. Linked to food security, is inflation whose trajectory has been in decline over the last 4 months and has then started to rise higher on the back of a currency rout that is breeding cost push inflationary effects. The Zambia Statistics Agency – ZSA recorded a September headline reading of 15.7% reflecting an upward trajectory as currency weakness weighed to offset the effects of falling food prices. The Kwacha has year to date suffered a 40% valuation loss as structural imbalances in the foreign exchange market have caused currency sell-off pressure. This is evidenced by a dollar liquidity backlog[2] exacerbated by uneven and unequitable allocation of foreign exchange at the expense of agriculture input demand. Earlier in the year the Zambian authorities requested for mining firms to pay all taxes, over and above mineral royalties, in dollars in a move to shore up foreign exchange reserves. This move has sucked foreign exchange supply[3] from the open market causing imbalances on the supply side which coupled with demand surges has weighed the exchange rate.

The copper producer's debt restructure process has slowly started to take shape as Lazard Freres ("the governments advisor") assigned to Morrow Sodali to assist in taking stock of Zambia's dollar bond holders well ahead of the solicitation request for coupon payment freeze. Eurobond holders in June – July period did form a committee which Lazard will deliberate with, in the restructure process. This was a precursor to the request by the Zambian government ("the principal") to Eurobond holders to defer its coupon payments for a period of 6-months starting October 14, 2020 to April 14, 2021 as it sought to book reprieve in creating fiscal space as COVID effects continued to weigh. A successful restructure would be tantamount to a technical default which markets await to see whether or not Zambia will meet its coupon payment in October given the initial position by bond holders on the 30 September after the solicitation request received no positive feedback on the back of various factors such as lack of transparency on other creditor engagements, vague progress on bailout talks with the Washington based lender the International Monetary Fund – IMF and above

all most creditors felt the budget did not have enough spark from a fiscal consolidation perspective. Zambia has been granted interest payment freeze with the Paris Club[4] from May 01 to December 30, 2020 while it waits for other creditors it has similarly engaged to respond. In the last week of June this year, the Denashwar Ghuram led IMF Article IV Mission team confirmed having been mandated to commence talks with Zambia while the Southern African nation also seeks a Rapid Credit Facility – RCF to absorb COVID related economic shocks.

Barely a day after the request by the Zambian authorities to have coupons frozen, international rating agency Fitch lowered the red metal producers credit assessment to ‘C’ from ‘CC’ aligning with Moody’s ‘Ca’ gradings a notch below Standards and Poor’s CCC (-ve) outlook. Moody’s and Fitch ratings are a notch below default while Standards and Poor’s the best rating of the three for Zambia. These credit ratings have credit risk gradings for commercial bank models with could widen credit impairments thereby affecting profitability of financial institutions.

Various pre-budget discussions were held with key stakeholders providing expectations based on submissions to the Ministry of Finance that had a few months earlier requested for inputs into the 2021 budget. Some private sector specialists felt that the world was not too short of capital, yet the biggest challenge was how to channel it to Zambia amidst an uncertain environment. Cognizance was given to Zambia’s wealth of resources ranging from mineral deposits to arable land and water bodies that could drive the ailing economic growth rebound. The Chamber of Mines felt the mining sector was the countries opportunity low hanging fruit for a quick rebound given the magnitude of projects in progress such as the Australian EMR Capital led Lubambe mine $1billion project and First Quantum Minining Kansanshi $1billion expansion projects, but require a change in taxation regime to attract exploration investment through quick wins such as making mineral royalty taxes tax deductible which has worked in Namibia. Currently Zambia’s exploration propensity remains low. The tax side of expertise believed that the Ministry of Finance could further ease tax burden on citizens through lowering PAYE[5] or better still widen tax bands which the 2021 budget did take into consideration. However, the generally feedback was that PAYE adjustments were inadequate to stimulate national spending. Additionally, loss carry forwards were recommended by tax experts with the expectation that some corporates will incur losses in the period. The Economics think-tank was of the view the Minister would have to balance budget expectations between citizens, private sector, multilaterals with clarity around funding sources which could have implications on the domestic money markets.

The private sector was of the strong view that Zambia needs to accelerate efforts to get onto a bailout program that would attract investment into the country to spur growth.

Into the budget, other outstanding key issues were ratification of the central bank governor which by September 25 was at committee stage. Christopher Mvunga’s appointment was on the first day of October ratified by parliament. Mvunga comes at a time when tthe red metal currency has weakened 40% as credit risks continue to deteriorate on the back of COVID induced counterparty and sovereign weighted risks. However, his ratification is nonetheless overshadowed by market expectations of what next for Zambia in the fiscal space after bondholders holding 40% of outstanding dollar debt could not give a positive response to the solicitation request by the Ministry of Finance for the suspension of coupon payments on dollar bond exposures for 6-months.

“I want to emphasize that as governor of the central bank, you have an enormous task ahead of you. You will oversee the operations of the entire financial sector as well as the performance of the country’s economy as a whole.

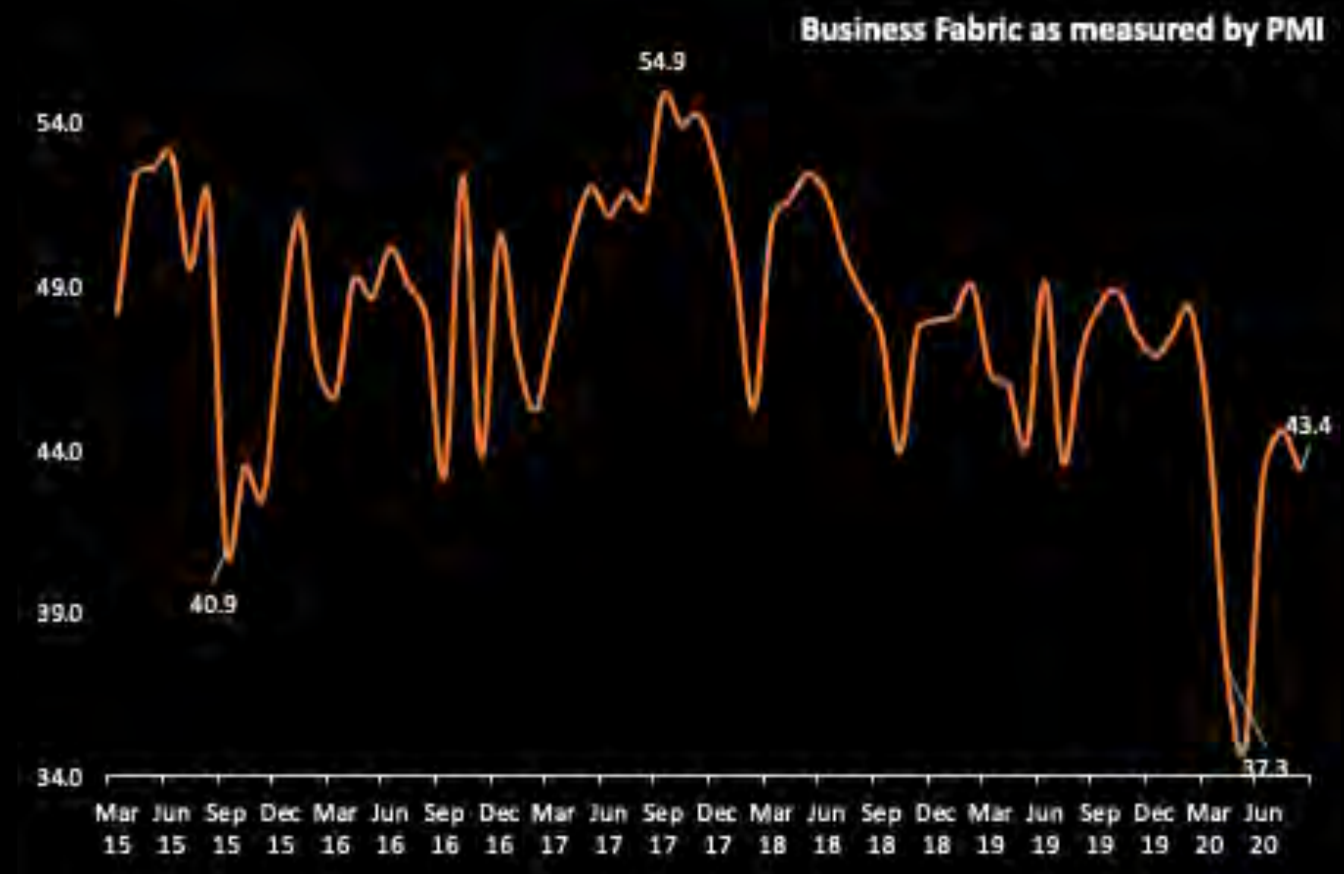
I am confident that with the over 30 years of experience in the public and private financial management sector, you will apply your skills and expertise to among others, review and formulate policy driven solutions to address the macroeconomic challenges that our economy is faced with.”

His Excellency President Edgar Lungu said.
(06 October 2020 during a swearing in ceremony at state house).

Economic Analysis with a Post Budget skew

Zambia's Finance Minister Dr. Bwalya Ng'andu presented a K119.6billion estimates of revenue and expenditure for 2021 representing a 12.2% growth from the previous fiscal year's budget. The fundamentals over the last one year have deteriorated with inflation in double digit zone of 15.7% (Sept) while the exchange rate has been on a losing streak having shaved over 40% to levels of 20 for a unit of dollar. Factoring these metrics and adjusting for election spend the 2021 budget was in real terms flat. Most analysts were highly optimistic about the presentation emanating from the fortnight earlier Presidential speech at parliament opening hinting economic rebound for 2021. Some of Dr. Ngandu's macroeconomic targets include 2.5 months of foreign exchange reserves import cover, growth of 1.8%, narrowing the fiscal deficit to 9.3% from 11.7% (2020).

The Zambian budget key stakeholders include citizenry whose livelihoods and cost of living has deteriorated by widening over the last year, creditors who concerns about adequate cover for debt service obligations owed to them given cash flow constraints the copper producer faces, the private sector that remain key drivers of real economic growth and lastly co-operating partners such as the IMF that would be seeking clues as to fiscal consolidation of some sort and other budget performance metrics to aid in critical decision making about bailout assistance. It is about a dry point of construction that the government's resource envelope has been constrained by disease pandemic effects on business fabric which continues to weigh the private sector whose cash flow generation ability has waned. This has resulted in lower tax remittances thereby denting the state's coffers. Pre-budget, various private sector players representing a wide array of sectors, suggested stimulus measures to support their operations to help spur growth. There is increasing realization in Zambia that the private sector needs more latitude to operate at full capacity which can only happen in a conducive environment which government continues to provide.



Purchasing Managers Index graph from Markit Economics.

Business pulse has contracted for 18 straight months and recorded the weakest activity in COVID era when factory activity plummeted to 34.2 in May weighed by slumping aggregate demand and falling selling prices. Zambia's purchasing managers index for the year has been themed with persistent energy challenges both at electricity generation level, high pump prices that have not adjusted lower even when crude prices slumped earlier in the year, currency depreciation causing rising input inflation, generally weak aggregate demand and lastly the black swan event, COVID19 that shocked business fabric to date. These in our views are the areas that if addressed would give a boost to private sector activity.

The 'V' shaped recovery intervention drivers

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A small offshoot of a plant on concrete depicting Zambia's V shaped recovery in difficult times.

The Ministry of Finance proposed some key stimulus measures in tax cuts across the sectors that are targeted towards boosting activity that drive Zambia's 'V' shaped recovery.

Exploration Investment propensity still a hurdle for Mining

Some of the tax adjustments include scrapping of import duty on copper concentrates which has for years hampered smelting business, which is driven by Zambia's Mopani, Konkola and Kansanshi Copper Mines including entities like Chambishi Metals Plc. With increased in production in the Democratic Republic of Congo – DRC which is north of 1.2million metric tons, Zambia stands to benefit more because of current unutilized smelter capacity which will help most mines meet contribution especially at a time when some face increasing production challenges. Much as the mining sector appreciates the 5% concentrate import tax scrap, another area that the authorities did not look at was how to attract exploration investment which has hampered Zambia's production growth capacity which remains constrained at below 890,000 metric tons annually. The Chamber of Mines continue to lobby for *tax deductibility of mineral royalty taxes*[6] which peer jurisdictions such as Namibia has seen influx of exploration investments. Zambia's propensity for exploration remains low and has capacity to increase but with the right tax policy which favors leaner costs.

Zambia's casing point for ongoing expansions[7] include the Kansanshi and Lubambe projects whose combined value is $2billion and are game changers for the country by 2024-2028 but for double taxation effects on mineral royalties through non-tax deductibility. Zambia's mineral diversification potential remains immense in the gemstones[8], nickel, manganese and gold industry. The Chamber of Mines are still lobbying for a waiver of the 15% export duty on manganese. Earlier in the year the Ministry of Mines scrapped the 15% duty on gemstones to help improve the mining environment. Ideally it has been proposed that the same waivers applied in the precious metals sector be extended to manganese and nickel.

Zambia's excess smelting capacity was given a boost after the Ministry of Finance announced a full tax waiver on import of concentrates.

A Manganese mine in Serenje. The Chamber of Mines have continued to lobby for removal of 15% export duty on the metal. This will boost mining diversification in the sector.

The small-scale mining sector for gold and manganese has potential to benefit the country's mining sector. Recently gold mining received much traction as an avenue to help boost falling reserves at the central bank. However, the general sense is that there has been no deliberate targeted gold production level correlation analysis with expected reserve numbers to help Zambia's real import cover to improve. Zambia will require 750,000 ounces of bullion (21,212kgs) annually if currency reserves are to be doubled from current levels. These are the kinds of discussions the Ministries of Finance and Mines combined should be having to drive performance driven solutions in the small-scale mining sector. This will address one of the Ministries macroeconomic objectives of 2.5months import cover[9].

Zambia's copper mining production rose 17.9% year to date to 572,729.62 metric tons (versus 526,336.09 metric tons in 2019) driven by the momentum for stockpiling in the 1H20 while receipts have declined 25% occasioned by copper price declines earlier in the year. However, copper prices have rebounded to current $6,579 a metric ton, a 51% recovery from March troughs of $4,343 a metric ton when COVID effects weighed the worlds severely. Much support for the red metal came from the supply angst in South America given disease pandemic effects and decongestion of mines at a time demand started to increase as China's factory activity was back above 50 as measured by strong PMI's. With the metal price fundamentals looking strong it is critical that Zambia's mining sentiment is addressed through the current litigation, energy related supply, care and maintenance quagmires that characterize key miners in the country

London Metal Exchange Copper. Source: Bloomberg

Manufacturing needs more than Tax Reprieve to drive Tangible Growth

Welding activity on Zambia's Copperbelt Province.

Manufacturing is one of the sectors that have been adversely impacted by COVID19 in 2020. On average the sector is in recession[10]. The 2021 budget despite a few tax adjustments to support agriculture mechanization, support cold storage processing through waiving duty on refrigerated trucks, taxes on import of skimmed milk and other favorable initiatives, manufacturers expected more given that structural issues as a result of current policies still exist. The budget spelled a reduction in the investment threshold for citizens to qualify for tax incentives under the Zambia Development Agency - ZDA from $500,000 to $100,000 for those intending to operate in a priority sectors, a Multi Facility Economic Zone – MFEZ or industrial park.

Some of the challenges that the Zambia Association of Manufacturers – ZAM faces are hinged on hurdles in ensuring value addition chains are boosted and ultimately competitiveness of credit terms as a result of tax refund periods for zero rated goods and services. These have rendered Zambian entities unattractive to the global village. The 2021 budget has made some strides towards giving the electric car era a boost after pronouncing a halved import duty on electric motor vehicles (EMVs) to 15% aimed at minimizing the use of fossil fuels in the long term. This move is an alignment to climate change resilience and Sustainable Development Goals -SDGs for 2030[11]. However, proponents of EMVs still require the state to consider knocking down import duty on semi – knocked down components for vehicles to stimulate local value addition for components. The regulation around EMVs and its registration still requires adjustment to accommodate for 100% electric cars[12]. This reflects the need for Zambia to adjust its Vision 2030 to ensure the nation is moving in tandem with global changing needs. The electric car era positions Zambia's mining to participate in the increased demand for copper - used in electric wire transmission capabilities and cobalt - required in lithium powered batteries. Energy is another key area that will be critical to charge these batteries during the EMV era.

Agriculture mechanization was given a boost after value added tax was scrapped on imported tractors with horsepower exceeding 90HP. The manufacturing sector is set to get a boost through construction yards across the country that will create 4,000 jobs. Zambia is set to have its first tomato plant in 2021 which would harness local produce to tap into agro - processing. Manufacturing still suffers structural issues that require addressing at a policy level if Zambia is to effectively grow and harness opportunity at its disposal. The COVID19 pandemic has exposed untapped opportunity to service the indigenous market which some firms have leveraged off to include entities specialized in FCMG, mill and grind media to mention but a few. The Zambia Association of Manufacturers in their submissions did point the Ministry of Finance towards leveraging off the Africa Continental Free Trade Area – ACFTA as the country extracts potential to export given the structures in place. There is need for immense policy intervention to make this a reality. The textile industry continues to suffer suppressed value chain momentum to support ginning and yarn production while reconstituted milk sector is faced with competitiveness given supply constrains in the market. With the higher duty on importation of reconstituted milk, various processing entities that have opted to import powdered milk because the local is not meeting indigenous demand will face higher costs which the authorities needs to relook.

Positive Energy Outlook – pricing still not Optimal and Cost reflective

Zambia's energy prospects remain bright backed by the pipeline of projects nearing completion. Grappling with an energy deficit of 810 Mega Watts the copper producer targets to add 300 Mega Watts after the Kafue Lower 750 Mega Watt project completes. The Minister of Finance in his budget speech reiterated the Presidents Parliaments opening speech about narrowing the deficit.

Energy deficit has been a consistent theme in the Southern Africa's private sector pulse since 2015 during the Zambezi crisis[13]. The Lower Kafue could have added 750 Mega Watts this year but for disease pandemic which dictated decongestion of staffing for social distancing purposes. However, the project will only add 300 Mega Watts to the grid in 4Q20 while the remaining 400 Mega Watt will be added by 1H20. The Zambian budget committed to energy reforms that would address competitiveness of energy prices after completion of the Cost of Service Study – CSS and eventual divorce of the government from petroleum procurement to allow the private sector to manage the process efficiently. Zambian consumers did not benefit from the earlier international crude price slump as global demand shriveled due to COVID effects. In this period, the Kwacha crude prices slid 38% signaling an opportunity for the Energy Regulation Board – ERB to trim fuel cost lower. However, the regulator did not pass the benefit to consumers on account of a feed stock and exchange rate depreciation counter argument in the period. At a time when disease pandemic effects had heightened, a lower fuel cost could have given manufacturing costs latitude for reprieve.

A Total filling station in Lusaka the capital. Fuel prices did not adjust downwards despite crude slumping earlier in the year.

Agriculture still has potential to drive Zambia's Agro - Processing agenda

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Cattle in Zambia's Southern Province. The 2021 budget increased import duty of meat products to 40% from regions outside SADC and COMESA

The 2021 budget zero-rated value-added tax on all tractors, an adjustment from only 90HP previously. This move is aimed at stimulating agriculture potential. The budget caters for zero duty on refrigeration trucks while import duty on meat products was hiked to 40% from regions outside SADC and COMESA. These protectionist measures were targeted towards promoting the local industry. Other private sector players believe protectionist measures in the long run exterminate competition which ideal should be healthy for sustainable growth. Other adjustments in the budget include removal of excise duty on crocodile skin while the horticultural industry was given a 10% development allowance to be claimed for 5 years. The pronouncements in the agriculture sector coupled with key infrastructure projects are set to position Zambia for trade purposes. Completion of the Kazungula bridge will open trade flows in the Southern African corridor which has been hampered in part due to the usage of the pontoon at Kazungula. With the two key International Airports set to complete in 2021, Zambia could leverage off these with its new airline launch to boost fresh cut flower industry into markets like the European Union emulating Kenya's[14] model. Other key milestones for Zambia are to double its maize reserves to a million metric tons for the Food Reserve Agency - FRA.

Forecast maize output is 3.4million metric tons for 2020 due to a good rainfall pattern. However, the maize production is said to have potential to ramp up to 8million metric tons with Zambia and South Africa's 14million metric tons able to potentially be Africa's breadbasket. The 2021 budget provides for K5.7billion, a 300% increase from K1.4billion previously, in Farmer Input Support Program – FISP targeting 1million farmers across Zambia. FISP programs have for years contributed to agriculture input driven dollar demand stemming from fertilizer purchases in dollars. Zambia continues to import fertilizer and ammonium nitrate from South Africa which are drivers of a widened import bill adding pressure to its exchange rate. Structural concerns have been raised for the copper producer to address through harnessing manufacturing capability locally to reduce vulnerabilities to external shocks.

The government must find more efficient ways to finance agricultural inputs and manage Zambia's oil procurement, Lungu said in Tuesday's speech. The central bank on September 15 listed those two factors as among the causes of the drain on foreign exchange, causing currency depreciation[15].

High Cost of Living has Citizens requiring more Social and Disposable Income

A Zambia food basket used to track cost of living for citizens.

As the most important stakeholder in the Zambian budget, citizens had mixed feelings about the 2021 budget given the elevated cost of living as the basic needs and nutrition food basket cost as measured by the Jesuit Centre for Theological Reflection - JCTR widened significantly to K7,406. COVID effects resulted in job losses and wage cuts for citizens as disease pandemic priced into the business ecosystem. Various sectors were impacted adversely resulting in a sharp slowdown in business pulse let alone aggregate demand waned.

The budget catered for the vulnerable through an increased social cash transfer allocation of K4.8billion accounting for an 84% increase given the need to cushion wider impact of disease pandemic. For the working-class citizens, the budget catered for a slight increase in respective disposable incomes through widened income tax bands for pay as you earn taxation line. This will result in a minimum of K175 to a maximum of K700 purchasing power upward adjustment. However, the argument remains that the tax adjustment is not significant enough to effect aggregate spending that will aid the economy to rebound in 'V' shape in 2021.

Jurisdictions like Kenya made more aggressive personal income tax adjustments lower to 20% on the upper bound from 30% to allow citizens a higher disposable income to stimulate spending that will spur growth in suppressed times. Kenya further lowered its value added tax to 14% from 16%, corporation tax to 25% from 30% while its turnover tax was adjusted lower to 1% from 3%. All these measures were aimed at easing the burden on locals. The budget also accounts for empowerment programs that will seek to assist youths and the vulnerable engage in survival activities that will alleviate poverty. The year 2020 has also seen significant empowerment programs whose allocations are yet to be audited for effective use. Empowerment programs by the state nonetheless remain more skewed towards handouts than seed capital to be grown into a revolving fund that assists the needy in a graduated fashion.

Local Small to Medium Enterprises – SMEs remain impacted by disease pandemic and got very minimal support in the 2021 budget as most tax cuts announced target larger corporates while the Multi Facility Economic Zone – MFEZ shift may be to advance for them. It is not a straight science for a welding business in a Zambian township to relocate to the MFEZ as it impacts their operational model. For some bigger corporates, tax cuts were beneficial nonetheless but for corporation tax that was unchanged save for the hotel and tourism sector. The tourism sector corporate tax cut was cut to 15% from 35% on accommodation and food only while other key activities such as game viewing and safari are subject to a higher tax which makes the computation process tedious. Local tourism boost remains a challenge when citizen's disposable incomes remain lower in real terms adjusted for inflation. The import duty suspension in tourism sector on game viewing motor vehicles, tourist buses and coaches will help businesses.

External and Internal Debt Provisions Underwater

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The 2021 budget provides for K27.5billion for external debt service which translates to $1.32billion against debt service in excess of $1.5billion. Debt service[16] continues to be the biggest consumer of resources and accounts for 48.3% of the expenditure side. An amount of K2.76billion was allocated towards dismantling of domestic arrears whose level is not known from the last K26.3billion reported in September 2019. However, based on this number unrealistically assume zero growth, the budget only caters for 10%. However, in the period the Finance Ministry has sold COVID bonds whose proceeds were purportedly earmarked for supplier, contractors and retirees. However, it is necessary that the Ministry of Finance clarifies the actual level of domestic arrears factoring in COVID bond proceeds. Domestic arrears reflect the level of liquidity the real sector of the economy is deprived of.

Zambia's total external debt was revealed by the fiscal head Dr. Bwalya Ng'andu as $18.5billion pushing the copper producer to a Debt to Gross Domestic Product of 104.2% above the 35% IMF acceptable threshold. Zambia has engaged all its creditors for potential suspension of interest payment at a time when its fiscals are in distress as a result of amplified effects due to disease pandemic. The Minister in his presentation to Parliament on September 25 and to investors on September 29, announced project rescoping and cancellation of $1.4billion in credit lines as it scales down on incurring external debt. The Minister also committed to prioritizing projects that are at above 80% completion and those that will be very critical such as energy generation and social type of projects.

Flyover bridge on Kafue road as part of the Lusaka decongestion project. Infrastructure projects are said to be drivers of Zambia's external debt position.

Dislocated Expansionary Monetary Policy from Growth Fundamentals

In the budget presentation it was revealed that stock of outstanding bills and bonds ballooned to K114.3billion to date versus K80.2billion (Dec19). This reflected among other things a balance sheet expansion program by the central bank supported by a confluence of measures such as quantitative easing, bond buying to restructure maturity profiling of local or domestic debt, consolidation of government securities. Disease pandemic has dislocated the correlation between balance sheet expansion manifesting in higher outstanding bills and bonds versus the economic growth pace which ideally is moving in the opposite direction. The Minister of Finance in the year advised that Zambia will fund its fiscal programs using the domestic money markets to curb further accumulation of external debt. The copper producer has issued pandemic bonds targeted towards absorbing retirees, suppliers and contractors arrears.

The Bank of Zambia increased its government security offerings by 36.7% beginning of 3Q20 whose size it will extend to 4Q20. The 2021 budget targets to raise K18billion in next year's government security sales. The Bank of Zambia has this year trimmed rates 350bps to 8% the lowest since the policy rate started being tracked in 2012. Statutory Reserve Ratio – SRR was unchanged at 9% for both local and foreign currency. In addition to expansionary measures, the central bank in the year relaxed its provisioning rules while increasing its presence in Open Market Operations – OMO to boost liquidity to absorb credit related credit risks. Inflation theme is currently shaped by a weakening currency while short term yields on government securities have rallied to lows lagging the bond curve that remains elevated.

> *"There's no way that I am going to compromise the operational independence of the central bank."*

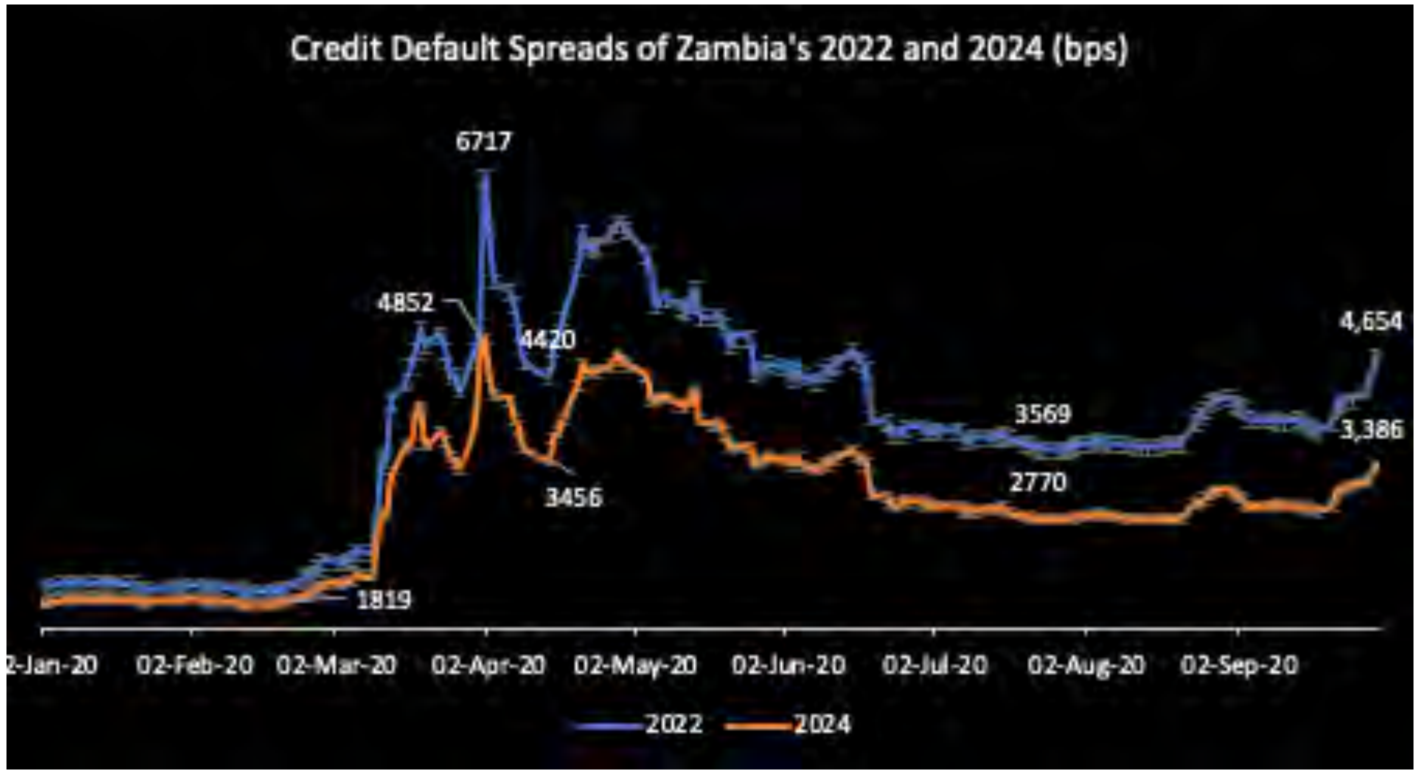
Zambia's incoming Central Bank Governor - Christopher Mvunga said.

Debt Redemption and Creditor Strategy

Deputy Commerce Minister - Miles Sampa (L), Deputy Governor Operations Dr. Bwalya Ng'andu (R), Permanent Secretary Economic Policy Management - Mukuli Chikuba (BH) in 2012.

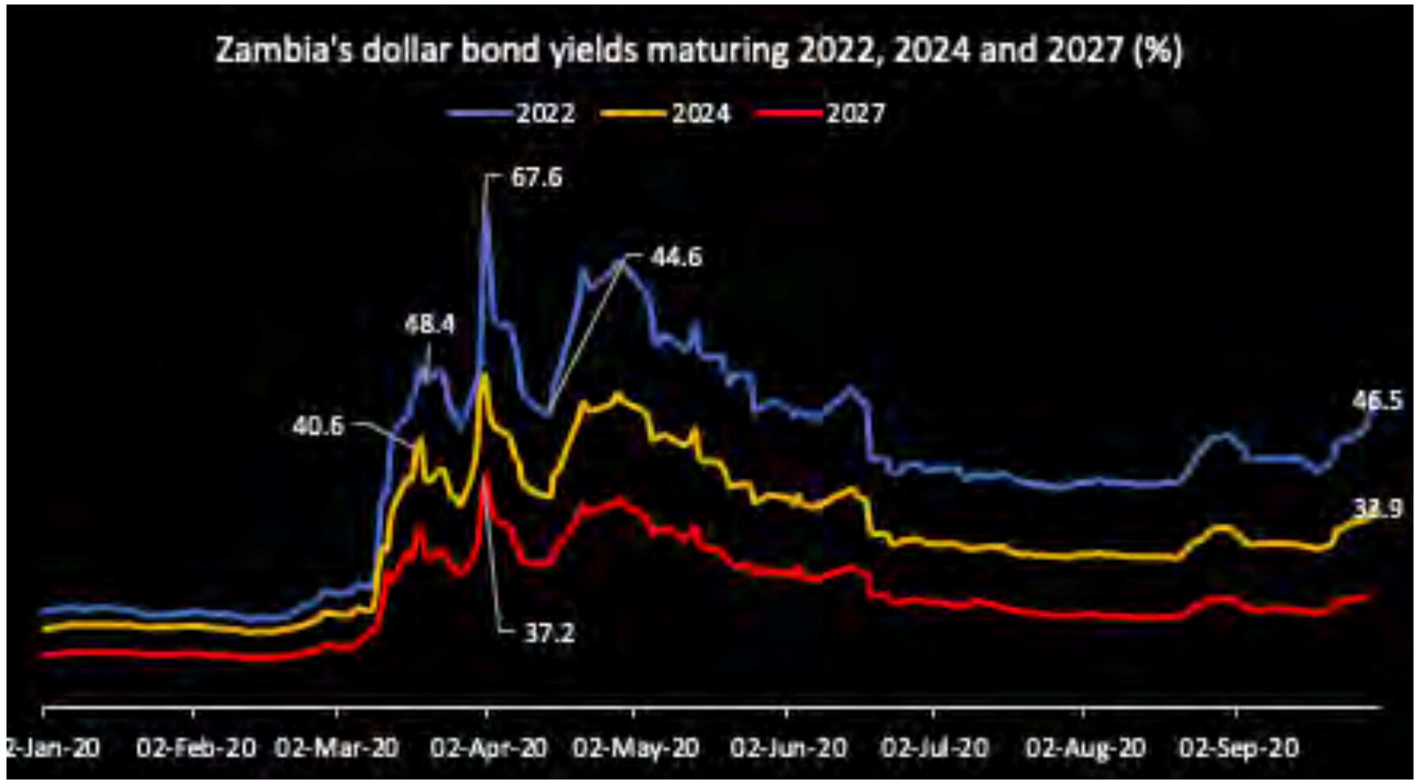
A Russian Roulette Moment in Zambia's Debt Restructure Process

Zambia's debt restructure process triggered a Russian roulette quagmire requiring bondholders to nod a solicitation commenced by the copper producer to have coupon payments frozen for 6-months. September 29 was a critical day for Zambia as its MinFin addressed investors on the Southern African nation's debt situation virtually at 12.30pm – London Time. Finance Minister Dr. Bwalya Ng'andu addressed investors about Zambia's debt situation. This follows an application by the Ministry of Finance to freeze coupon payments in the period between October 14, 2020 to April 14, 2021. Eagerness continues to grip Africa's second largest copper hotspot on what next as bondholders holding 40% of Zambia's debt could not provide a positive response to the request to defer the coupon payments in question.



Source: Bloomberg

Credit default spreads on Zambia's dollar bonds widened blew out 394 – 790 basis points over the last 8 days following news around the solicitation of interest payment freeze to the dollar bondholder's rejection of the request on September 30 (see appendix 1 for African Dollar Bond Pricing). This period will be characterized by uncertainty and could breed flight to safety tendencies that are likely to add pressure to the exchange rate. Other concerns would be risk appetite related for credit appetite for commercial banking models. The rejection is raising key concerns around potential default risk if the authorities do not act quick enough to meet the bondholder's concerns. A deferment is still eminent but could take longer than anticipated given the concerns raised by Zambia's Eurobond holders Committee. It is vivid that this creditor class is ready to work with Zambia for a win- win outcome but will need the copper producer to provide clarity around progress with an IMF deal, clear fiscal consolidation which they could not see in the 2021 budget presentation and more transparency about other creditors that Zambia is engaging. A week earlier, Fitch rating agency lowered Zambia's credit assessment to "C" from "CC" aligning to Moody's "Ca" level while Standards and Poor's (S&P) still rate Zambia CCC- with negative outlook. These downgrades were effected as a reflection of the credit risk quality of the sovereign given harsh pandemic effects causing a deterioration in not only business fabric but fiscal posture.



Source: Bloomberg

Zambia's dollar bond yields have since widened between 26.8% - 46.5% the worst performers of all emerging and frontier market assets. Bond pricing this year has been a confluence of both endogenous[17] and exogenous[18] factors. These will explain the gyrations in term structure of the CDS curve.

The Southern African nation, on September 22, reached out to its Eurobond holders requesting deferment of interest payment for a period of 182 days as part of a debt restructure process commenced by advisors Lazard at a time when disease pandemic has weighed acutely. The copper producer was earlier granted an interest freeze on its Paris Club debt nodded by the G20 running 01 May to 31 December 2020 after it had requested for a 2-year moratorium, nonetheless. Zambia has reached out to all its key creditors for reprieve in debt service with responses awaited.

Zambia's Finance Minister Dr. Bwalya Ng'andu carrying a copper case on 25 September at Parliament.

Reforms to address Fiscal Fragility

Zambia's chances of convincing bondholders are largely dependent on the authority's tact in convincing its creditors about its debt restructure program to get it within the prescribed International Monetary Fund – IMF thresholds. The Minister of Finance in Africa's red metal hotspot on September 29 revealed Zambia's total indebtedness inclusive of continent liabilities and debt owed by State Owned Entities - SOE's as $18.5billion[19] with an average interest of 4.5%. Speaking during an investor call on the opening of the voting session following the copper producers request to defer coupon payments on its dollar bonds for 6-months, fiscal head Dr. Bwalya Ng'andu told the private creditor class that the country's debt position to gross domestic product was 104%[20], breaching the Washington based lenders threshold of 35%.

The Minister in his presentation revealed that Zambia was spending half of government revenue collections to service interest on debt currently compared to a few years ago when only 20% of revenues were allocated towards these obligations. It has become increasingly difficult to service debt. COVID disease pandemic has necessitated interest payment deferral to create fiscal space in crisis time and will cushion the country against interest penalties for delayed payments. Zambia has written to key creditors of which some such as the Paris Club have provided the copper producer with reprieve from 01 May to 31 December 2020.

The Zambian authorities remain committed and confident that Zambia will implement measures adequate to get economic bailout assistance from the International Monetary Fund – IMF at the end of the interest payment stand still period. It is increasingly evident that debt stand still is vital for the Southern African nation to work with the IMF under the Debt Service Suspension Initiative – DSSI rules which will aid the country to qualify for the upper credit crunch program. The red metal producer currently in breach of the Washington based lenders benchmark but has strongly committed towards implementing reforms that will address its current balance sheet fragilities through extensive systematic creditor engagement and debt management strategy[21]. Zambia has rescoped some of its infrastructure projects[22] to ensure that only those critical as the Kafue 750Mega Watts for energy generation and those of social importance are prioritized. The money, however, in the 2021 budget presentation alluded to some projects such road works, the two international airports, the Kazungula bridge and incomplete toll gates to mention but a few to proceed to completion because of necessity. A total of $1.4billion worth of potential disbursements were cancelled[23] in 2020 while the MinFin seeks to cancel a further $1.8billion next year.

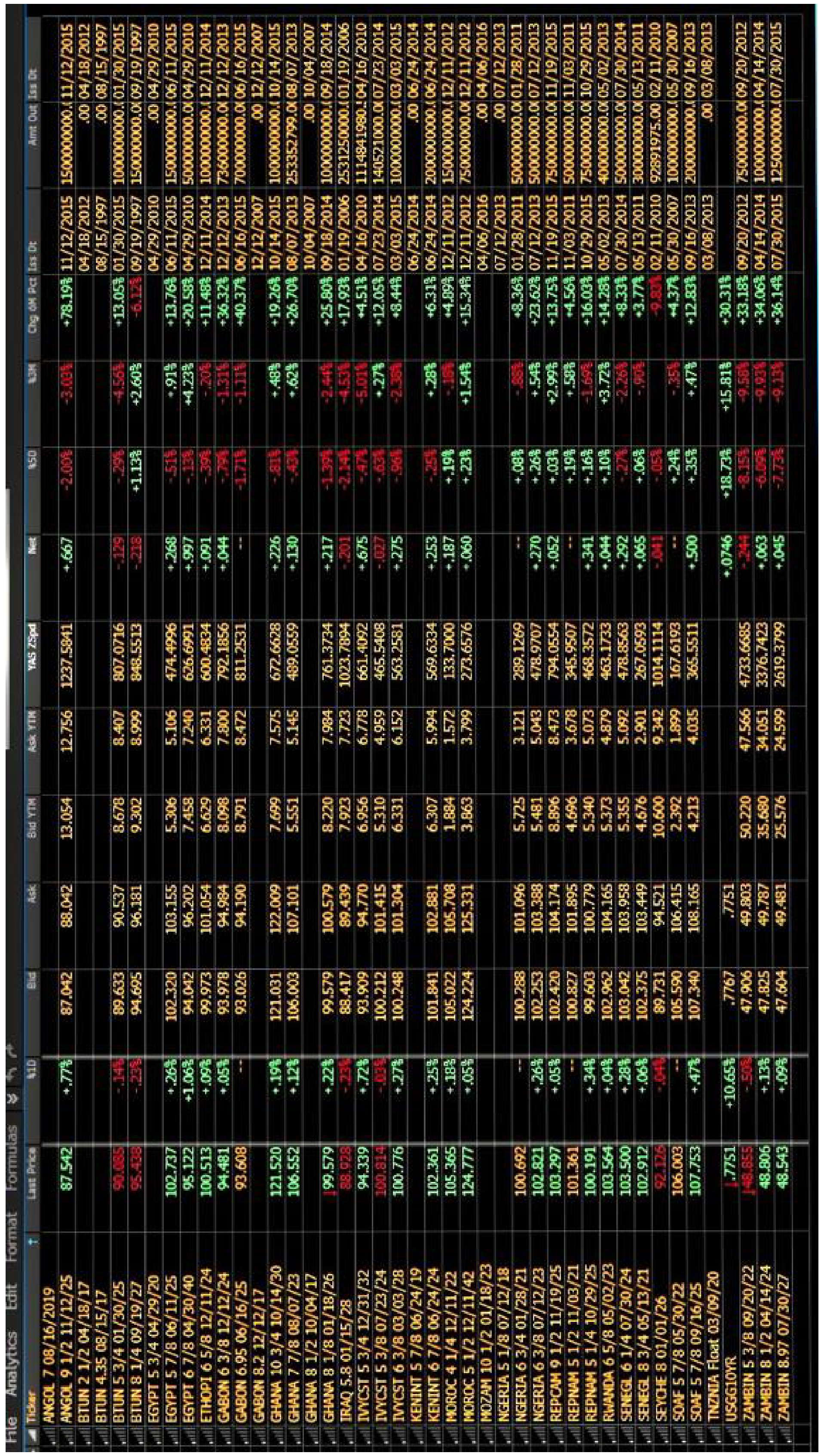
Bondholders eventual nodding will trigger a Credit Event

Dollar bondholder's acceptance of Zambia's $160million coupon request will trigger a credit event that will further result in increased appetite for protection[24] using Credit Default Swaps – CDS's for periods in excess of 6 months. (>6months reflects the uncertainty given the country's sovereign risk profile). Last week, Fitch rating agency further lowered the copper producers credit assessment to "C" from "CC" while Zambia remains "CCC-" (-ve) for S&P and "Ca" for Moody's. Zambia's deteriorating risk profile has already started to reflect in wider provisions in the commercial banking sector as credit appetite declines.

Budget lacked Fireworks – Bondholders

When the budget was presented on September 25, bondholders sought clues around economic turnaround and adequacy of resources to meet their dues. However, the widened fiscal deficit of 9.3% projected for next year from 11.7%[25]. The vague strategy around fiscal consolidation was an area highlighted in the press statement from the Eurobond holders committee[26]. Zambia has, in the 2021 budget, provided for $1.3billion (K27.3billion) for external debt service but given the currency rout, this provision could be eroded by depreciation of the local currency. The $6.6billion (K119.6billion) estimates or revenues and expenditures is expected to "V-shape" recover growth to 1.8% next year from a 4.2% recession this year.

Appendix 1: African Dollar Bond Pricing



Appendix 2

[1] Purchasing Managers Index – PMI is tracked by Markit Economics London and Zambia last headlined 45 and has been below 50. The 50 level is the benchmark for expansion and contraction.

[2] The estimated backlog is excess of $100million inferred from the industry pipeline of clients seeking dollar funding.

[3] Dollarization of mining taxes has sucked an estimated 45-55% of foreign exchange supply from the open market.

[4] The Paris Club nodded by the G20 gave Zambia interest repayment reprieve for 8 months to the end of the year.

[5] PAYE – Pay as You Earn is a personal income tax.

[6] Zambia has $2billion worth of investments on halt because of mineral royalty tax non-tax deductibility which have been said to render projects unviable. Kansanshi and EMR Capital backed Lubambe Copper Mines are the key players affected by this concern. https://m.mimimgweekly.com/article/zambian-royalty-spat-halts-2bn-of-copper-mine-investment-2020-09-30/rep_id:3861

[7] Key investments in the mining sectors include the $1billion Kansanshi Mine Sulphide expansion, $1billion Lubambe expansion and NFCA Chambishi South East Ore body.

[8] Zambia's emerald auctions have attracted attention due to the quality produced such as the 'Inkalamu' the biggest lion emerald globally in addition to the 'Insofu' elephant stone. These stones are highly competitive.

attention due to the quality produced such as the 'Inkalamu' the biggest lion emerald globally in addition to the 'Insofu' elephant stone. These stones are highly competitive.

[9] The Ministry of Finance import cover target of 2.5months should be looked at in tandem with actual reserve number as opposed to the ratio which can be inadequate and misleading in times when import cover is declining and reserve number stagnant.

[10] Manufacturing is in recession at -4.3% year to date given disease pandemic effects according to the Zambia Association of Manufacturers.

[11] Sustainable Development Goals 2030 advocate for cleaner energy and more climate change resilience.

[12] Zambia has dealers of EMVs such as Amilak Investments that are happy with the import duty adjustment but require that the authorities address the regulatory framework that will support 100% EMVs.

[13] This is the term that has been used to describe the 2013-2015 period when Zambia suffered a severe drought.

[14] Kenya has a $5billion fresh cut flower industry tapping into the European Union – EU. Zambia through ZEGA and the defunct Agri flora Ltd decades ago exported fresh cut flowers directly from Lusaka's International Airport to the EU.

[15] https://www-bloomberg-com.cdn.ampproject.org/c/s/www.bloomberg.com/amp/news/articles/2020-10-06/zambian-leader-tells-central-bank-chief-to-stabilize-currency.

[16] This caters for internal and external debt service in addition to recurrent expenditure such as wage bills.

[17] Endogenous factors include feeble sentiment as fiscal vulnerabilities amplified in part by disease pandemic widen. These have triggered rating downgrades that have caused asset – sell off pressure in the international capital market. Zambia grapples with a currency rout, energy bottlenecks and sustainability concerns.

[18] Exogenous factors relate to the general risk sentiment where players rushed for dollar 'safe haven' at a time when financial markets were cash thin. This then triggered massive monetary and fiscal stimulus globally that left markets cash flush resulting in ultra-thin interest rates.

[19] Of the total indebtedness of $18.5bilion, external debt owed by government directly is $11.97billion while the remainder reflects obligations owed by State owned Entities – SOE's and other contingent liabilities.

[20] This was a jump from the official 60-65% estimate reported last year. Debt to GDP calculation is impacted by the 40% steep exchange rate depreciation observed year to date.

[21] Zambia hired Lazard Frere's a French Investment banking form to restructure its liabilities.

[22] Infrastructure projects have been said to be the largest debt drivers for Zambia hence the focus on slowing down accumulation as it embarks on a journey towards restoring fiscal fitness.

[23] Cancelation of lines not drawn on nonetheless has legal ramifications which the MinFin are dealing.

[24] Protection in question refers to credit risk hedging through purchase of credit default swaps.

[25] The Minister of Finance estimated the Zambia's deficit will average 11.7% for 2021.

[26] The committee of Eurobond holders comprises 14 European and United States banks that account for 40% of Zambia's Eurobonds.

Mutisunge Zulu (Author)

He is a non-executive Chief Macro Business Strategist at the Kwacha Arbitrageur an Economics and Research unit of the Business Telegraph. He also serves as National Secretary of the Economics Association of Zambia. He has over a decade and half experience in financial risk management as a seasoned market, integrated operational and credit specialist.

Niza Chikuse (Creative Designer)

Lead Data Scientist at the Kwacha Arbitrageur and also serves Creative Director at Kai Innovative Africa, a startup creative agency. He apecializes in Graphic Design, Digital Marketing and Brand Development.

Disclamer: All information used to publish this economic outlook document is publicly available. The view expressed are purely the authors.

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