

# AN ASSESSMENT OF **ARREARS CLEARANCE** **AND SUSTAINABLE** **DEBT OPTIONS** FOR ZIMBABWE

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## ACRONYMS

AfDB	African Development Bank
CPIA	Country Policy Institutional Assessment
DRC	Democratic Republic of Congo
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFS	International Financial Institutions
IMF	International Monetary Fund
LICs	Low Income Countries
MDRI	Multilateral Debt Relief Initiative
NPV	Net Present Value
ODA	Official Development Assistance
PPG	Public and Publicly Guaranteed
PSI	Policy Support Instrument
PV	Present Value
RBZ	Reserve Bank of Zimbabwe
SDR	Special Drawing Rights
UK	United Kingdom
US	United States
ZADMO	Zimbabwe Aid and Debt Management Office
ZIMSTAT	Zimbabwe National Statistics Agency

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## EXECUTIVE SUMMARY

This paper provides an assessment of external payment arrears clearance strategy for Zimbabwe with a view to come up with optimal strategies for debt and arrears resolution, which entrenches fiscal sustainability, sustained economic growth and social cohesion. The paper applies the external debt dynamics equation to project the evolution of external debt. The analysis is premised on an ambitious macroeconomic framework envisaged under the new dispensation that projects sustained real GDP growth rates of 4.5% in 2018 and stabilizing between 6-8% in the medium to long term. FDI flows are assumed to average 4% during the projection period, reflecting the increased role that the private sector is expected to play in spearheading infrastructure development. The results suggest that the country's external debt burden indicators would remain high and above the indicative thresholds applicable to Zimbabwe, even after debt restructuring in the short term and reverts to sustainable levels in the medium to long term. The unsustainable debt position is exacerbated by the recent pace of domestic debt accumulation to finance growing fiscal expenditure, which recorded US\$7.1 billion in December 2017. The debt stock is also vulnerable to shocks, mainly export and growth shocks. Moreover, debt service indicators from the envisaged debt resolution strategy suggest that the country would be required to fork out amounts in excess of 20% of its exports or government revenues in settling restructured debt, which is largely unproductive in nature.

The projected high scheduled debt service payments from the unproductive restructured debt means that interest payments would take up an increasingly large share of taxes and expenditure. This will somewhat crowd out social expenditures with adverse implications on attainment of Sustainable Development Goals. Additional pressure, will also come from expected new external debt contracted to enhance economic growth. This additional debt service pressure would affect medium to long term growth through the debt Laffer curve if not properly planned and managed. Nevertheless, the goodwill to be realised from clearing external payment arrears potentially far much outweighs the fiscal sacrifice ratio on social spending. In essence, normalisation of relations with the international community from clearance of arrears will also unlock additional donor financing which virtually dried out following Zimbabwe's isolation from the international community. This additional money to be unlocked together with budgetary donor support will go a long way in supporting the social sectors of the economy.

The projected violation of the solvency condition even after the assumed debt restructuring in the short term implies that the country's public debt distress cannot be resolved by simply debt restructuring but needs a hybrid approach, which encompasses both debt restructuring and write-offs. In this regard, the Government should capitalise on provisions of engaging the Paris and non-Paris club to negotiate for debt write-offs to restore sustainability. Government also needs to pursue policies that support medium-term growth by promoting

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the growth of human and physical capital, and by increasing productivity to ensure strong and broad-based growth. This growth will enable the government to rebuild fiscal buffers, improve government balances, and anchor public debt. Government should also commit to firmly put its fiscal deficits within sustainable ranges by mobilizing revenues, rationalizing spending, and improve spending efficiency. The fiscal adjustment needs to be anchored on strong structural reforms, and adherence to fiscal rules that support potential growth. There is also need to put in place a proper institutional framework for borrowing to manage public debt prudently and avoid a recurrence of debt distress episodes, while adequately financing sustained future growth. This underscores the need for comprehensive capacity building initiatives in public debt management.

## I. INTRODUCTION

Zimbabwe has been in debt distress since the year 2000, when the country first defaulted on its external obligations to the International Financial Institutions (IFI). The defaults resulted in the country being denied access to external financing by IFIs and other traditional multilateral and bilateral creditors. Consequently, Zimbabwe has not been in a position to access funding from traditional bilateral and multilateral creditors. The constrained access to external finance partly contributed to a decline in economic activity witnessed between 2000 and 2008. The low growth trajectory during the crisis period affected the country's debt carrying capacity and its ability to service debt. Prior to the 2000 crisis, Zimbabwe had a clean record of servicing its debt. Thus, it can be said that Zimbabwe's debt problem was not a result of imprudent borrowing, but merely reflects growth crisis, which compromised the sources of debt servicing, as measured by exports and or government revenues.

The accumulation of external payment arrears resulted in the International Monetary Fund (IMF) declaring the country ineligible for the general resources account of the IMF financing window (IMF, 2001). Equally the same, other multilateral institutions, notably the World Bank and the African Development Bank (AfDB) and traditional creditors from the Paris Club also suspended disbursements of existing loan facilities and also declared the country ineligible for new loans. The country has not been in a position to receive Official Development Assistance (ODA) from traditional creditors as well as balance of payments (BOP) support from the IMF. The country had been relying on semi concessional financing mainly from China. The lack of access to long-term capital has led to significant infrastructural deficiencies in the economy, thereby militating against the country's growth efforts. In particular, the road, rail, air, water and energy systems have deteriorated significantly owing to under-investment in the sectors. This has forced a number of projects to be suspended or cancelled. Additionally, underlying fiscal constraints have undermined government's ability to inject meaningful investment in infrastructure and public service delivery.

Whilst the economy has shown signs of recovery since 2009, the continued isolation of the country remains an albatross to the country's growth initiatives. The sustained underperformance of the economy significantly undermined the country's debt carrying capacity to the extent of being classified as in debt distress for over a decade. The accumulation of external payment arrears also increased the country risk premium. This eventually translated into high cost of funds even for the private sector. With longstanding external arrears, foreign financing has been scarce, and large fiscal deficits have mainly been financed through domestic borrowing. Domestic debt, which was negligible during the early years of adopting the multicurrency regime in 2009, increased sharply to more than 40% of gross domestic product (GDP) in 2017 and has also been on an unsustainable trajectory (IMF, 2017).

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Realizing the importance of clearing external payment arrears, the Zimbabwean authorities took bold steps to re-engage with the international community, with the immediate objective of resolving arrears with the IMF, the World Bank Group (WBG), and the AfDB. The plan involves clearing the country's external arrears to the three IFIs through a combination of the country's own resources, bridge financing from a regional financial institution, and a long-term loan from a bilateral creditor. The strategy received support from creditors and development partners during a meeting held in Lima, Peru in October 2015. As part of this strategy, arrears to the IMF-administered Poverty Reduction and Growth Trust (PRGT) were cleared in October 2016, allowing Zimbabwe's PRGT eligibility to be restored and the declaration of noncooperation to be lifted (IMF, 2016). Discussions are still ongoing over financing and modalities to clear the arrears to the World Bank and the AfDB.

The country's external debt position, however, remains precarious, with additional debt servicing pressure coming from escalating domestic debt borrowing amid limited fiscal space. With limited access to external resources, large fiscal deficits are being financed domestically through central bank advances and treasury bill issuance. The expansionary fiscal stance led to the government's absorption of domestic capital, exacerbating the dollar scarcity in the economy, and crowding out the private sector (IMF, 2017). The combination of high domestic debt and external payment arrears underscore the need to relook holistically at the feasibility of the country arrears clearance strategy and its implications on growth, social spending and debt sustainability. The Zimbabwean government has continued to contract new loans from China and regional banks. These threaten to repeat past mistakes of over-reliance on foreign borrowing rather than using domestic resources and using foreign borrowing for activities which will not create sufficient returns to repay the loans. In future, the Zimbabwean governments could find itself in similar challenges with China as it did with the other creditors in 1990s following the dwindling of the country's capacity to service the loans and accumulation of arrears.

With the dawn of the new economic and political dispensation in November 2017, the new government is accelerating the re-engagement process with the international community to improve international relations and to resolve the external payment arrears to the remaining IFIs as well as bilateral creditors (Reserve Bank of Zimbabwe (RBZ), 2018). The ability to clear debt arrears is expected to open avenues for concessionary funding for expansion of public investment in order to rehabilitate and expand infrastructure (road, rail, air, energy, water, and housing) and improve health, education and other social services in Zimbabwe. Furthermore, the ushering in of the new political and economic dispensation implies that Zimbabwe is likely to face a new external borrowing landscape characterized by new lenders, in a more volatile and uncertain financial environment. As such, the need for strengthening the current institutional framework for borrowing to manage public debt prudently and avoid a recurrence of debt distress episodes, while adequately financing future growth cannot be over-emphasized.

It is against this backdrop that this paper intends to re-visit the subject of debt and arrears clearance to move the economy in this new political dispensation. Precisely, the paper seeks to assess the implications of the current arrears clearance strategy on the economy and proffer solutions on the way forward. The study will unpack the major drivers of debt and arrears accumulation in Zimbabwe with a view to come up with an appropriate arrears clearance strategy. The study also examines the nature of Zimbabwe's debt sustainability challenge in terms of solvency, liquidity and vulnerability. This assessment is necessary to the recommendation of an appropriate debt resolution strategy. Countries that are solvent but facing liquidity challenges may seek for debt restructuring to enable them to create space for servicing the debt when income streams improve. However, countries that are facing solvency challenges require an exceptional debt resolution in the form of debt forgiveness.

### 1.1. OBJECTIVES OF THE STUDY

The objectives of the study are to:

- Assess the evolution of external debt and external payment arrears;
- Assess the drivers of debt accumulation in Zimbabwe;
- Assess the implications of proposed Government arrears clearance strategy on debt sustainability, economic growth and social spending;
- Assess cost and benefits of alternative arrears clearance strategies; and
- Propose sustainable debt stabilisation policy path for Zimbabwe.

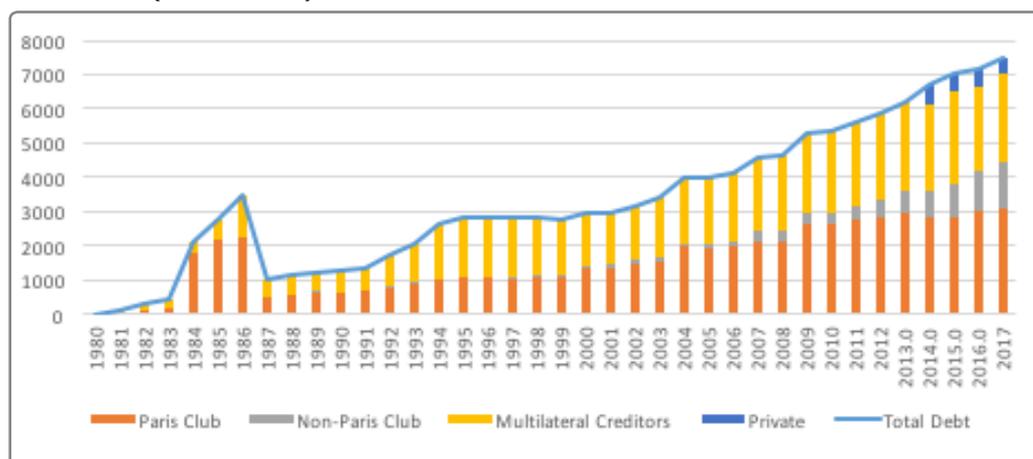
### 1.2. ORGANIZATION OF THE STUDY

The rest of the paper is organized as follows. Section two discusses the stylized facts on Zimbabwe public debt and external payment arrears. Section three reviews options for debt relief and arrears clearance strategies including country experiences. The empirical analysis and analysis of results are discussed in section four and five whereas section six concludes and proffers policy recommendations.

## 2. STYLISTED FACTS ON PUBLIC DEBT AND EXTERNAL PAYMENT ARREARS

At independence in 1980, Zimbabwe inherited about US\$700 million of debt from the Rhodesian government, which mainly emanated from the United Nations sanction-busting loans to the white regime to buy arms during the civil war (Jones, 2011). Since then the country has been on a borrowing spree to finance development expenditure. The country accessed loans for structural adjustment programme from the IMF, social development and emergency relief expenditures, such as drought from World Bank and ODA from bilateral creditors. Over the period 1980-2000, the country had a good record of settling its external payments to multilateral and bilateral creditors and did not experience major challenges with external payment arrears. However, Zimbabwe public external debt stood at US\$7.5 billion at the end of 2017. Traditionally Zimbabwe has been borrowing from the multilateral creditors and the Paris club. The non-Paris club credit started to grow from 1999. Private creditors also surfaced from 2014 going forward. Figure 1 shows the evolution of Zimbabwe's external debt.

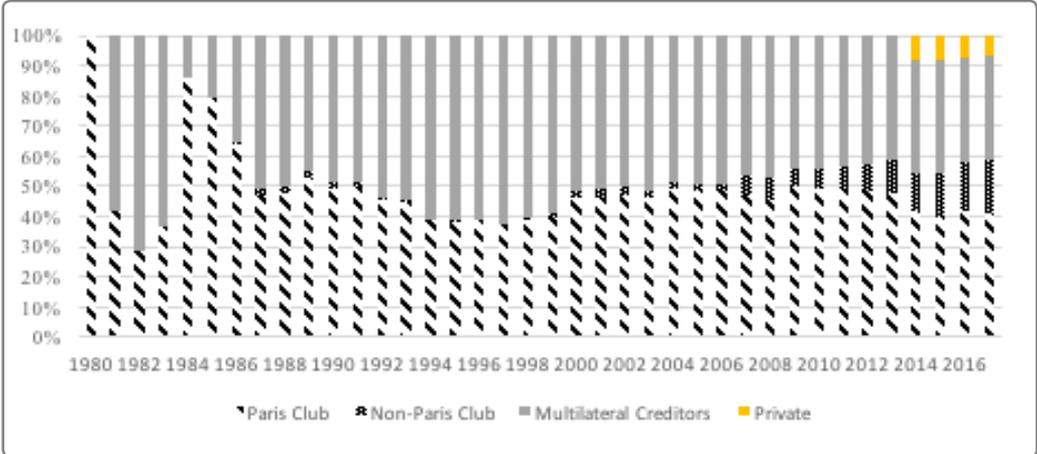
**Figure 1: Evolution of Zimbabwe's Public and Publicly Guaranteed External Debt 1980-2017 (US\$ million)**



Source: Authors own construct based on data from the Zimbabwe Aid and Debt and Management Office (ZADMO)

In terms of composition by creditor, 41% of external debt was owed to Paris Club creditors, 34% to Multilateral creditors, 18% to non Paris Club creditors and 7% to private creditors. Figure 2 shows the evolution in the composition of Zimbabwe's public debt.

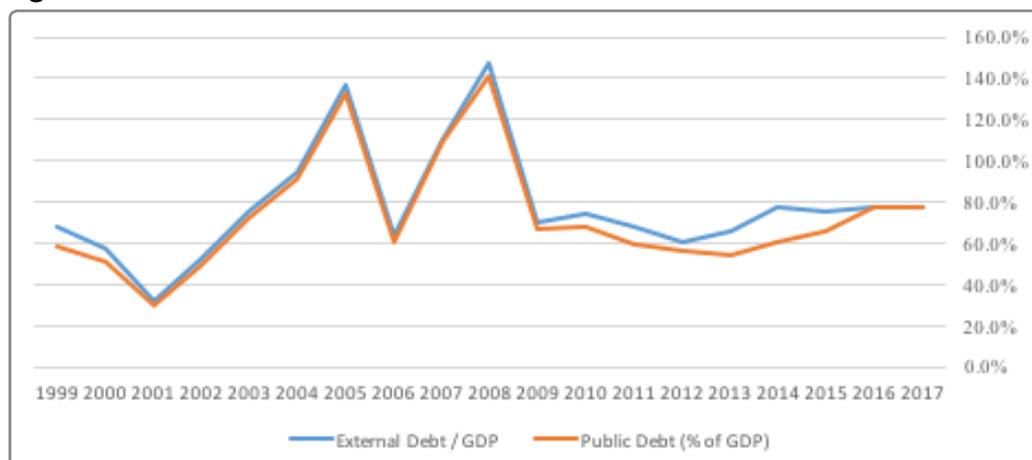
**Figure 2: Evolution of the composition of Zimbabwe’s Public and Publicly Guaranteed External Debt, 1980-2017**



Source: Authors own construct based on data from ZADMO

The current external debt overhang has its roots from the 1990s, when a combination of high debt service obligations, fiscal deficits, stunted growth and constrained access to new external financing culminated in a net outflow of resources from the country, with the consequence of default by 2000. The situation was exacerbated by an economic crisis in 2000 and the contestations that accompanied the land reform programme. Zimbabwe started experiencing difficulties settling its external obligations as growth stagnated and exports were depressed. This marked the beginning of incurrence of external payment arrears. The country’s debt burden indicators as measured by debt to GDP ratio also significantly increased to levels above 100% in 2005 and 2008. Figure 3, shows the evolution of Zimbabwe external and public debt indicators from 1999 to 2017. External and public debt rose significantly from 31.4% and 29.4% in 2001 to 136.3% and 132.1% in 2005, respectively.

**Figure 3: Zimbabwe's External and Public Debt, 1999-2017**



Source: Authors own construct based on data from ZADMO and IMF World Economic Forum (WEO)

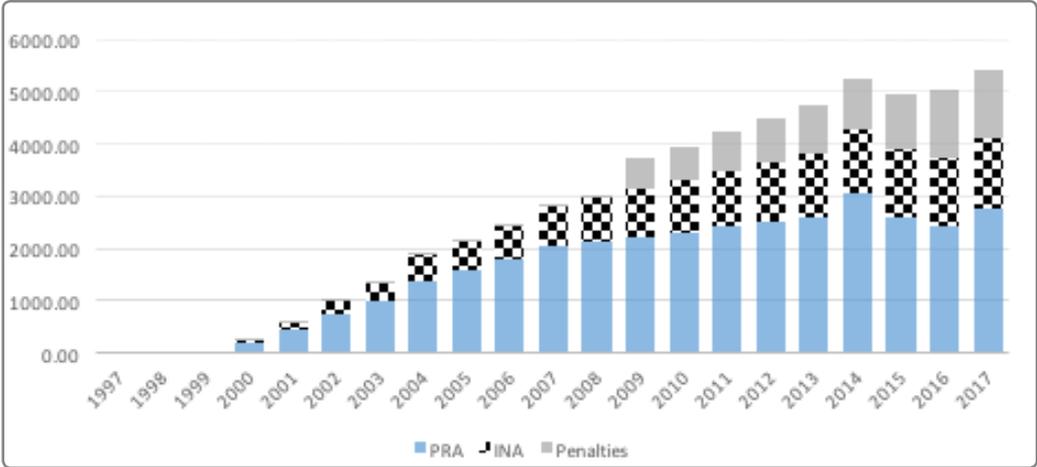
As shown in Figure 3, the total public and publicly guaranteed (PPG) debt to GDP significantly escalated during the crisis period 2000-2008, before stabilising between 2009 and 2017. During this period, economic growth fell from averaging 4.5% in the 1980s to 2.9% between 1991 and 1997 and a cumulative decline of -50.2% between year 2000 and 2008 (Zimbabwe National Statistics Agency (ZIMSTAT), 2009).<sup>2</sup> The public debt to GDP improved following the economic recovery starting in 2009. The fall in the country's PPG external debt to GDP, temporarily returned the country's debt position to solvency and attest to the fact that Zimbabwe's debt crisis emanated from a growth crisis as opposed to fiscal imprudence. In essence, the country could simply overgrow its debt obligations with sustained high growth rates envisaged under the new political and economic dispensation.

## 2.1 EVOLUTION OF EXTERNAL PAYMENT ARREARS

The country's external payment arrears continually increased from US\$109 million in 1999 to US\$5.4 billion in 2017. In 2016, arrears were partially reduced by the clearance of arrears to IMF of US\$107.8 million and token payments to other multilateral creditors. The external payment arrears are a combination of both unsettled interest payments, penalty charges and principal payments. The penalty charges for late payment have grown to about US\$1.2 billion as at end 2017. Removing the penalty charges and interest payments, Zimbabwe's public debt would be a mere US\$1.8 billion, an insignificant figure considering the country's size in terms of GDP, estimated at US\$18.13 billion as of end 2017 (Ministry of Finance, 2017). Figure 4 shows the evolution of external payment arrears.

<sup>2</sup>The cumulative figure of 50.2% was computed using ZIMSTAT figures

**Figure 4: Evolution and Composition of External Payment Arrears (US\$ Million), 1997 - 2017<sup>3</sup>**

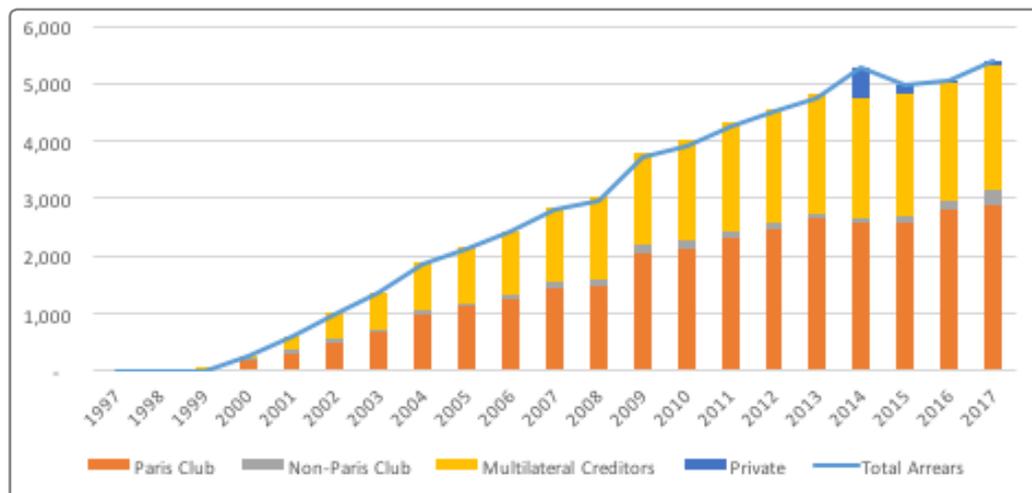


Source: Authors own construct based on data from ZADMO

Figure 5 shows the evolution in the composition of external payment arrears by creditor category. The bulk of the arrears are to Paris Club creditors (US\$2893 million), representing 54% of the total arrears followed by arrears to multilateral creditors (US\$2181 million) which constituted 39%. Arrears to non paris club and private creditors accounted for the balance of 7%.

<sup>3</sup>PRA – principal arrears, INA – interest arrears

**Figure 5: Evolution in the Composition of arrears by creditor category (US\$ Million), 1997 - 2017**



Source: Authors own construct based on data from ZADMO

## 2.2 DEBT SERVICING CAPACITY

The debt service ratio for the external debt portfolio had been above 10% of exports, which could be manageable in the absence of external payment arrears and significant new borrowing going forward. Table I shows the evolution of debt service indicators from 2009 to 2015.

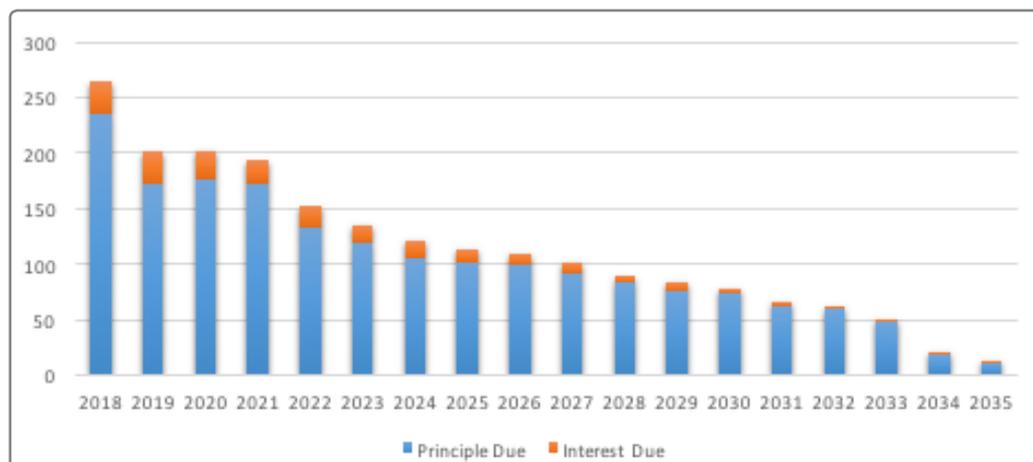
**Table I: Historical debt service to export Ratios, 2009 - 2015**

	2009	2010	2011	2012	2013	2014	2015
Debt Service- Government (US\$)	170	188	170	172	240	240	173.3
Capital (US\$)	131	154	142	136	156	156	130.4
Interest (US\$)	39	34	28	36	84	84	43
Exports of Goods and Services (US\$)	1591	3541	4771	4076	3849	4480	3841.9
Debt Service ratio (%)	16.6	7.7	9.2	13.0	15.6	12.4	15
Capital Service Ratio (%)	13	6	7	10	12	10	10
Interest Service ratio (%)	3	1	2	3	3	3	5

Source: Authors own construct based on data from ZADMO and World Development Indicators (WDI), 2016

In the medium term, the scheduled debt service indicators are projected to taper off as shown by the redemption profile of the current debt portfolio in Figure 6.

**Figure 6: Redemption Profile of Outstanding Debt Excluding Arrears December 2017**



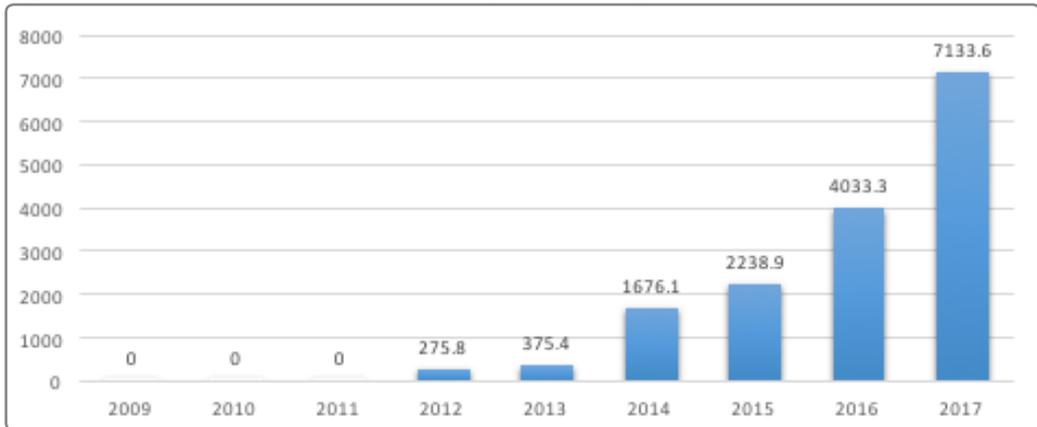
Source: Authors own construct based on data from ZADMO

The redemption profile shows debt service obligations of around US\$250 million which is below historical average debt service obligations of around US\$600 million. The debt service projections exclude debt in arrears (US\$5.4 billion).

### 2.3 EVOLUTION OF DOMESTIC DEBT

With limited access to external resources, large fiscal deficits are being financed domestically through central bank advances and treasury bill issuance. Domestic debt had reached almost 45% of GDP in 2017, driven mainly by the issuance of treasury bills and the use of an overdraft facility from the RBZ. Recapitalization of the RBZ and other public enterprises has also led to an increase in domestic debt, as has the issuance of government paper to commercial banks through the Zimbabwe Asset Management Company (ZAMCO), in an effort to reduce the stock of non-performing loans held by the banking system. In 2009, the government adopted a cash budgeting system which curtailed domestic debt. However, this was not sustained for long due to the pressures from the binding fiscal constraints which forced government to borrow from the domestic market and accumulate payment arrears to service providers. This saw domestic debt skyrocketing by 2486.5% to US\$7.1 billion in 2017 from US\$275 million in 2012 (Figure 7). This level of domestic debt is not sustainable given that Zimbabwe is already under the weight of high external debt.

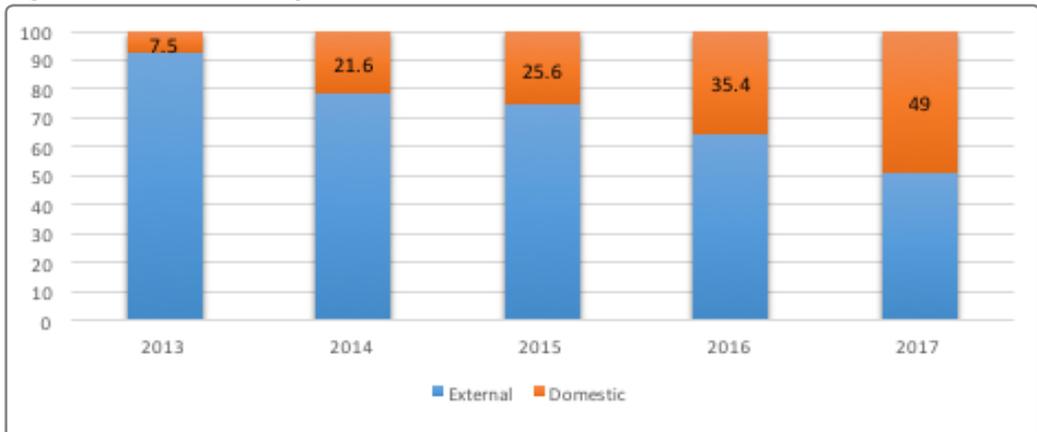
**Figure 7: Evolution of Domestic Debt (US\$ Million), 2009 - 2017**



Source: Authors own construct based on data from ZADMO

The share of domestic debt in total PPG debt increased significantly from only 7.5% in 2013 to a 49% in 2017 (Figure 8). The expansionary fiscal stance led to the government’s absorption of domestic capital, exacerbating the dollar scarcity in the economy, and crowding out the private sector. The growing domestic debt should be looked at very closely to find ways of curbing this debt and its adverse effects on the economy.

**Figure 8: Evolution Proportion of Domestic Debt in Total PPG Debt, 2013 - 2017**

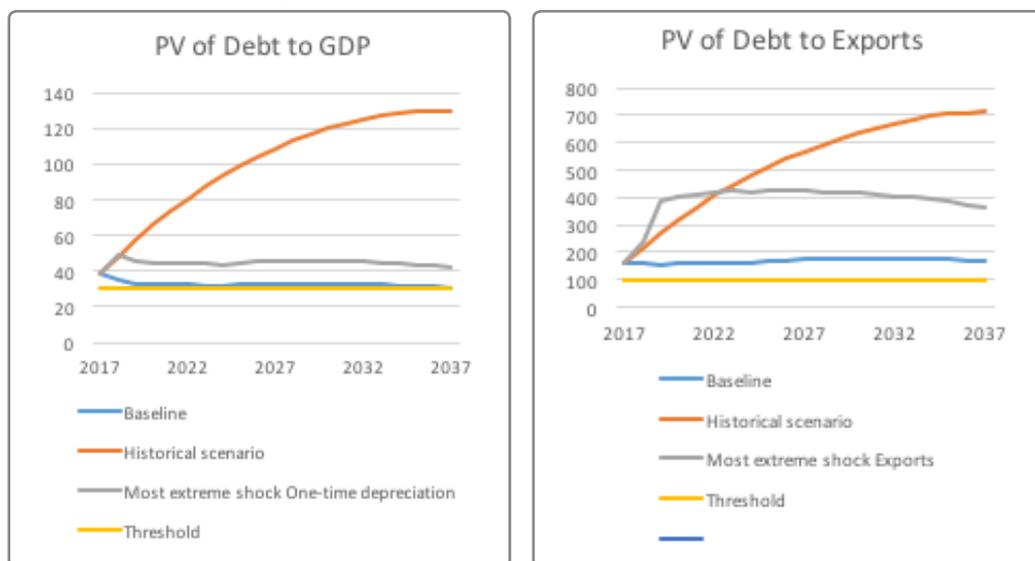


Source: Authors own construct based on data from ZADMO

## 2.4 DEBT SUSTAINABILITY INDICATORS

The debt sustainability analysis (DSA) conducted by the IMF in 2017, suggest that Zimbabwe’s external debt remains in distress. As of end-2016, with a present value (PV) of PPG external debt-to-GDP ratio of 41.8%, a PV of debt-to-revenue ratio of 192.3%, and a PV of debt-to-export ratio of 168.6%, Zimbabwe’s PPG external debt breached most indicative thresholds. Moreover, the IMF DSA for Zimbabwe for the period 2017 to 2037 reveals that external debt to GDP will remain unsustainable for the projected 20 year period (Figure 9).

**Figure 9: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2017–2037**



Source: IMF Zimbabwe Debt sustainability Analysis, 2017

Moreover, external debt in relation to exports remains above the threshold throughout the 20-year projection period by a substantial margin of around 70% meaning Zimbabwe is constrained to service its debt through proceeds from exports. The IMF results suggest that without stronger growth or more concessional financing and debt relief, Zimbabwe has little chance of emerging from its debt problems even in the long term. These outturns, together with the existence of substantial arrears, support the determination that Zimbabwe is in external debt distress.

## 2.5 DEBT RELIEF OPTIONS AND ROADMAP TO DEBT RELIEF

In a bid to resolve external payment arrears, the Zimbabwean Government came up with various options. The government also undertook significant reforms in Public Financial Management aimed to strengthen the regulatory framework that supports government's financial oversight role over public entities. In September 2010, the Government formulated a debt plan known as the Zimbabwe Accelerated Arrears Clearance Debt and Development Strategy (ZAADDs). The initiative was considering a debt relief mechanism under the Heavily Indebted Poor Countries (HIPC) initiative and making use of fresh financing from international institutions and mineral wealth to achieve sustainable development. The plan's key objective was to enable Zimbabwe to secure comprehensive external arrears clearance and debt relief from creditors at the same time laying a solid foundation for economic growth supported by investment from both domestic resources and external support. In October 2015, the Government of Zimbabwe devised an arrears clearance strategy to its creditors that includes (a) using special drawing rights (SDR) allocations to repay arrears to the IMF, (b) a bridge loan to repay arrears owed to the AfDB and International Development Association (IDA) of the World Bank, and (c) a long term loan from a bilateral creditor to repay arrears to the World Bank's International Bank for Reconstruction and Development (IBRD).

The Government expected arrears clearance to be followed by a resumption of lending from these institutions and, eventually, debt relief from the Paris Club and other creditors. Other initiatives included the establishment of the Zimbabwe Aid and Debt Management Office (ZADMO) in December 2010. However, Zimbabwe is yet to clear outstanding arrears owed to the World Bank and the AfDB as per the debt clearance strategy presented on the side-lines of the 2015 Lima Conference in Peru.

The arrears clearance strategy was premised on the assumption that clearance of arrears to the AfDB would immediately unlock additional financing which could be used to settle the bridging loan. Similarly, clearing arrears to the IMF could immediately unlock the country's SDR holdings amounting to SDR 66.4 million currently encumbered in the Escrow account due to the country's arrears to the IMF. Such holdings would only be available to Zimbabwe upon the settlement of all overdue obligations to the IMF. The government envisaged to sequence the repayments starting with the IMF, followed by the AfDB and World Bank in that order.

## 2.6 RESOLUTION OF BILATERAL DEBT

Once arrears to IFIs are cleared, the government envisages to negotiate with the Paris Club creditors by pursuing the '**Evian Approach**', which works on a case by case basis taking into account Zimbabwe's unique circumstances. Consistent with the Paris Club framework, government will also engage the non-Paris Club bilateral creditors, which include, China, Kuwait and South Africa to negotiate for debt relief comparable to that sought from the Paris Club creditors.

### 3. OPTIONS FOR DEBT RELIEF AND ARREARS CLEARANCE

This section discusses the options for debt and arrears clearance with a view to assess the viable option for Zimbabwe. The section also discusses selected country experiences on debt relief.

#### 3.1 HIPC INITIATIVE

The HIPC initiative is a comprehensive approach to debt reduction for heavily indebted poor countries pursuing IMF and World Bank, supported adjustment and reform programs. The HIPC initiative was launched in 1996 by the IMF and World Bank, to enable poor countries to pay back their loans without compromising economic growth and without building up arrears to unsustainable levels. Since then, the international financial community, including multilateral organizations and governments have worked together to reduce the external debt burdens of the most heavily indebted poor countries to sustainable levels. The Multilateral Debt Relief Initiative (MDRI) allows for 100% relief on eligible debts by three multilateral institutions, the IMF, the IDA of the World Bank, and the AfDB, for countries completing the HIPC initiative process. In 2007, the Inter-American Development Bank (IADB) also decided to provide additional (“beyond HIPC”) debt relief to the five HIPCs in the Western Hemisphere.

##### 3.1.1 HIPC Eligibility Criteria

Countries must meet certain criteria, commit to poverty reduction through policy changes and demonstrate a good track-record over time to be considered HIPC eligible. The IMF and World Bank provide interim debt relief in the initial stage, and when a country meets its commitments, full debt-relief is provided. Under the initiative, after the eligible country has established a track record of economic reform over a period of three years, the Paris Club creditors provide a 67% reduction in eligible debt stock. All the other creditors, including non-Organisation for Economic Co-operation and Development (OECD) bilateral creditors and commercial banks will follow suit and provide comparable reductions.

If these actions do not result in a sustainable debt reduction, the country moves to the second three-year stage, during which time it might get support from the IFIs for economic reform and poverty reduction. At the end of six years, provided the country has established an acceptable track record by implementing required economic reforms, it will receive up to 80% reduction in eligible Paris Club debt stock. To be considered for HIPC initiative assistance, a country must fulfill the following conditions:

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- Be eligible to borrow from the World Bank's International Development Agency (IDA-only), which provides interest-free loans and grants to the world's poorest countries, and from the IMF's Poverty Reduction and Growth Facility (PRGF), which provides loans to low-income countries at subsidized rates, with a per capita income of less than US\$1,095;
- The country must face an unsustainable debt burden that cannot be addressed through traditional debt relief mechanisms;
- Clear any outstanding arrears, meaning the country must be up-to-date on all of its debt payments with IFIs;
- Establish a track record of reform and sound policies through IMF, and IDA-supported programs; and
- Have developed a Poverty Reduction Strategy Paper (PRSP) through a broad-based participatory process.

Once a country has met or made sufficient progress in meeting these criteria, the Executive Boards of the IMF and World Bank formally decide on its eligibility for debt relief, and the international community commits to reducing debt to a level that is considered sustainable. The World Bank and IMF will then conduct a DSA to determine the amount of debt relief a country can receive. This stage under the HIPC initiative is referred to as the decision point. Once a country reaches its decision point, it may immediately begin receiving interim relief on its debt service falling due.

So far 36 countries have received the full amount of debt relief through HIPC initiative and MDRI, of which 30 of them are in Africa (Table 2). Three countries, namely Eritrea, Somalia and Sudan which have been identified as potentially eligible for HIPC assistance have not yet reached their decision points. IMF (2018) argues that countries that benefited from HIPC markedly increased their debt position post-completion points bringing their debt indicators below those of other HIPC and non-HIPC countries. The debt burden in countries that reached the completion point is estimated to have fallen by about 90% after the full delivery of debt relief. For instance, debt service has declined by about 1.5 percentage points of GDP between 2001 and 2015 for all the countries that received debt relief. The HIPC initiative also increased spending on social services such as education and health for the 36 countries receiving debt relief. However, the challenges remain to ensure that debt burdens does not return to unsustainable levels as countries remain vulnerable to shocks, particularly those affecting exports. Hence, countries need to pursue cautious borrowing policies and strengthen their public debt management. World Bank (2018) also argues that prudent borrowing, suitable concessional finance, sustained economic growth, diversified exports, and greater access to markets in developed countries can be adopted to maintain debt sustainability.

**Table 2: HIPC and MDRI beneficiaries**

Afghanistan	Central African Republic	Ethiopia	Haiti	Mauritania	Senegal
Benin	Chad	The Gambia	Honduras	Mozambique	Sierra Leone
Bolivia	Comoros	Ghana	Liberia	Nicaragua	Tanzania
Burkina Faso	Republic of Congo	Guinea	Madagascar	Niger	Togo
Burundi	Democratic Republic of Congo	Guinea-Bissau	Malawi	Rwanda	Uganda
Cameroon	Cote d'Ivoire	Guyana	Mali	Sao Tome and Principe	Zambia

Source: IMF (2018) and World Bank (2018)

A critical analysis of the HIPC initiative reveals that debt cancellation is not automatic, even for countries that reached the post-completion point. Poor countries are required to meet eligibility criteria before they can receive debt relief from the multilateral creditors. The HIPC process takes too long to implement and does not take into consideration the desperate poverty situations in many HIPC countries. The relief is spread over a number of years for instance, 20 years, for the World Bank, 3-5 years for the IMF and 14 years for AfDB.

A further financial problem for countries completing HIPC has been vulture funds. Vulture funds buy up debt owed by countries in default or thought likely to default at a cheap price. Once HIPC debt relief has made a country solvent again, vulture funds then look to sue countries for the full amount of debt plus interest, making a huge profit. HIPC is an entirely voluntary scheme so there is no requirement on private creditors such as vulture funds to reduce the level of their claimed debt. Vulture funds look to sue a country for debt repayments in a third party country in which the debtor holds assets. The majority of cases, against countries such as Zambia, Liberia and Democratic Republic of Congo, have been in United Kingdom (UK) or United States (US) courts. In 2010 the UK Parliament passed a law which says vulture funds can only sue HIPC countries for the debt which would be remaining if they had taken part in HIPC debt relief. This effectively makes it worthless for vulture funds to now pursue cases against HIPC countries in UK courts.

### 3.1.2 Zimbabwe HIPC Eligibility

Although Zimbabwe has been in debt distress since the year 2000, it was declared ineligible for debt relief under the HIPC by the IMF and World Bank. The country failed to meet the indebtedness criterion of per-capita income of US\$380 or less. On the other hand, the country's per-capita income was estimated at US\$840 as at end of 2014. For the country to be considered HIPC eligible, all the debt burden indicators should show that the country's debt is unsustainable. However, the HIPC assessment based on end 2014 public and publicly guaranteed external debt and macroeconomic figures show that Zimbabwe does not qualify for HIPC based on the PV of debt to revenues of 176% against a threshold of 250%.

Based on the PV of debt to exports, Zimbabwe would, however, qualify for HIPC as the PV of debt to exports is 172% which exceeds the 150% threshold. It is noteworthy that exports had been subdued since 2012 on the back of industrial under-capacity utilization and subdued mineral prices on the international market. Table 3 shows debt sustainability indicators using end December 2014 data.

**Table 3: Zimbabwe Debt Sustainability Indicators for HIPC Assessment**

	End-2004	E n d - 2010	E n d - 2013	E n d 2014	H I P C Benchmark
PV of debt after traditional relief to 3 year moving average of exports	155.0	196.4	129.5	171.7	150
PV of debt after traditional relief to current year revenue	190.2	211.5	145.6	175.7	250

Source: Authors own construct from IMF Zimbabwe DSA, 2017

The fact that Zimbabwe did not qualify for debt relief under HIPC underscored the need for alternative debt resolution strategies outside traditional debt relief mechanisms (non-HIPC options). An envisaged improvement in country performance and institutional assessment rating under the new economic order would further improve the sustainability of Zimbabwe debt. According to the 2017 country policy institutional assessment (CPIA) rating, Zimbabwe is classified as a weak policy performer with a three-year moving average CPIA score of 2.7 (World Bank, 2017). Accordingly, Zimbabwe's external debt is gauged using the solvency and liquidity thresholds<sup>4</sup> of external debt for a country classified as a weak policy performer.

Moreover, Zimbabwe has never been reclassified as being poor enough to be eligible to borrow solely from the World Bank's IDA. For Zimbabwe to be eligible for HIPC, it would require the international financial institutions to change either their rules or retrospectively say Zimbabwe is and was an IDA-only country borrowing classification in 2004. Zimbabwe

<sup>4</sup> Solvency ratios indicate capacity to generate cash flows to meet short and long term liabilities; Liquidity ratios indicate capacity to meet current obligations that are falling due.

also needs to clear its arrears to multilateral financial institutions beforehand, part of the process already being covered under the Lima debt and arrears clearance strategy.

### 3.2 DEBT RESTRUCTURING

The debt rescheduling of the external debt portfolio usually results in stabilization of external payment arrears and improvement of the country's creditworthiness. For a country to be granted debt rescheduling opportunity, there are conditions that it should meet. The country should be failing to meet in full current and future debt service foreign obligations (accumulation of arrears). Eligibility or admittance to the debt rescheduling scheme, requires that the country be in an IMF staff monitored programme, and must prove that it is unable to meet its external financial obligations. Declaring a debt moratorium is part of such proof. Many Paris Club creditors go beyond HIPC cancelling 100% of outstanding debts. The UK for example, cancels 100% of all outstanding debts at HIPC completion point. Whether or not a country cancels 100% often depends on the debt and when it was contracted. For example, Germany, the United States of America (USA) and Italy cancel 100% of all debt assumed prior to the Cologne summit in 1999.

This provides an opportunity for the country to direct foreign exchange inflows towards the procurement of critical imports, such as raw materials and spare parts and energy. Acceptance of the Paris/London Club terms may boost international confidence, which can unlock further financial assistance from bilateral donors. Debt rescheduling affords a country the opportunity to find long lasting solutions to its domestic and other external problems. Debt rescheduling merely defers payment obligations, without permanently resolving the country's external debt problems. The debt may be rescheduled at higher premiums.

The accelerated re-engagement process under the new political and economic dispensation has potential to allow Zimbabwe to enter into an IMF supported programme. In order for Government to reschedule its bilateral debt with the Paris Club member countries, the country would need to resume programme negotiations with the IMF in the shortest possible period. While support of the IMF is a precondition for the country's eligibility for debt relief, under the Paris Club and other creditor groups, an IMF programme does unlock the much-needed bridging finance, while the country's export sectors recover.

### 3.3 DEBT SWAPS/CONVERSIONS

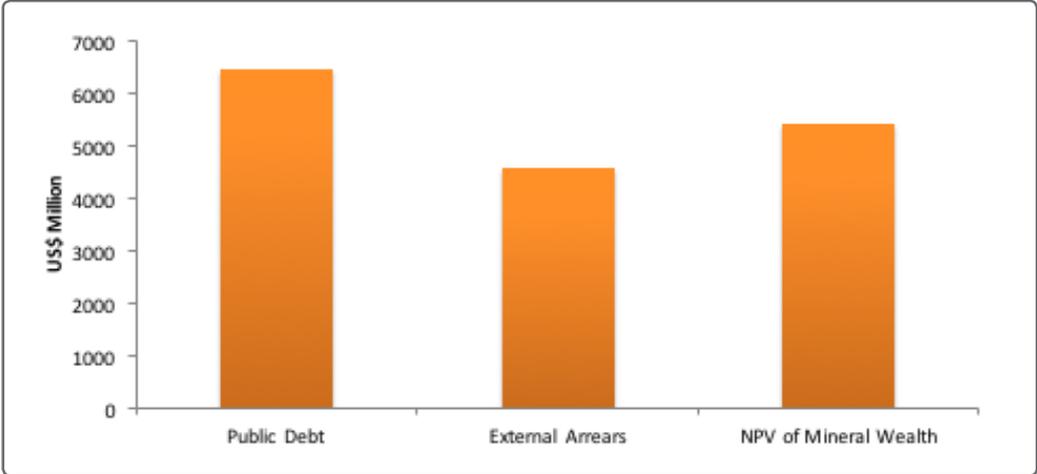
Debt swaps/conversions alter the original valuation or nature of a debt instrument. For example, a straight loan can be converted into an equity investment or into an infrastructural investment. Under this arrangement, a foreign organisation such as Debt Advisory International (DAI) will acquire a hard currency sovereign debt at a discount, and uses the local currency equivalent to purchase domestic assets or to invest in some developmental projects. In this way, the external debt is extinguished.

Successful completion of the conversion programme will enhance the credit rating of Zimbabwe and enable it to attract new capital. It will reduce the country's external debt obligations and, consequently the debt service burden without necessarily having to use the country's scarce foreign exchange resources. It is a vehicle for encouraging capital inflows, thereby benefiting from high levels of economic activity and employment. It helps in the development of the local equity market, which will subsequently provide an efficient avenue for equity capital for local companies. It assists in the re-capitalization of the private sector and generates tax revenues from profitable investments into which redemption proceeds are injected. A debt conversion programme requires a willing international organization that has the confidence to invest in the country. The discount for the country's debt is likely to be prohibitively high due to the perceived risks. Favourable terms on such programmes can, however, be obtained from Paris Club negotiations where debt swaps/conversions are part of the relief package.

### 3.4 BORROW AGAINST SECURITY OF DOMESTIC ASSETS

This option involves external borrowing to retire debt, using identified public assets as collateral. Valuation of these public assets, in foreign currency, gives an indication of how much the country can borrow under this option. This option enables the country to retire its external debt without the outright sell of its domestic assets. It can also be used as a debt restructuring or debt conversion mechanism. The country runs the risk of mortgaging its strategic assets to foreigners, particularly if macro-economic stability is not quickly restored. The country completely loses control over the collateralized assets. The option does not necessarily address the root causes of external imbalances. The net value of most public enterprises in Zimbabwe is low, due to losses accumulated over a number of years. Moreover, a study done by the IMF in 2010 shows that Zimbabwe's present value of future mineral inflows are inadequate to extinguish the current debt obligations. At the end of 2010, Zimbabwe's net foreign asset (NFA) position, including the net present value of future mineral wealth was less than the country's public debt as shown in Figure 10.

Figure 10: Feasibility of the Resource Backed Strategy



Source: Based on IMF Staff Estimates, 2012

The same study also noted that the country’s external financing requirements outweigh the projected flows from mining receipts. This implies that the country can not avoid some form of debt forgiveness in the form of HIPC type initiative if the country’s debt is to become sustainable.

### 3.5 DEBT REFINANCING

Debt refinancing involves borrowing a new loan to repay or prepay an existing debt. Refinancing can be voluntary, that is at the borrower’s initiative, or involuntary through the Paris Club. Refinancing is, however, mainly used to reduce the cost of borrowing, improve maturity structure of the debt or to alter its currency composition. To a large extent, the cost of refinancing debt depends on the currency denomination and the interest rate structure of the new loan. The country is able to extinguish expensive short-term debt and borrow for longer periods, at favourable terms and conditions. Debt refinancing reduces the cost of borrowing, particularly if the terms of the new loan are softer.

While debt refinancing offers temporary relief on foreign obligations, it merely postpones debt service, without permanently resolving the country’s external debt problems. In Zimbabwe, most short-term foreign loans attract the London Interbank Offered Rate (LIBOR) rate, plus some premium. There is little likelihood, therefore, that the country would be able to refinance its debt at these interest rates. The country’s perceived risk might make it difficult to attract funds from abroad. Refinancing, however, is more favourable when it is done as a bridging finance to trigger Paris Club negotiations.

### 3.6 DEBT RESTRUCTURING

This involves shifting the composition of external debt from short-term to medium and long-term debt. If granted, it temporarily relieves the country of pressure of external payments obligations, without straining its relations with international creditors. It gives the country time to restore macro-economic stability, thus create potential to meet its external obligations. It may temporarily reduce debt service requirements. It may result in higher interest repayments. It also involves additional negotiation costs, for debt restructuring.

In Zimbabwe, the debt restructuring option requires express consent of the country's external creditors. This may be difficult for Zimbabwe, since it has already accumulated external payment arrears, which have undermined the chances for successful negotiations. Furthermore, debt restructuring involves a re-evaluation of the country's economic situation, which may result in more unfavourable terms. Zimbabwe's external debt is predominantly medium to long-term, and the chance of shifting it further may be remote.

### 3.7 DEBT BUYBACKS

Debt buybacks are repurchase agreements. The country sells its debt, at a discount, with an undertaking to repurchase the debt at a future date. The proceeds could then be used to prepay the debt. The debtor country must, of course, anticipate a positive turnaround in its external economic performance. The debtor country enjoys a temporary relief on its foreign obligations. The option prevents further accumulation of arrears. Debt buybacks merely defer payment obligations, without permanently resolving the country's underlying external debt problems. The debt may be repurchased at higher premiums. Debt buyback arrangements are more suitable for countries that are not in arrears. The country would need to improve its macroeconomic policies and enhance its creditworthiness in order to attract a buyer. Countries such as Czech Republic and Slovakia implemented debt buyback programmes at discounts of 80–90%. These favourable terms were obtained as a result of the countries being in an IMF monitored programme.

### 3.8. SELECTED COUNTRY EXPERIENCES

#### UGANDA

Uganda became the first country to benefit from HIPC relief initiative in April 1998. Under HIPC I, Uganda received debt relief of US\$4347 million in NPV terms. Of this 79% was due to multilateral creditors. However, Uganda's debt quickly returned to unsustainable levels with a debt stock of US\$3.6 billion, mainly on account of the El Nino weather phenomenon, which affected export performance in 1999. In May 2000, the country received further relief under the Enhanced HIPC.

## ZAMBIA

Zambia received tremendous debt relief in form of actual debt stock reduction and debt service amounts payable to its creditors. Total external debt declined by 7% to US\$6.6 billion at end-June 2005 from US\$7.1 billion in 2004. This decline was on account of debt cancellations by the Paris Club creditors. Debt service payments in the first half of 2005 amounted to US\$209.8 million. On another positive note, the government of Zambia increased resource allocations to the social sectors to 30% of total budget. These included recruitment of personnel in the education and health sectors, infrastructure development, purchase of drugs, and provision of food supplements especially for people living with human immunodeficiency virus (HIV) and acquired immune deficiency syndrome (AIDS).

## ETHIOPIA

Ethiopia became the 13<sup>th</sup> country to reach the completion point, after Benin, Bolivia, Burkina Faso, Guyana, Mauritania, Mali, Mozambique, Nicaragua, Niger, Senegal, Tanzania, and Uganda. Total debt service relief under the enhanced HIPC initiative from all of Ethiopia's creditors amounted to approximately US\$3.3 billion in nominal terms. Further, the track record of the Ethiopian authorities in policy and reform implementation has been strong, and the authorities have borrowed prudently despite being adversely affected by a severe drought and lower coffee prices.

## HAITI

The IMF agreed with the government of Haiti in June 2003 on a macroeconomic program to limit Haiti's budget deficit, improve transparency, and curb inflation. There was successful performance by the Haitian government under its IMF Staff Monitored Program and it managed to clear its World Bank arrears and commitments to the IMF.

## MYANMAR

In 2012, Myanmar cleared its arrears to the World Bank and Asian Development Bank and secured debt write-off from Paris Club creditors. The country adopted a Non-HIPC debt resolution strategy with Japan as the champion. The country obtained a bridge finance to settle IDA and Asian Development Bank arrears and received 50% Paris Club write off in 2013 and the remaining debt was re-scheduled over 15 years with 7 years grace period. The country also received additional debt relief from Japan, Norway and Italy.

### COTE D'VOIRE

Cote d'Voire received debt relief under the AfDB Fragile state facility, with France as the champion to resolve its US\$14 billion external debt, of which 36% was in arrears. The country used IDA resources and its own funds to clear 50% of IDA resources and a bridge finance to clear the remainder. At completion point, the country qualified for additional resources under MDRI (World Bank, IMF 2017 DSA).

### NIGERIA

Firstly Nigeria engaged the Policy Support Instrument (PSI) by the IMF. PSI is a non-financial instrument offered by the IMF to low-income countries, whereby the IMF helps countries in designing effective economic programs. This gave them close preparation and endorsement of their economic policy framework by the IMF. Nigeria's performance under the PSI was very strong with real GDP in non-oil sector increasing by 8% and inflation rates falling. This increment in income was used to clear the debt.

Secondly, Paris Club creditors granted Nigeria a Comprehensive Concessional Debt Treatment of arrears in two phases thus:

- Debt reduction under Naples terms on eligible debt.
- Buying back of the remaining debt at a market related discount.

### DEMOCRATIC REPUBLIC OF CONGO (DRC)

On July 1, 2010, the World Bank and IMF approved irrevocable debt relief assistance to DRC under the enhanced HIPC initiative. The triggers that have been implemented include the following:

- Completion of a full Poverty Reduction Strategy through a participatory process and its implementation for one year;
- Continued maintenance of macroeconomic stability, as demonstrated by satisfactory performance under the IMF programme;
- Extended Credit Facility-supported program;
- Use of budgetary savings resulting from enhanced HIPC initiative-related debt relief;
- Strengthened public expenditure management;
- Improvements in governance and service delivery in priority sectors;
- Adoption of satisfactory sectoral development strategies and related implementation plans for health, education and rural development; and
- Improved debt management systems and strategies.

## Zimbabwe Economic Policy and Research Unit - ZEPARU

The country agreed with the AfDB and African Development Fund to pay through partial consolidation approach. This lightened the burden gradually. The country also received a bridge loan from Sweden, South Africa, France and Belgium to clear its arrears with the African Development Fund. They granted their central bank independence in conducting monetary policy which helped the country in fulfilling its obligations with the AfDB and African Development Fund.

## 4. EMPIRICAL ANALYSIS

The study applies an external debt dynamics equation to assess the likely path that Zimbabwe's external debt would take following implementation of the current debt and arrears clearance strategy. The evolution of external debt is based on the balance of payments identities and can be written as

$$D_t = C_t - NFDI_t + (1 + r_{t-1}) D_{t-1} + Z_t$$

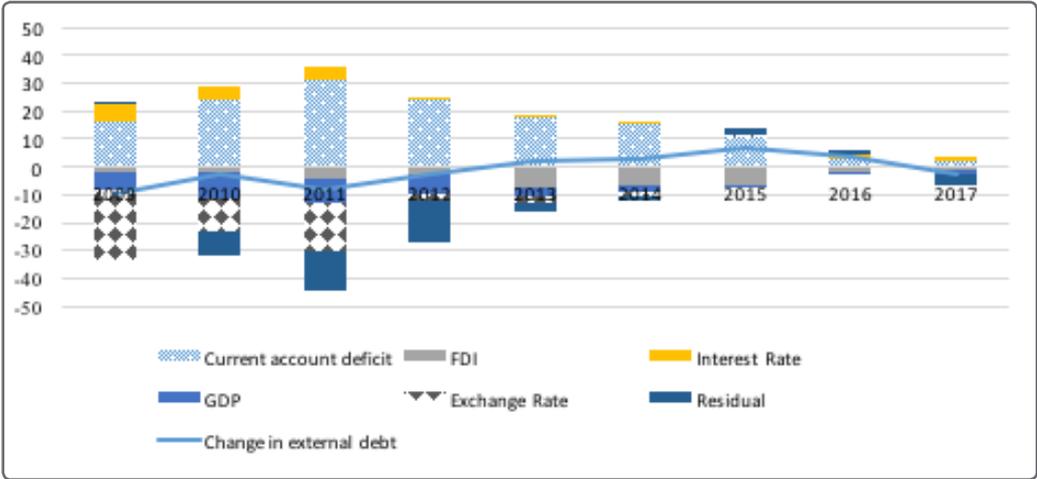
Where:  $D_t$  is nominal external debt at time  $t$ ,  $C_t$  is the external current account balance excluding interest payments on external debt,  $NFDI_t$  is net foreign direct investment,  $r_t$  is the nominal interest rate on the nominal external debt and  $Z$  refers to other factors. Other factors include other non-debt creating net capital flows, exceptional financing, such as debt relief and changes in arrears, changes in gross foreign assets such as foreign exchange reserves, cross-exchange rate effects and valuation adjustment. Moreover, it includes the fraction of the financing gap that is financed through additional external loans (IMF, 2006).

A persistent negative current account balance is likely to indicate that a country may face an increase in its probability of debt distress. The interest, growth and exchange rate components are shown separately in order to assess the extent to which GDP growth has alleviated the external debt burden. Since interest rates on loans to low-income countries are largely fixed and de-linked from market movements, the nominal interest rate effect largely reflects a change in the concessionality of debt.

Real GDP growth captures the changes in the country's earning capacity. The quality of the GDP growth projections is therefore crucial for assessing a country's debt sustainability outlook. Changes in US dollar inflation and the real exchange rate may also affect the debt sustainability outlook since a depreciation of the local currency is likely to worsen the debt burden. A substantial share of Zimbabwe's external debt is denominated in other currencies than the US dollar, such as Euro or SDR. The cross-currency changes, however, are not taken into consideration here, but form part of the residual.

The above equation helps to project the external debt stock, which in turn is expressed as a percentage of GDP in present value terms. The decomposition helps to identify whether the change in the debt burden indicators is largely driven by the current account of the balance of payments or is rather the result of the behaviors of interest rates, growth rates and/or price and exchange rate movements. In the case of Zimbabwe, the non-interest current account deficit, largely financed by the creation of offshore credits to private sector has been the major contributor to changes in total external debt. The contributions to changes in total external debt are shown in the Figure 11.

**Figure 11: Contributions to Changes in External Debt, 2009 - 2017**



Source: Authors own construct based on Various IMF DSAs for Zimbabwe

The graph shows that the non-interest current account deficit has been the major driver of external debt accumulation. The GDP growth and FDI play a pivotal role in reducing the rate of external debt accumulation, although their influence has been minimal. In this respect, the debt to GDP ratio has increased by the difference between interest, current account deficit and non-debt creating flows. The increase in the stock of external debt has been modest not because of a lower financing need, but due to Zimbabwe’s limited access to financing. Nonetheless, weak export competitiveness and the withdrawal of foreign investment have hampered the country’s debt service capability (IMF, 2017).

**4.1 ASSESSING DEBT SUSTAINABILITY AFTER DEBT RELIEF**

The sustainability of debt after debt restructuring was assessed using the standardized joint World Bank/IMF Debt Sustainability Framework (DSF) for low income countries (LICs) thresholds of debt burden indicators. These indicators depend on the quality of a country’s policies and institutions as measured by the World Bank under the country CPIA. According to the 2016 CPIA rating, Zimbabwe is classified as weak policy performer, with a three-year moving average CPIA score of 2.7 (World Bank 2017). Accordingly, the relevant solvency thresholds of external debt for a country classified as a weak policy performer are PV of debt-to-GDP ratio less than 30%, PV of debt-to-exports ratio should be less than 100%, PV of debt-to-fiscal revenues ratio should be less than 200%, the debt service to exports ratio should be less than 15%, debt service to revenue ratio should be less than 18% and PV of public debt should be less than 56%. The main assumption is that countries with strong (weak) policies and institutions can sustain higher (lower) levels of external debt. This is

## An Assessment of Arrears Clearance Strategy and Sustainable Debt Options

based on a study by Kraay and Nehru (2004), which found that the likelihood of external debt distress in LICs is explained by three main factors, namely: the quality of policies and institutions, vulnerability to macro shocks and the traditional debt burden indicators. Table 4 shows indicative debt burden thresholds.

**Table 4: Indicative Debt Burden Thresholds**

	<b>Weak CPIA &lt;3.25</b>	<b>Medium 3.25 &lt; CPIA &lt;3.75</b>	<b>Strong CPIA &gt;3.75</b>
Solvency Ratios			
PV of Debt to GDP	30	40	50
PV of Debt to Exports	100	150	200
PV of Debt to Revenue	200	250	300
Liquidity Ratios			
Debt Service to Exports	15	20	25
Debt Service to Revenue	18	20	22
PV of Public debt to GDP	36	56	74

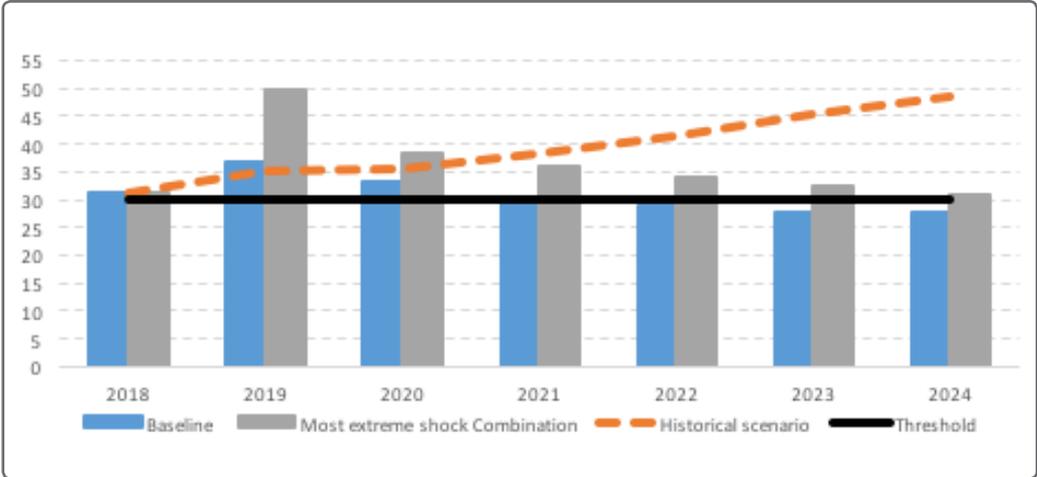
Source: World Bank, 2017

The sustainability of Zimbabwe's public debt after debt relief was also assessed based on the envisaged macroeconomic framework which assumes a target growth rate of between 6-8% in the medium term, and a US GDP deflator and a sustainable current account deficit greater than 5% and foreign direct investment (FDI) levels in excess of 4% of GDP, consistent with regional FDI proportions to nominal GDP.

### 5. ANALYSIS OF RESULTS

The results based on envisaged macroeconomic framework under the new dispensation, suggest that Zimbabwe’s external debt would become sustainable from a solvency perspective after two years following resolution of arrears to IFIs. This could be attributed to anticipated robust growth of the economy assumed under the new economic dispensation in the medium to long-term. However, if there is a negative shock to the country’s key macroeconomic variables, notably GDP and exports, the country’s debt would only become sustainable after six years as shown by the shock scenario, which is computed as a combination of shocks to exports and growth (Figure 12 and Figure 13).

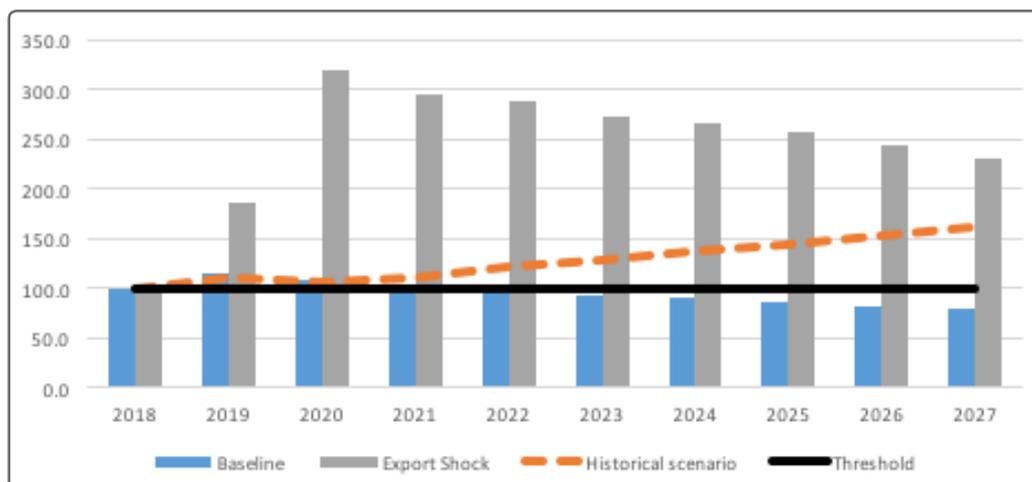
**Figure 12: Evolution of PV of Debt to GDP (%), 2018 - 2024**



Source: Authors own construct using LIC DSF Template

The dotted line in the Figure 12 (historical scenario) suggest that the country’s debt would remain unsustainable if the country follows its 10 year historical average performance of high debt and subdued and volatile economic growth rates. The historical average is distorted by the weak performance during the crisis period of 2000-2008. As such this scenario is highly unlikely as the economy has greatly recovered from the crisis period to stability. Moreover, assuming that the country’s CPIA rating improves to a strong policy performer, the country’s debt would automatically become sustainable since it will be assessed against higher thresholds of PV of debt to GDP of 50% instead of the 30% for countries rated as weak policy performers. The results depict a similar picture when the PV of debt to exports is used as a sustainability indicator. The external debt-to-exports indicator remains well below the 150% threshold level in both cases.

**Figure 13: Evolution of PV of Debt exports (%), 2018 - 2027**



Source: Authors own construct using LIC DSF Template

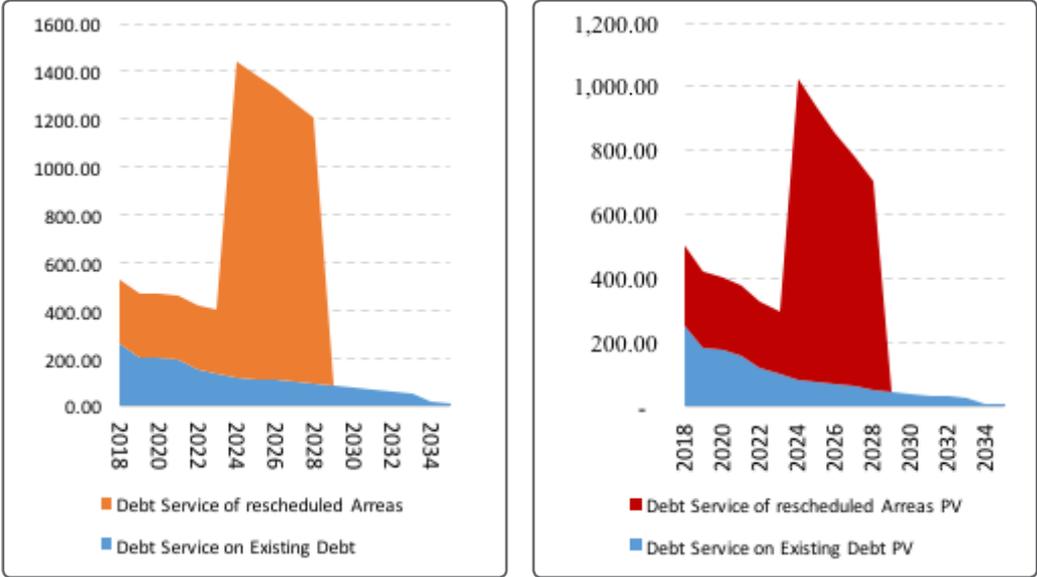
While the proposed arrears clearance strategy reduces Zimbabwe’s debt burden, the sensitivity analysis clearly shows that the country would remain vulnerable to lower exports and real GDP growth than assumed in the baseline scenario.

## 5.1 LIQUIDITY INDICATORS

The quantum of debt service obligations, however, presents a worrisome development in the medium term when taking into consideration its potential implications on fiscal position and social cohesion. In fact, the projected external debt service obligations from restructuring external payment arrears suggest that the country would be expected to fork out amounts in excess of US\$1 billion in present value terms on servicing both the current and restructured debt (Figure 14). This is assuming restructuring at favourable terms of obtaining a 10 year loan maturity with five years grace period and concessional rates of 3%<sup>5</sup> per annum.

<sup>5</sup>Consistant with average terms offered by Paris and non-Paris club creditors on ODA

**Figure 14: Projected debt Service Profile (US\$ millions): Nominal Values and Present Value Terms, 2018 - 2035**

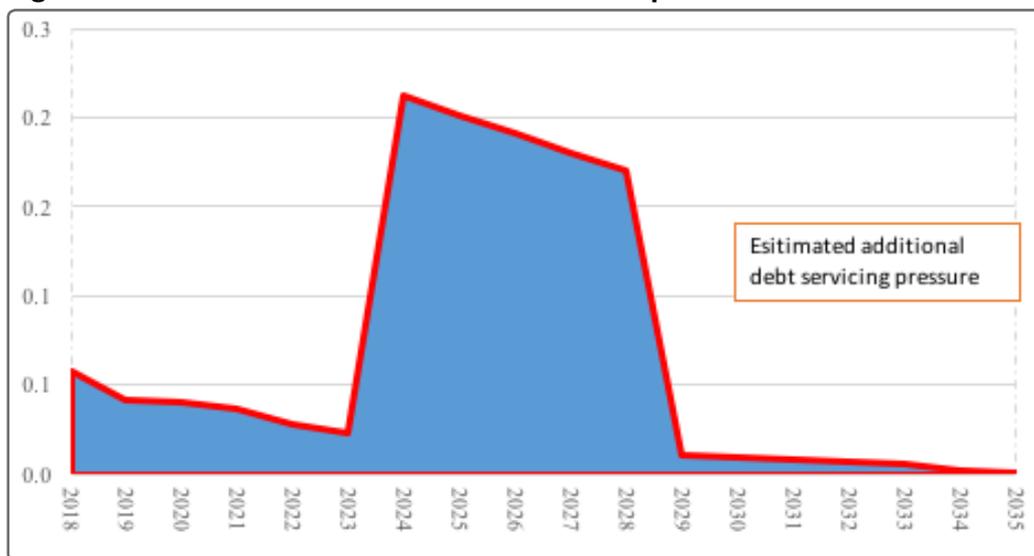


Source: Authors Own Construct

The liquidity indicator as measured by debt service to exports<sup>6</sup> depict a spike in debt service ratios in the medium term. Figure 15 shows the projected evolution in debt service indicators.

<sup>6</sup>Exports are projected to grow at the same rate as the GDP growth.

**Figure 15: Evolution of PV of Total Debt Service/Exports, 2018 - 2035**



Source: Authors own construct

As shown in the Figure 15, there will be significant debt service pressure from maturing loans used to restructure the debt. Precisely, the debt service obligations from current and restructured debt is projected to reach 20% of exports. There will also be some additional debt service pressure from new<sup>7</sup> loans unlocked to jumpstart the economy, which are not adequately captured in this analysis. A combination of these factors would result in a high risk of debt distress even after debt restructuring. The projected sizeable debt service peaks in 2023, imply that the country will be exposed to huge rollover and refinancing risk from the maturing loans. This implies that the country faces high liquidity risk from maturing loans.

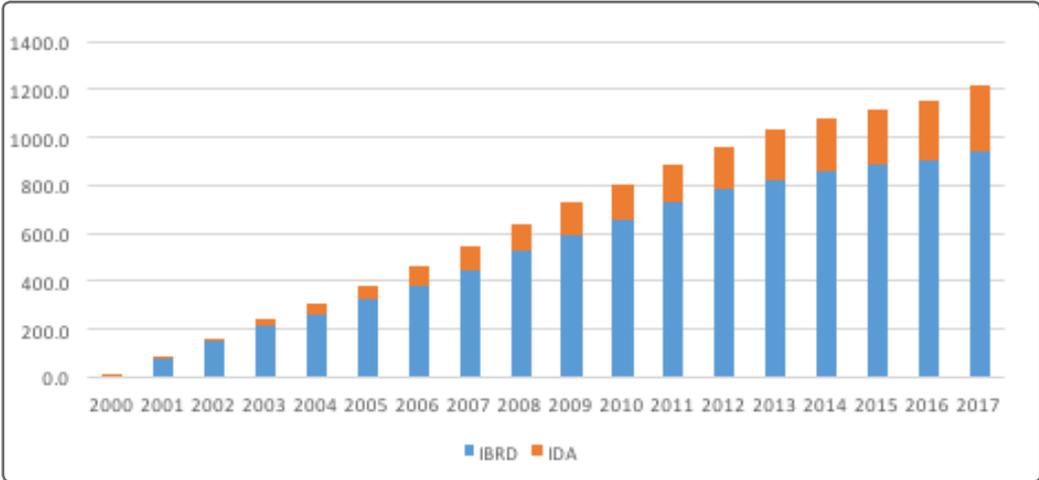
From the preceding analysis, it follows that the risk of external debt distress remains high even after clearing arrears under the current debt strategy. Our results are consistent with DSA findings by IMF (2016), which also suggest that Zimbabwe’s external debt would remain at high risk of debt distress even after debt restructuring following the Lima strategy (ibid). The combined effect of debt service obligations from current, restructured and new debt would result in Zimbabwe remaining in high risk of debt distress.

## 5.2 DEBT SERVICING IMPLICATIONS OF WORLD BANK ARREARS

Figure 17 shows the debt servicing implications of clearing outstanding arrears to the World Bank’s IBRD and IDA using a bridge loan. The arrears to these creditors amounted to US\$936 million and US\$281 million as at end 2017, respectively. Figure 16 shows the evolution in external payment arrears to World Bank.

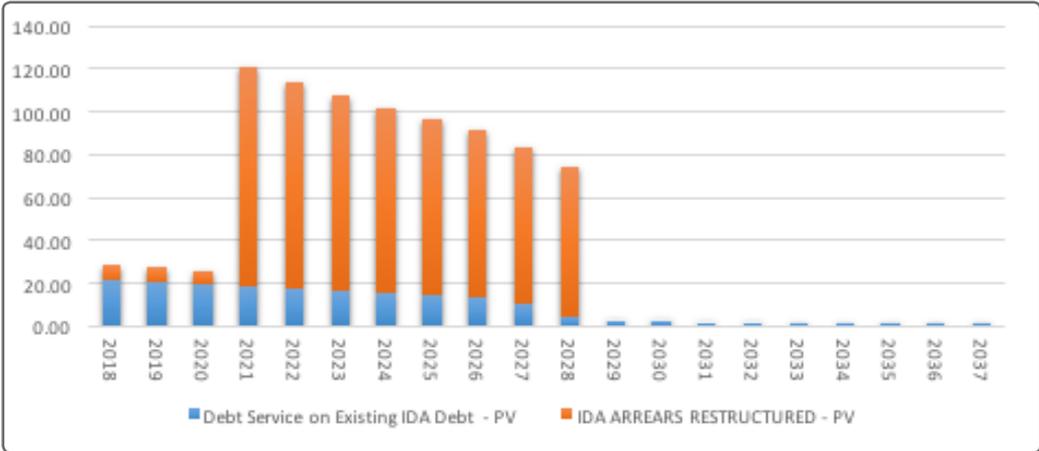
<sup>7</sup>New external loans are subsumed in non-interest current account projections

**Figure 16: Evolution of External Payment arrears to World Bank IDA and IBRD, 2000 - 2017**



Authors own construct based on data from ZDMO

**Figure 17: Impact of restructuring World Bank arrears on debt service (US\$1 464 million) (present value), 2018 - 2037**



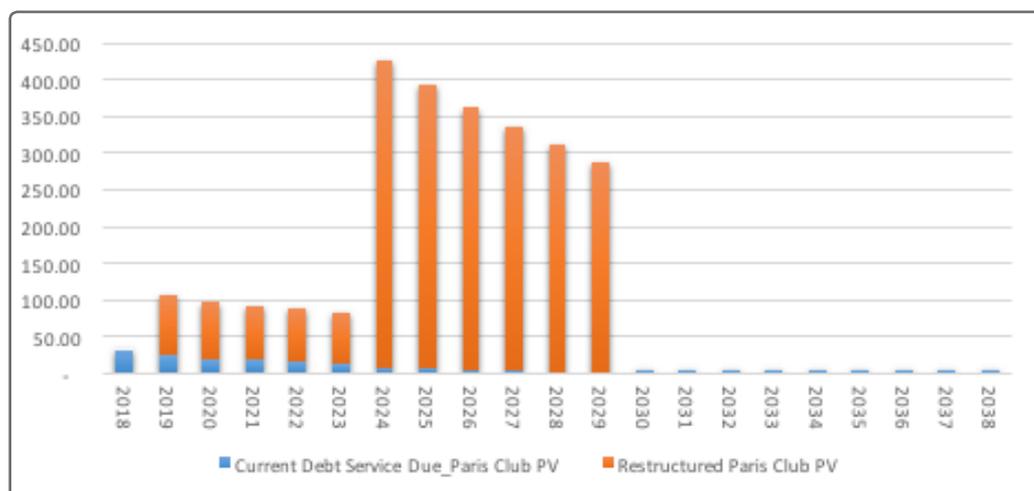
Source: Authors own construct

As shown in the figure 17, the debt service profile of current debt owed to World Bank is very low, less than US\$20 million, excluding outstanding arrears. However, there will be additional pressure arising from restructuring the arrears through a bridge loan of nearly US\$100 million in the medium term.

### 5.3 DEBT SERVICING IMPLICATIONS OF PARIS CLUB ARREARS

Similarly, in the event that the country restructures its outstanding arrears to Paris Club, the debt servicing profile would be as depicted in Figure 18. The arrears to Paris club creditors as at end 2017 stood at US\$2.9 billion. Similarly, these arrears are assumed to be restructured at favourable terms of 10 year loan maturity, Five year grace period and 3% interest rate and 5% discount rate. The redemption profiles shows that restructuring Paris club debt result in country paying amounts in excess of US\$400 million in present value terms in the medium term (Figure 18).

**Figure 18: Structure of Paris club debt service before and after restructuring (US\$ Millions), 2018 - 2038**

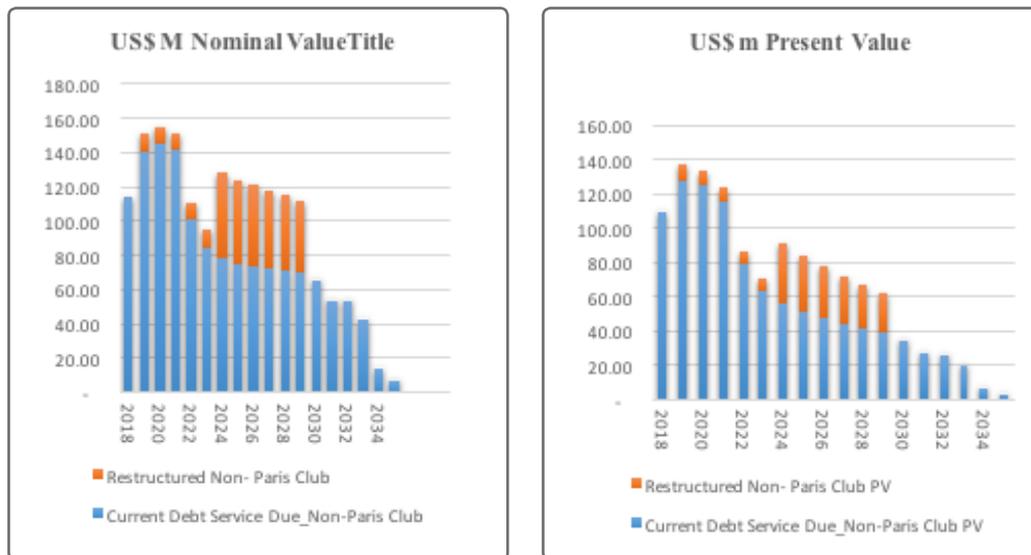


Source: Authors own construct

### 5.4 DEBT SERVICING IMPLICATIONS OF NON PARIS CLUB ARREARS

The current debt strategy will have an insignificant impact on arrears owed to non-Paris Club creditors as most of the outstanding debt to these creditors is current. The outstanding debt to non-Paris Club creditors which is not yet in arrears stood at US\$1.096 billion as at end December 2017. The external payment arrears to non-paris club creditors as at end 2017 stood at only US\$240.7 million. Figure 19 shows the implications of restructuring arrears to non-Paris Club creditors.

**Figure 19: Structure of Non-Paris Club Debt Service before and after Restructuring (US\$261 millions), 2018 - 2035**



Source: Authors own construct

## 5.5 IMPLICATIONS OF ARREARS CLEARANCE STRATEGY ON GROWTH

The RBZ (2015) identified access to finance as one of the key binding constraint to sustainable economic growth and development in Zimbabwe. This issue was further acknowledged by IFIs. The major reason behind lack of access to loans from traditional bilateral and multilateral creditors is the existence of external payment arrears to these institutions. As such, clearance of external payment arrears will unlock the much needed finance that is necessary to revive the economy. Zimbabwe has also been facing huge premiums on credit because of its history of credit unworthiness. Accordingly, successful clearance of arrears will help reduce this credit risk premium making the country capable of accessing affordable funding for both government and the private sector. Access to cheap finance is crucial for industry to retool and replace obsolete and antiquated machinery which has been hampering industry’s contribution to sustained economic growth in the country.

However, the additional debt service pressure if not carefully managed would eventually become a drag to future economic growth through the debt Laffer curve. The debt Laffer curve exists, where debt contributes to economic growth up to a certain point (maximal threshold) and then starts to have a negative effect on growth afterwards. It supports the hypothesis that debt has some positive contribution to economic growth in low-income countries, albeit up to a point. If debt goes on increasing beyond the level where it would be sustainable, it may start to be a drag on economic growth.

### 5.6 IMPLICATIONS OF ARREARS CLEARANCE STRATEGY ON FISCAL POSITION

As suggested by the foregoing DSA, Zimbabwe is already in debt distress. In this regard, clearance of arrears will make Zimbabwe's external obligations current and remove it from the debt overhang category. Debt distress is assigned to a country when it has arrears to external creditors (IMF, 2016). The envisaged higher growth rates under the new dispensation will reduce significantly the country's debt ratios to ranges within sustainable limits. Consequently, Zimbabwe's debt would be considered sustainable. In essence, Zimbabwe will also be in a position to negotiate for highly concessional loans after clearance of arrears. The lower interest costs and long dated maturity of the new loans will provide government with relief to build enough fiscal buffers which will enable it to settle both the restructured debts and new loans contracted to kick start the economy.

### 5.7 IMPLICATIONS OF THE ARREARS CLEARANCE STRATEGY ON SOCIAL SPENDING

In the short term, repayment of arrears will somewhat crowd out money that was earmarked towards social spending such as in health, education, water and sanitation. However, the goodwill to be realised from clearing external payment arrears outweighs the fiscal sacrifice ratio on social spending<sup>8</sup>. In essence, normalisation of relations with the international community from clearance of arrears will also unlock additional donor financing which virtually dried out following Zimbabwe's isolation from the international community. Additional money to be unlocked together with budgetary donor support will go a long way in supporting the social sectors of the economy.

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<sup>8</sup>Here fiscal sacrifice ratio refers to the potential output loss as a result of either tax increases to meet debt servicing obligations or expenditure cuts either social, recurrent or capital to meet debt servicing obligations

## 6. CONCLUSION AND POLICY RECOMMENDATIONS

### 6.1. CONCLUSION

This study assesses the implications of the impact of the arrears and debt clearance strategy being implemented by Government on debt sustainability, fiscal position and social cohesion. The results suggest that Zimbabwe faces both a solvency and liquidity problem and is vulnerable to growth and export shocks. The external debt indicators are however, projected to fall within sustainable thresholds following debt and arrears resolution. Although debt is expected to return to sustainable position after arrears clearance, stress tests suggest that Zimbabwe would remain vulnerable to high risk of debt distress. Moreover, the debt servicing pressure from the restructured arrears, which is largely, a de-facto unproductive new external debt, would present debt servicing challenges, by putting pressure on fiscal position and crowding out social expenditures in health and education. The results are corroborated by the DSA conducted by IMF in 2016, which suggest that even with clearing of arrears to the IFIs, which is expected to unlock concessional financing, Zimbabwe's debt burden would only marginally improve.

The fact that Zimbabwe faces both a solvency, liquidity and vulnerability problem in the short to medium term suggest that it should seek a combination of debt restructuring and write-offs to solve its arrears problem. In this regard, the current stance being taken by Government to resolve its debt in a restructuring manner needs to be complemented with negotiations for debt write-offs with Paris and non-Paris club creditors. The sensitivity of external debt to shocks also highlights the need to diversify the economy to reduce the risk of adverse shocks and maintain low debt vulnerabilities by implementing prudent debt management strategies. This needs to be accompanied by robust growth rates that guarantee the ability of the country to service the non-productive debt obligations using domestically generated results. Zimbabwe also needs to strengthen its CPIA rating to improve its debt carrying capacity. An improvement in CPIA rating would see Zimbabwe debt sustainability ratios being assessed using high debt ratios compared to the current thresholds based on CPIA rating of a weak policy performer.

Government also needs to put in place a contingency plan to prepare for servicing of newly contracted debts when they fall due to avoid costly policy adjustments or refinancing at unrealistically high costs. The ability and commitment by authorities to service the debt will also enhance credibility and creditworthiness of the Government which in turn will enable it to access subsequent loans at affordable costs. In addition, concerted efforts should be made to sustain current efforts to improve doing business indicators and to create a conducive investment climate that attracts the much needed debt and non-debt creating capital flows. The successful implementation of these policy initiatives would provide strong impetus to efforts geared at accelerating accumulation of capital, productivity and economic growth,

build confidence and enhance the country's ability to meet future external debt obligations when they fall due.

### 6.2. RECOMMENDATIONS

The analysis in this paper suggest that the risk of debt distress remains high following arrears clearance through debt restructuring. Accordingly, attaining debt sustainability will require concessional financing and debt relief from the international community. Based on the analysis and also from empirical literature the study recommends the need for a hybrid approach to resolve Zimbabwe arrears problem which make use of both internal resources and some key elements of the HIPC initiative. Precisely, the study recommends the following:

- The country has to borrow on concessional terms in the medium to long term and only borrow on commercial terms for financing productive sectors which yield high returns;
- Promote attraction on non-debt creating flows, particularly FDI for financing the non-interest current account deficit;
- Fiscal discipline is required to ensure that the primary balance remains within sustainable levels. This underscores the need for a coherent debt strategy linked to fiscal rules;
- There is need for Government to continue strengthening development of the domestic debt market to mitigate potential exchange rate risks;
- There is need to craft and adhere to a borrowing plan to ensure that future borrowing entrenches both debt sustainability and sustained economic growth. In this regard, capacity building initiatives in sovereign risk management and modelling are crucial;
- Strengthen public debt management legislation to close potential loopholes in the current law;
- Strengthen the legal and institutional framework for contracting external debt;
- Independence of the institutions that advise government e.g. the central bank is critical to contain debt accrual;
- Need to ensure strict evaluation of project loans prior, during and at completion; and
- Ensure transparency in the borrowing process by involving opinions of civil society and affected groups as well as Parliament. All project documents and evaluation should be available for public scrutiny.

Overall, the coming in of the new dispensation imply that Zimbabwe will face a new landscape characterized by new lenders, in a more volatile and uncertain financial environment. As such, strengthening the institutional framework for borrowing is necessary to manage public debt prudently and avoid a recurrence of debt distress episodes, while adequately financing future growth. The reforms being implemented by government in public financial management will engender transparency and assist in guaranteeing debt sustainability going forward.

## 7. AREAS FOR FUTURE STUDY

The study can be extended further by looking at the long term strategies necessary to move the economy out of debt, instead of sustained reliance on external borrowings from IFIs. This can be done by drawing lessons from countries like Ghana, which outlined the 'Ghana beyond debt and Ghana beyond aid strategy'. The need for this study is out of the realization that countries that received debt relief under HIPC and MDRI are gravitating towards being in the high risk of debt distress again.

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