GOVERNMENT SECURITIES MARKET IN ZAMBIA - STATUS AND PROSPECTS

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Implementation of capital market reforms and regulation

This paper has been prepared as a requirement and a fulfilment of the fellows programme under the Macroeconomic and Financial Management Institute (MEFMI)

Abstract
This paper is on the operations of the government securities market in Zambia. The government securities market has grown since the early 1990s when major economic reforms were undertaken. The Zambian capital market is still and remains to be underdeveloped. This is due to a number of factors such as equity markets lacking sufficient liquidity, a weak regulatory structure requiring institutional reform, and a poorly functioning trading and depository system and lack of benchmark yield curves due to short term nature of the government securities. Significant development, reform, and depth are needed, both to meet the countries’ ambitious economic development goals and to build capital market sector. As such the development and reforming of the government securities markets is an important ingredient in developing the capital markets. In the paper, I stipulate the necessary conditions for the development of the government securities market and compare with what is obtaining in Zambia and offer recommendations.
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Preface
This paper is part of my contribution toward my fellowship programme under Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI). The paper is on the Government securities market in Zambia. It outlines how the government securities market has evolved to its current status. A number of topics have been covered, that range from the macroeconomic environment to the private sector debt market.

There is consensus that the development of the domestic financial markets is important for the economy. The development of financial markets in the region is of high priority, hence the need to have well trained fellows to articulate securities market development in the region.

A well developed securities market provides the government and the private sector an opportunity to finance the budget deficit gaps through issuance of paper in the market. The securities market also provides information to policy makers on risks based on the pricing of these securities. The developments of the securities market can also be an indicator of the monetary policy stance of the central bank.

This paper is structured as follows; there is an introduction, followed by the historical background of the securities market in Zambia. Section three covers the basic prerequisites for a successful development of government securities, section four will look at the current status of the securities market in Zambia in which the following will be covered; macroeconomic situation, composition of domestic debt, financial sector development, market for government securities – instruments and investor base, institutional framework and legal aspects of debt management, objectives and guidelines of debt management, organisation of the debt management, coordination between monetary policy and debt policy, government securities selling techniques, planning and borrowing policy, trading arrangements and clearing and settlement systems of government securities, a brief on the corporate bond market in Zambia and the final section is the conclusion.
Acknowledgements

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Finally, I would like to thank my wife Meya and Children Anne, Towela and Lazarus Jr. for their understanding while I travelled to undertake my training.
Acronyms

BES  Book Entry System
BFSA  Banking and Financial Services Act
BoZ  Bank of Zambia
HIPC  Highly indebted Poor Country
IDA  International Development Agency
LuSE  Lusaka Stock Exchange
OMO  Open Market Operations
OTC  Over the counter
1.0 Introduction

In the recent past, most developing countries have been promoting the development of the capital markets. Capital Markets Development is focused on developing the equity and long-term financial instruments markets in most developing countries. Capital market sector is increasingly viewed as a critical component in the economic development plans of these countries. In Zambia, the government has been putting in place policies that would ensure the growth and development of capital markets. It has been reforming the economy in general and the government securities markets. The government also put in place the legal and regulatory structures to oversee the development of the capital markets. This market has shown significant potential for development, but has been plagued with endemic deficiencies such as equity markets lacking sufficient liquidity, a weak regulatory structure requiring institutional reform, and a poorly functioning trading and depository system and lack of benchmark yield curves. Significant development, reform, and depth are needed, both to meet the countries’ ambitious economic development goals and to build capital market sector. A well-developed capital market plays an important role in an economy as it bridges the gap between would be savers (surplus units) and would be borrowers (deficit units). In order to develop a strong capital market, the government has an important role in ensuring that there is an enabling environment that allows the development of the capital market.

The government securities market is the market that makes it possible for the government to finance its budget deficit in a non-inflationary way and hence reduces the budgetary restriction. Development of a government bond market provides a number of important benefits if the prerequisites to a sound market are in place. At a macroeconomic policy level, a government securities market provides an avenue for domestic funding of budget deficits other than that provided by the central bank. It thereby, can reduce the need to potentially damaging monetary financing of government budget deficits and avoid a build-up of foreign currency denominated debt. Further, the government securities market can also strengthen the transmission of monetary policy as the market uses the government securities yield or interest rates as the benchmark for reference rates when setting the lending and deposits rates.

The development of a government securities market is prerequisite to the development of the capital market. A well-developed capital market promotes growth in the economy as a whole since it reallocates money and risk and thus creates business opportunities that would not take place without the help of the financial market. In order to mitigate the over-concentration of risk in banks, it is important that government securities market is developed that will be used as a benchmark for the corporate debt market. The risks would then be dispersed, and companies would be enabled to finance their investment from various financing sources in the domestic markets. The role of banks as intermediaries can still be significant in developing bond markets, given their predominance in the financial systems in most developing countries. The retail network of local banks should be utilised by, for example, letting them sell bonds to investors.

This paper will look at the current status and prospects of improving the operations of government securities market in Zambia that should be the prerequisite for the development

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of the capital markets thereby adopting the best practices in the issuance of the government securities. The paper is divided as follows: section two will look at the historical background of the Zambian securities market, section three will look at the basic prerequisites for successful development of government securities market and section four will look at the current status of the securities market in which the following will be covered; macroeconomic situation, composition of domestic debt, financial sector development, market for government securities – instruments and investor base, institutional framework and legal aspects of debt management, objectives and guidelines of debt management, organisation of the debt management, coordination between monetary policy and debt policy, government securities selling techniques, planning and borrowing policy, trading arrangements and clearing and settlement systems of government securities. The final section is the conclusion.

2.0 Historical background of the government securities market
The government securities market has been operating for a long time. The colonial government used this market to raise funds through issuance of bonds. After independence in 1964, the government continued issuing bonds and in addition, treasury bills were introduced. The Zambian government securities market has undergone a number of changes since 1992. The government started with the liberalisation of the economy and financial sector. A number of policies have been implemented in order to improve the issuance and management of government securities. In line with the liberalisation process, the government liberalised interest rates that included the government securities yield rates. Secondly, the introduction of auctions that replaced the old method of selling government securities by tap basis in order to meet government borrowing needs. Thirdly, was the introduction of electronic book entry system to replace the certificates. The government securities market has continued to be dominated by the banking sector that has held more than 70 percent of total government securities in circulation.

The Zambian government through the Bank of Zambia (BOZ) does issue government securities on the market to raise funds to finance the budget deficit when domestically raised revenues are less than expenditure, monetary policy when the central bank buys and sells government securities through open market operations (OMO) and financial sector development purposes by ensuring there is a steady supply and range of financial instruments to be traded. Currently the government issues Treasury bills and bonds. Treasury bills are issued at a discount and can be discounted at the BOZ. Government bonds are issued on a fixed coupon rate basis.

2.1 Financial sector reforms
The Zambian financial sector has gone through tremendous changes; in line with the government’s economic reforms. In 1992 the government announced measures to liberalise the economy and in the financial sector, controls on interest rates on deposits and loans were lifted, foreign exchange controls were lifted and a new regulatory framework was enhanced through the introduction of the Banking and Financial Services Act (BFSA) chapter 387 of the laws of Zambia. This piece of legislation was enacted to enhance the powers of the BOZ in its capacity as a regulatory authority of the banking and other financial institutions.
These changes in the law saw new entrants enter the financial markets, particularly in banking industry. A total number of 8 new banks were registered bringing the total number of banks to 19. Insurance companies increased to 5 from the only government owned insurance company, the Zambia State Insurance Corporation. The number of privately owned pension funds increased to about 200. The expansion in the number of new entrants in to the financial sector brought about increased competition. The liberalised financial sector meant that financial institutions were free to price the services they provide without any government interference.

The securities market was enhanced further with the opening of the Lusaka Stock Exchange (LuSE) the only stock exchange in Zambia in 1995. Prior to the opening of LuSE, equity and other long term private issued instruments were traded on over the counter (OTC) basis. The establishment of the LuSE was for the enhancement of the development of the capital market and as a means to speed up the privatisation initiatives by the government in the parastatal companies. As at today there are 12 listed companies and 4 quoted companies trading at the LuSE.

Interest rates on government securities were also liberalised. To have market determined government securities yield rates, the Bank of Zambia (BOZ) introduced the auction system for the sale of government securities. The first Treasury bills auction was held January 1993 and the first bond auction was in February 1995. Prior to the introduction of auctions for both Treasury bills and bonds, government securities were sold on an ad hoc and tap basis.

3.0 Basic prerequisites for successful development of government securities markets

A more developed bond market provides the economy with a more balanced financial infrastructure, thereby diversifying the risk of intermediation across a large number of institutions and market players. This so-called sharing of risks through pricing of risks and trading of risks is aimed to achieve a better structure and balance between bank financing, equity financing, and debt financing².

Development of a liquid bond market also provides other benefits. It allows private and public sector issuers to finance long-term projects at lower cost, thus reducing maturity risks. A liquid government bond market also provides the basis for development of other segments of the financial sector that could draw in significant foreign participation – including forward and future markets, for example, which are needed to support risk management functions of banks and firms. Developments in these markets will not only make local bond markets a more desirable investment alternative to both local and foreign investors, but would be vital in the development of a local-currency bond market. An active local bond market also supports financial system stability. Holders of bonds – in particular commercial banks – can make use of these bonds in securing emergency funding from the monetary authorities.³ The commercial banks can use the bonds as collateral when borrowing funds from the central bank.

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² Strengthening capital markets and the development of regional bond markets Lessons from the Asian Crisis – A local perspective: the need for more balanced financial markets Thailand’s Experience Page 2

³ Ibid, Page 3
An active bond market where securities are marked-to-market on a daily basis will facilitate commercial banks’ access to emergency liquidity assistance through their sale or the use of such instruments as collateral. This mechanism provides a more efficient and transparent process than the use of other types of collateral such as land, title deeds, or receivables, which have less transparent market value and less liquidity.

The development of government securities market should be viewed as a dynamic process in which continued macroeconomic and financial stability are essential to building an efficient market and establishing the credibility of the government as an issuer of debt securities. In order to develop a successful government securities market, certain things have to be in place some of which are;

3.1 Stable macroeconomic environment
A stable macroeconomic environment plays an important role in the development of any financial market. Investors have to have confidence in the stability of the factors in the economy such as the level of economic growth, inflation, interest rates, exchange rates and above all the stability of the financial sector. Both foreign and domestic investors will be willing to lend to government if inflation is low and stable, the exchange rate is stable and have confidence in the financial sector. The investors, both foreign and domestic will be reluctant to purchase government securities, especially medium and long term instruments when there are expectations of high inflation, large devaluations or high risks of default. All countries particularly in the developing world to work towards a macroeconomic policy framework with a credible commitment to prudent and sustainable fiscal policies, stable monetary conditions and credible exchange rate regime.

3.2 Sound fiscal policies
Fiscal policies are a key determinant of both national and international economic development. A transparent state fiscal policy is one of the main prerequisites for a profitable and secure capital market. If the state fiscal policy is transparent, while the tax and state debt burden is small, the market is very attractive to investors. Fiscal policy implementation plays an important role in the development of the financial markets.

3.3 Comprehensive debt policy
The other important issue pertaining to fiscal policy is the issue of the execution of the government budget, the financing of the budget deficit. Interaction between fiscal policy and debt management is very important in building overall credibility. Governments must establish a sound and prudent debt management operation and a policy of broad market access so that markets can count on substantial predictability in government actions. The policy will should ensure that government sticks to the methods of financing the deficit in a non-inflationary way than borrowing from the central bank. The government should always be consistent with its financing programmes. The policy should also clearly state the

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4 Developing a government bond market, A handbook by IMF and World bank. Page 5
5 ibid page 6
6 Guidelines for fiscal adjustment, Pamphlet series No. 49, IMF 1995, page 1
7 Developing a government bond market: an overview page 47
objectives of the debt management process. A pre-announced and regular issuance calendar for the year is should be made available to help investors plan their investment horizon. This will enable the government to borrow at low cost and will no longer be penalized for opportunistic behaviour of irregular issuance schedules.

3.4 Money market and monetary policies;
An active money market is a prerequisite for government securities market development. The money market supports the bond market by increasing the liquidity of securities. It also makes it easier for financial institutions to cover short term liquidity needs and makes it less risky and cheaper to warehouse government securities for on sale to investors and to fund trading portfolios of securities.\(^8\) The way a central bank implements monetary policy also has a major impact in the development of the money and government securities markets. It is important that indirect instruments of monetary policy are adopted, such as open market operations. Indirect monetary policy instruments have the advantage of improving the efficiency of monetary policy by having financial resources allocated on a market basis.\(^9\)

3.5 Effective legal framework for debt management;
The legal framework should clarify the authority to borrow and issue new debt instruments into the domestic market. The authority to borrow should be clearly defined in legislation.\(^10\) A clear legal framework will give confidence to investors on the mandate of each institution involved in the debt management. The legal framework should give counterparties assurances that the debt manager have the legal authority to represent government and that the government will stand behind the transactions they enter into.

3.6 Tax regime;
Taxation policy is one of the prerequisites in the development of the financial sector and particularly the government securities market. Tax policy on income earned on financial instruments should be applied equitably. If withholding tax on income earned on government securities is not applied on an equal basis, it might discourage certain groups of investors. Withholding tax should apply equally between foreign and domestic investors, and between institutional and smaller investors.

3.7 Regulatory infrastructure and clear legal framework for trading and settlement;
The regulatory infrastructure in any market is an important factor that contributes to the development and growth of a particular sector. The financial sector with all the risks inherent should be regulated to the extent of allowing it to grow and not stifle competition. In this vein, securities markets need to be well regulated to mitigate the risks. The legal framework should cover areas of securities trading and settlement. Rules on insider trading should be well covered in the laws of the land. Regulation of the financial sector will enhance the safety on investors’ funds and soundness of the financial sector as a whole.

3.8 Smooth and secure settlement arrangements;

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\(^8\) Developing a Government bond market Page 8
\(^9\) Ibid page 9
\(^10\) Guidelines for public debt management IMF and World bank publication, Page 15
Another factor that plays an important role in the development of a government securities market is having a secure settlement system for both funds and securities once traded either in the primary or secondary market. The payment and settlement system should be efficient and secure.

4.0 Current status of the Zambia government securities market

4.1 Macroeconomic and Fiscal Situation

Current situation
Since independence the Zambian economy has been dominated by the copper industry. Copper has been contributing over 60 percent of Gross National Product (GDP) and about 90 of the export proceeds of the country. Zambia has been and continues to be affected by both internal and external economic shocks. Internally, the economy was affected by shocks such as low copper production coupled with unfavourable prices of the commodity, poor weather patterns that affected agricultural production. External shocks included the rise of oil prices in the mid 1970s affecting the country as the balance of payments worsened. Due to reduction in revenues from copper earnings fiscal deficits widened. This problem was compounded further with the huge inefficient parastatal sector dominating the economy. The widening budget deficits prompted the government to borrow both domestically and externally.

The Zambian economy has been going through restructuring since the early 1990s. The macroeconomic situation has been characterised with low and at times, negative growth, high inflation, high interest rates, widening budget and current account deficits. The Kwacha has been weakening against the major currencies. Further, the country has a huge external debt that has been taking away the resources needed for poverty reduction. Zambia has thus been classified Highly Indebted Poor country (HIPC) status.

After two decades of low levels of growth and persistent high inflation, economic conditions have remarkably improved over the last 5 years. GDP growth has been in positive territory since 1999 exceeding 5 percent in 2003, while inflation at 15.9 percent in December 2005 was at the lowest level recorded in 10 years. Inflation is currently in single digit at 7.9 percent recorded in October 2006. Interest rates were generally high but have recently been reducing with the 91 day rate at 8.5 percent October 2006. The nominal exchange rate, though depreciating has recently shown signs of stability recording a significant appreciation between 2002 and 2005.

Table 1 Macroeconomic statistics on the Zambian Economy

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (% change)</td>
<td>2.2</td>
<td>3.6</td>
<td>4.9</td>
<td>3.3</td>
<td>5.1</td>
<td>5.1</td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>20.6</td>
<td>30.1</td>
<td>18.7</td>
<td>26.7</td>
<td>17.2</td>
<td>21.5</td>
<td>15.9</td>
</tr>
<tr>
<td>Government balance (%GDP)</td>
<td>-4.0</td>
<td>-3.3</td>
<td>-8.1</td>
<td>-6.4</td>
<td>-6.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rates %*</td>
<td>36.2</td>
<td>34.1</td>
<td>37.3</td>
<td>32.0</td>
<td>19.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exchange rate**</td>
<td>2,93.59</td>
<td>4, 110.34</td>
<td>3, 820.33</td>
<td>4, 740.05</td>
<td>4, 583.88</td>
<td>3508.98</td>
<td></td>
</tr>
</tbody>
</table>

*91 days Treasury bills rate has been used
** Bank of Zambia mid rate has been used

Comment
A stable macroeconomic environment plays an important role in the development of any financial market. Investors must have confidence in the stability of the economy, and issues such as the level of economic growth, inflation, interest rates, exchange rates and above all the stability of the financial sector. Both foreign and domestic investors will be willing to lend to government if inflation is low and stable, the exchange rate is stable and have confidence in the financial sector. The investors, both foreign and domestic will be reluctant to purchase government securities, especially medium and long term instruments when there are expectation of high inflation, large devaluations or high risks of default. All countries particularly in the developing world should work towards a macroeconomic policy framework with a credible commitment to prudent and sustainable fiscal policies, stable monetary conditions and a credible exchange rate regime.

**Recommendation**

In order to develop the government securities market further, the Zambian government should strive at achieving macroeconomic stability through prudent fiscal and monetary policies. The macroeconomic situation is a necessary precondition, and for this the government needs a tighter budget and a clear commitment to pursue market solutions in borrowing, and not rely on captive sources of financing. In the last two years most of the macroeconomic variables look to be stabilising, inflation has been coming down; the exchange rate has remained stable.

### 4.2 Debt situation and fiscal policy

The public debt in Zambia is very high and is dominated by the external debt which was about 160 percent of GDP in 2003. Domestic debt has also been growing reaching 25 percent of GDP by end 2003. The huge unsustainable external debt has made Zambia qualify for debt relief under the Highly Indebted Poor Country (HIPC) initiative. The country’s external debt has averaged US$6.5 billion. This means that the country can not access commercial loans in the international markets but can only borrow on International Development Association (IDA) loan terms that are very concessionary. The huge external and the growing domestic debt create unsatisfactory risk exposure to the government. The government faces a number of risks as it manages it debt such as exchange rate, interest rate and rollover risks. The depreciation of the Kwacha and or a rise in domestic interest rates will have an adverse impact on the budget in an immediate and substantial way. Given the short term to maturity of domestic debt, the government faces the rollover risk if investors in government paper decide not to refinance the debt, requiring more resources from the budget.

Given the need to meet the budget deficit, the government has relied more on borrowing from the domestic market through issuance of Treasury bills and Government bonds. As can be seen from the table below the stock of domestic debt has been increasing while the stock of external has remained the same. The increase in the domestic debt will in the medium to long be very unsustainable. As efforts are being made with external debt, nothing is being done to domestic debt. This will have a big impact on fiscal policy, as more resources will required to meet the interest costs and to amortize the stock.

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11 ibid page 6
The table below shows the outstanding domestic and external debt for Zambia in US$ covering 1999 – 2003

<table>
<thead>
<tr>
<th>Stock</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>134</td>
<td>138</td>
<td>282</td>
<td>393</td>
<td>937</td>
</tr>
<tr>
<td>External</td>
<td>6,005</td>
<td>5,842</td>
<td>6,438</td>
<td>6,470</td>
<td>6,121</td>
</tr>
<tr>
<td>Total</td>
<td>6,139</td>
<td>5,980</td>
<td>6,720</td>
<td>6,863</td>
<td>7,058</td>
</tr>
</tbody>
</table>

**Comment**
The domestic debt has been increasing while external debt has changed marginally since 1998. The increase in domestic debt is mainly on account of borrowing more domestically in order to meet budget requirement one of which is servicing external debt. Even though Zambia may qualify for debt relief under the HIPC initiative, the domestic debt will remain unsustainable. This requires urgent attention to find solutions to the domestic debt situation. Government needs to draw up a domestic debt management strategy in line with the efforts being made to alleviating the external debt burden.

The table below shows total debt stock as a percentage of GDP

<table>
<thead>
<tr>
<th>Stock</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>5</td>
<td>6</td>
<td>8</td>
<td>11</td>
<td>25</td>
</tr>
<tr>
<td>External</td>
<td>208</td>
<td>238</td>
<td>188</td>
<td>173</td>
<td>162</td>
</tr>
<tr>
<td>Total</td>
<td>213</td>
<td>244</td>
<td>196</td>
<td>184</td>
<td>187</td>
</tr>
</tbody>
</table>

Note: Nominal outstanding, exchange rate as of end of year. Domestic debt is excluding arrears.
Source: IMF Poverty Reduction Strategy Paper, June 2004 and BoZ

From the table above, the statistics show that the total debt as a percentage of GDP is very high: an indication that the debt is unsustainable in the medium to long term

**Recommendation**
The government needs to draw up a clear debt management strategy given the unsustainability of the debt situation. The strategy should generally be the guide in management of the debt and specifically the management of the domestic debt given that the external debt is being dealt under the HIPC initiative.

4.2.1 Domestic debt composition
The domestic debt in Zambia is composed of government securities and the non-securitised debt. For the purpose of this paper reference is only made to government securities. There are two types of instruments issued by the Zambian government Treasury: Treasury bills which are short term securities issued at a discount and government bonds which are medium to long term with semi annual coupon payments. Both types of instruments are represented by book entries and issued via regular competitive auctions.

Currently, the government through the Bank of Zambia issues four maturity profiles of Treasury bills and three maturity profiles of government bonds, that is, 28 days, 91 days, 182 days and 273 days and 12 months, 18 months and 24 months Treasury bills and bonds respectively. In the past, treasury bills were the most popular given the period of maturity and that they are rediscountable at the Bank of Zambia. Bonds demand picked up in the period of 1998 to 2002.

Table 4 below shows the outstanding government securities made up of government bonds and Treasury bills.

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stock</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treasury bills</td>
<td>101.6</td>
<td>83.8</td>
<td>177.1</td>
<td>172.5</td>
<td>293.9</td>
</tr>
<tr>
<td>Bonds</td>
<td>27.1</td>
<td>49.1</td>
<td>105.4</td>
<td>186.2</td>
<td>307.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>128.7</td>
<td>132.9</td>
<td>282.5</td>
<td>358.7</td>
<td>601.8</td>
</tr>
</tbody>
</table>

Source: Bank of Zambia

Total Government securities in circulation have increased over the past five years, increasing by 68 percent in the period 2002 and 2003. The increase has mainly been caused by the need to cover government deficit financing.

**Comment**

The Zambian total debt is unsustainable, hence the country’s qualification for the HIPC status in 2000. The country is yet to reach the HIPC completion point where it is expected that about half of its debt will either be rescheduled or cancelled completely. In the mean time, the domestic debt stock continues to increase as the country is still experiences large budget deficits and continued shortfalls in donor budget support. The continued shortfall of external budget support implies the country has to rely more on the domestic borrowings to fill the budget gap. This has a crowding out effect on the private sector as commercial banks are more comfortable to lend to government through the purchase of government securities that have lower default risk.

The government has also relied on borrowing from the central bank and postponing paying suppliers of goods and services to government. Central bank borrowings have monetary policy implications as it expands its balance sheet in order to accommodate government borrowings. In most cases the outstanding amount is over and above the legal limit as set in the Bank of Zambia Act. Central bank borrowings have an immediate expansionary effect on money supply which that leads to inflation. Further, direct government borrowings from
the central bank have implications on monetary policy implementation as the central bank continues to accommodate huge government borrowing requirements.

Failure to pay the government’s suppliers of goods and services erodes the government’s credibility. The suppliers in the medium to long term do not trust government policies. This failure to pay suppliers has implications on the pricing of goods and services supplied to government as it results in a premium. As the credibility of government becomes more questionable, in the medium to long run, this has implications on the fiscal policy of the country.

The reliance on central bank borrowings and suppliers arrears is an impediment to the development of the securities market. The undeveloped domestic securities market has implication for the development of a long term capital market for funding the private enterprises.

Recommendation
From the data above, the most striking features with the government domestic debt is that the stock of both Treasury bills and bonds has been rising. In order to restructure the government domestic debt, it is recommended that the government should increase the maturity profile of the domestic debt. In order for the government to undertake domestic debt management, there is an urgent need to develop a comprehensive domestic debt policy.

4.3 Market for Government securities and debt – Instruments and Investor base

Current situation
The government securities market is open to the general public on the domestic front to purchase government securities directly at auctions at the Bank of Zambia. Foreign investors can purchase Zambian government securities only through the commercial banks registered and operating in Zambia. The investor base in government securities is diverse with 14 commercial banks, 8 pension funds, 4 insurance companies, private companies, non-governmental organisation and several individuals. Given that foreign investors can only participate on the Zambian government securities market through commercial banks operating in Zambia, it is difficult to ascertain the total number of foreign investors on the local market.

The Bank of Zambia went further to institute more measures in 2001 by allowing individuals and corporate institutions to bid directly in the primary market of the government securities. The Bank of Zambia has gone further to reopen the off-tender window that will cater for investors that cannot afford the minimum amount per bid in the competitive window.

4.3.1 Treasury bills holdings by category
The stock of Treasury bills has been increasing since the beginning of 1993. The holding of government treasury bills has been dominated by the commercial banks. This is mainly on account of the high returns due to high yield rates on treasury bills and the regulatory requirement for commercial banks to maintain liquid assets as percentage of liabilities. Commercial banks were US$224.5 million representing 76 percent, Non-bank institutions US$68.8 million representing 24 percent and the Bank of Zambia was holding US$0.68. See
By end 2005, the non bank institutions were holding more of the treasury bills than the banks.

Table 5 Out standing Treasury bills by holder, US$ million

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>72.52</td>
<td>55.91</td>
<td>137.45</td>
<td>108.53</td>
<td>224.48</td>
<td>198.65</td>
<td>289.27</td>
</tr>
<tr>
<td>Bank of Zambia</td>
<td>9.13</td>
<td>11.60</td>
<td>9.70</td>
<td>11.47</td>
<td>0.68</td>
<td>14.52</td>
<td>1.16</td>
</tr>
<tr>
<td>Non-bank</td>
<td>19.91</td>
<td>16.34</td>
<td>29.98</td>
<td>52.49</td>
<td>68.82</td>
<td>88.35</td>
<td>304.79</td>
</tr>
<tr>
<td>Total</td>
<td>101.56</td>
<td>83.85</td>
<td>177.13</td>
<td>172.49</td>
<td>293.98</td>
<td>301.54</td>
<td>595.23</td>
</tr>
</tbody>
</table>

Source Bank of Zambia

4.3.2 Government bonds holdings by category

The holding of government bonds shows a similar pattern as the holding of Treasury bills where the commercial banks continue to dominate. As at end December 2003 commercial banks were holding bonds worth US$189.4 million representing 61 percent, the non-bank public was holding US$105.5 million representing 34 percent and the Bank of Zambia was holding US$12.9 million representing 5 percent of the total bonds outstanding.

Table 6 Out standing Government bonds by holder, US$ million

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>17.19</td>
<td>32.23</td>
<td>75.74</td>
<td>132.65</td>
<td>189.43</td>
<td>302.14</td>
<td>239.65</td>
</tr>
<tr>
<td>Bank of Zambia</td>
<td>0.00</td>
<td>6.04</td>
<td>11.07</td>
<td>8.53</td>
<td>12.97</td>
<td>469.35</td>
<td>393.77</td>
</tr>
<tr>
<td>Non-bank</td>
<td>9.95</td>
<td>10.80</td>
<td>18.56</td>
<td>44.98</td>
<td>105.53</td>
<td>129.57</td>
<td>206.56</td>
</tr>
<tr>
<td>Total</td>
<td>27.14</td>
<td>49.07</td>
<td>105.38</td>
<td>186.17</td>
<td>307.93</td>
<td>901.06</td>
<td>839.99</td>
</tr>
</tbody>
</table>

Source Bank of Zambia

Table 7 below shows data on outstanding marketable government securities, broken down by different types of securities and maturities.

Table 7 Outstanding Government Securities by instruments, US$ million

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 Days T-bill</td>
<td>37.96</td>
<td>0.21</td>
<td>7.32</td>
<td>3.21</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>91 Days T-bill</td>
<td>41.51</td>
<td>33.60</td>
<td>62.86</td>
<td>43.40</td>
<td>59.05</td>
<td>71.05</td>
<td>53.95</td>
</tr>
<tr>
<td>182 Days T-bill</td>
<td>22.10</td>
<td>43.18</td>
<td>65.84</td>
<td>62.83</td>
<td>90.27</td>
<td>109.15</td>
<td>117.43</td>
</tr>
<tr>
<td>273 Days T-bill</td>
<td>0.00</td>
<td>6.86</td>
<td>41.12</td>
<td>63.05</td>
<td>144.66</td>
<td>121.34</td>
<td>248.13</td>
</tr>
<tr>
<td>364 days T- bill</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>175.72</td>
</tr>
<tr>
<td>12 Months bond</td>
<td>25.83</td>
<td>30.30</td>
<td>52.55</td>
<td>59.22</td>
<td>61.19</td>
<td>36.45</td>
<td>49.32</td>
</tr>
<tr>
<td>18 Months bond</td>
<td>1.31</td>
<td>17.42</td>
<td>33.93</td>
<td>33.20</td>
<td>82.42</td>
<td>77.48</td>
<td>82.75</td>
</tr>
<tr>
<td>24 Months bond</td>
<td>0.00</td>
<td>1.36</td>
<td>18.89</td>
<td>93.74</td>
<td>164.32</td>
<td>175.04</td>
<td>164.13</td>
</tr>
<tr>
<td>3 Years bond</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>61.30</td>
</tr>
<tr>
<td>5 &amp; &gt; 5 Years bond</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>543.56</td>
</tr>
<tr>
<td>Total</td>
<td>128.70</td>
<td>132.92</td>
<td>282.51</td>
<td>358.66</td>
<td>601.91</td>
<td>590.51</td>
<td>1,496.29</td>
</tr>
</tbody>
</table>

Source Bank of Zambia

Comment
The government securities market has been dominated by the commercial banking sector. This is basically due to a number of reasons. Currently all commercial banks are required to maintain minimum core liquid assets as a percentage of the total deposit liability, and Treasury bills are one of the instruments considered as part of the core liquid assets. The yields on the government securities have been very high making them more lucrative. In order to break the dominance of the banks in the government securities market, more non bank financial institutions should be encouraged to participate in this market.

Fixed income benchmark bonds are a necessity in the development of the capital market. In any market where there are no benchmark instruments, the private sector will not issue its own debt, if the private sector issues any thing, all the instruments shall be floating rate bonds as evidenced by the Barclays bank Zambia Plc 12 year notes which are linked to 182 day yield rate.

**Recommendation**

It is strongly recommended that the government should discontinue issuing 12 months bonds. The government should continue to lengthen the maturity structure as it has done in the past through the introduction of 273 days and 24 months bonds. On the Treasury bills front the government should introduce the 364 days Treasury bills. On the bonds, the government should introduce 3, 5, 7, 10 and 15 years bonds into the market. In addition a survey conducted in mid 2004 established that there is market appetite for these long term instruments. The market participants responded by indicating that they would like the Government to introduce long term bonds with term to maturity of 3, 5, 7, 10, and 15 years

In the region a number of countries are introducing long term bonds. In Uganda, they have been successful to introduce long term bonds. The Treasury bonds successfully issued so far are of tenors of 2 years, 3 years, 5 years and 10 years.

**4.4 Financial sector development**

**Current situation**

Since independence in 1964, the financial sector in Zambia has undergone two notable phases in its development. In 1968 the government instituted economic reforms. The policies were intended to empower the indigenous population through the ownership of means of production. These reforms were in the form of nationalization of the major sectors of the economy. These reforms did not spare the financial sector. Before the 1990s financial reforms, the banking sector in Zambia consisted of four distinct groups – pre-independence foreign banks, Government banks, post independence foreign banks and local banks. Although commercial banks were spared, all other major financial institutions were nationalised and merged to form government owned institutions such as the Zambia State Insurance Corporation (ZSIC) and the Zambia National Building Society. Entry of non-bank financial institutions into the financial sector became restrictive.

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However, Government established financial, institutions such as the Development Bank of Zambia, the Local Authority Superannuation Fund (LASF) and the Zambia Export and Import Bank, through Acts of Parliament. Further, the government established the National Savings and Credit Bank, Lima Bank and the Cooperative Bank. All these government institutions were established with the view of providing financial services to the local population that were not being serviced by the foreign banks. Overall, government involvement in the financial sector resulted in an inefficient and non-competitive market, which inhibited the development of the private sector financial institutions and discouraged private savings.\(^{13}\)

The second phase of notable change in the financial sector in Zambia has been the liberalisation as part of the World Bank and International Monetary Fund (IMF) economic reforms. The financial sector reforms were multifaceted, (i) the reforms involved restructuring of the government owned banks, (ii) there were supervisory and prudential reforms, (iii) there was the liberalisation of the foreign exchange and interest rates and (iv) the introduction of a formal capital market.

4.4.1 Restructuring of government owned banks
By the late 1980s, a number of the state owned banks were financially distressed, illiquid or insolvent. In order to put these institutions on a good footing, some institutions such those involved in the agriculture sector like Lima bank and Cooperative bank had to be closed. These operations of the closed institutions were mainly affected by the poor management, severe drought and low loan recovery rates.\(^{14}\) The government had to recapitalise some of the remaining banks. Other institutions are in the process of being privatised such as the Zambia National Commercial Bank and increase private sector involvement such as the Development Bank of Zambia.

4.4.2 Reforms to the prudential system.
Prudential reforms involved the repealing of the Banking Act of 1972 and replacing with the Banking and Financial Services Act (BFSA) of 1994, the introduction of new reporting and accounting procedures and strengthening of BoZ supervisory capacity.\(^{15}\) The new Act granted BoZ new legal powers to licence regulate and supervise banks.

4.4.3 Liberalisation of foreign exchange and interest rates
In 1992, the financial markets were liberalised, interest rates on both deposits and lending were decontrolled and foreign exchange controls were lifted. This prompted the government through BoZ to introduce the auction system for all government securities offered on the market and this entailed that interest rates on government securities were market determined. The BoZ also introduced weekly foreign exchange auctions which were completely done away with in 2003 with the introduction of a broad based interbank foreign exchange market system (IFEM).

4.4.4 Introduction of a formal capital Market

\(^{13}\) Ibid Page 5
\(^{14}\) Ibid Page 6
\(^{15}\) Ibid Page 6
In 1995, the government with the help of the World Bank established the first ever stock exchange in Zambia, the Lusaka Stock Exchange (LuSE). The formation of the Exchange was part of the government's economic reform programme aimed at developing the financial and capital market in order to support and enhance private sector initiative. The Lusaka Stock Exchange was also expected to attract foreign portfolio investment through recognition of Zambia and the region as an emerging capital market with potentially high investment returns. Another important role of the Exchange is to facilitate the divestiture of Government ownership in parastatals and realisation of the objectives of creating a broad and wide shareholding ownership by the citizenry via a fair and transparent process.

The introduction of a formal capital market was mainly to provide a secondary market for the shares offered through the privatisation of the State Owned Enterprises (SOEs), provide a maximum financing opportunities for the business community and diverse investment opportunities for the local population. The stock exchange was established to provide secondary market, financing opportunities and diversify investment opportunities for the Zambian population. In Zambia, privatisation provided the catalyst for the formation of the stock exchange. To date 13 companies that have been privatised have also been listed on the LuSE. The shares of these companies are trading at the exchange.

Comment
The financial sector now comprises the Central Bank, commercial banks, non-bank financial institutions (comprising the three building societies, some micro finance institutions, the National Savings and Credit Bank, the Development Bank of Zambia, the 37 Bureau de changes and leasing companies), insurance companies, pension funds and the capital markets, that is, LuSE. The financial sector has mainly been dominated by the commercial banking sector as can be seen by the amount of the asset base as a proportion of the financial sector. Commercial banks hold 70% percent of the assets base.

Financial regulation and supervision in Zambia has over the last decade been structured around specialist organs that were mainly established after the liberalisation of the economy in 1991. This situation has led to a number of overlaps and areas of conflict in the regulatory environment of financial services in Zambia leaving room for regulatory arbitrage. In addition, the Zambian financial sector still has a number of unregulated financial service providers such as venture capital funds.

The financial sector is supervised by three institutions, Bank of Zambia responsible for the supervision of the banking and certain non bank financial institution such as leasing, foreign exchange bureaus and Development Financial institutions (DFIs), the Securities and Exchange Commission (SEC) responsible for the supervision of the capital markets institutions. The SEC is responsible the licensing and regulation of all institutions involved in the capital markets such as stock exchange, brokers and Issuers. While the Pensions and Insurance Authority (PIA) responsible for the supervision of the pensions and insurance companies.

Recommendation

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It is recommended that the laws should be harmonised to make it easy for entry and regulation. There is need to draw up the Financial Sector Development Plan that will look at issues of taking the financial sector to higher heights in line with international best practices. The plan should aim at promoting competition and financial markets depth. The legal framework should make it easier for more financial institutions to enter the market.

In order to comprehensively address regulatory arbitrage in the medium to long term in the Zambian financial sector it is proposed that Government pass an appropriate law on the integration of the separate financial sector regulators to a Financial Services Authority (FSA).

Further, enhance the use of the capital markets by the emerging enterprises through specific incentives to allow these enterprises to issue medium to long term financial instruments for recapitalisation.

4.5 Institutional framework and legal aspects of debt management

The legal framework clearly defines the authority to borrow both domestically and externally. The Minister of Finance and National Planning is given the power by the constitution of the Republic of Zambia to commit the country to any kind of borrowings, that is, external or internal borrowings.

There are a number of legislations that empowers the Minister of Finance to borrow on behalf of the Government through different instruments. The Treasury bills Act Cap 332 stipulates that the Minister, whenever authorised thereto by the resolution of the National Assembly can borrow by the issue of Treasury bills, sums not exceeding the amount specified in the resolution and the Minister may also borrow from time to time in manner aforesaid such sums as may be required to pay off at maturity bills already lawfully issued by the government.\(^{17}\)

The Local loans (Registered stock and securities) Act Cap 366 stipulates that whenever by any Act authority is given to the President or the Minister to raise any sum of money by way of loan for any purpose mentioned in this Act, or whenever it is necessary to raise any sum of money for the purpose of repaying any loan raised by the Government under this or any other Act, the Minister may from time to time raise such sum or any part therefore under the provisions of this Act in either of the following modes:

a) By the creation and issue of registered stock
b) By the issue of securities in the form of bonds or debentures\(^{18}\).

Comment

The ideal situation should be that all borrowings by the government should be authorised by parliament. In modern democratic states, most power is vested in Parliament which as a body with the right to authorise taxation measures, should also decide the principal on state

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\(^{17}\) The Treasury bills Act CAP 332
\(^{18}\) The Local loans (Registered Stock and Securities) Act Cap 336
borrowings, including the issue of financial guarantees. In Zambia the legal framework gives powers to the Minister of Finance to borrow on behalf of the government both externally and domestically.

The legal framework at a minimum should clarify the authority to borrow and to issue new debt, invest and undertake transactions on the government’s behalf. Counterparties need assurances that debt managers have the legal authority to represent the government and that the government will stand behind the transactions they enter into.

Institutional arrangements for debt management may be strengthened by including debt management objectives in legislation, as well as requirements to publish on timely basis information on the public debt and the government’s debt management strategy.

**Recommendation**

It is recommended that parliament should provide a clear objective for debt management and a clear framework for delegation of power, the Parliament should decide on:

- the objective of debt management that should include:
  - to meet government’s borrowing requirements;
  - to minimise government cost of borrowing while taking into account risks;
  - to facilitate the development of the secondary market in government securities;
  - to facilitate co-ordination between government debt management and monetary policy management.

- that the Government or any other body appointed by it has the right to borrow on behalf of the Republic for the following purposes:
  - approved expenditures (including on-lending to local governments),
  - redemption of government debt,
  - repurchase of government debt, and
  - a margin for liquidity purposes.

Further, the Government should in turn delegate to the Minister of Finance to borrow according to this act and according to guidelines given to the Minister by the Government.

The Ministry of finance and National Planning should also update the legal framework under which debt is contracted and managed. All the old pieces of legislation should be reviewed in line with the developments in the market.

In addition, there is need to modernise all laws governing the financial markets in order for the market place to have clear guidance. Some of the laws to be reviewed are:

1. Bank of Zambia Act
2. The Government securities Act
3. The loans and guarantees Act

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4. The treasury bills Act
5. The Central Securities Depository Act
6. The Payment System Act

4.6 Objectives and guidelines for debt management

There currently no clearly defined objectives and guidelines for debt management particularly, domestic debt. In the external debt Zambia is currently an International Development Agency (IDA) only country. This means that Zambia cannot borrow commercially in the international markets but borrow very concessional loans through IDA at the World Bank. On domestic debt front, it is only clear that when issuing securities, the first call is to ensure you meet the maturing debt and cover new government borrowings as in line with the yearly deficit financing objectives.

Comment

Currently, government is in the process in formulating the domestic debt management strategy. A common debt management objective in most countries is to fund the Government at the lowest possible long-term cost, taking into account the risks involved. This objective should be enshrined in the Act of Parliament and clearly stipulated in the guidelines for all institutions involved in the government borrowing.

The Government should delegate to the Minister authority to borrow and to manage the national debt on behalf of the Republic in accordance with the Parliament’s decision and subject to overall guidelines decided by the Government.

Recommendations

The Government should be responsible to set limits and guidelines for the debt management operations. The Government delegates to the Minister the power to engage in transactions on behalf of the republic within these limits and guidelines. The Ministers should in turn delegate it further in the organization. By delegating power in this way a more efficient organization would emerge that could take quick decisions and be held responsible for those decisions. The Minister should report back to the Government regarding the transactions being carried out under his mandate.

In order to give an understanding of how such rules could be made operational, the Government could decide on the following principles:

- On a net basis, domestic borrowing should only be conducted outside the Central bank. This makes it possible for the Central Bank to roll over its existing stock of government debt, but not to increase it.
- The use of the arrears should be abolished so that the government should always pay its bills as the fall due.

4.7 Organisation

Current situation

In Zambia, Debt Management responsibility is officially shared between the Ministry of Finance and National Planning and the Bank of Zambia. Within the Ministry of Finance and
National Planning, the Unit responsible for management of domestic debt is the Domestic debt Unit under the Department of Investment and Debt Management. However, other department such as the Accountant General’s Office is also involved in recording some components of domestic debt such as the domestic arrears. The budget office records the debts and also the debt serving payments.

The Bank of Zambia is also involved in the management of debt as the fiscal agent of the government as stipulated in the Bank of Zambia Act number 43 of 1996. The Bank of Zambia is mainly directly involved through the Financial markets Department that conducts the auctions of Government securities on behalf of the Ministry of Finance. De facto charge for issuing of government securities is therefore the Bank of Zambia. Further, the Bank of Zambia also plays a role of financial adviser to the government on both domestic and external debt.

Comments
The following are some of the organisational weaknesses in domestic debt in Zambia:

The Ministry of Finance and National Planning has chosen to take a back seat in issues relating to issuance and management of government paper (Government securities). In this case, the issues of issuance and management of government paper should always be on the agenda at the Bank of Zambia Monetary Policy Meetings at which the Ministry of Finance is represented. Generally, domestic debt management is weak within Government and the Ministry of Finance in particular.

The recording, analysis and management of non-securitised debts (on-lending, Government guaranteed debt, domestic arrears etc) have been difficult because of inadequacies in legal framework, institutional linkages (lack of reporting system between departments in the Ministry of Finance and National Planning (MoFNP) and also between the Ministry and outside organisations), as well as capacity constraints within the MoFNP. The lack of a database on domestic debt and lack of database management skills hampers the maintenance of an up to date inventory on non-securitised public sector debts. The flow of information on domestic debt between MoFNP, Bank of Zambia, Zambia Privatisation Agency and other parastatals is weak and a working system needs to be established to provide an accurate basis for debt service forecasting. Within MoFNP, better reporting and monitoring is required of the size of various domestic debt components that are variously handled between Budget Office, Accountant General’s Office and Investments and debt Management Department (IDM).

Recommendation
To produce a debt strategy and new borrowing policy guidelines, in the short term there is need to form two committees such as the Debt Coordination Committee (DCC) and the Debt management Committee (DMC), which will be the technical arm of DCC to advise the Minister of Finance on various debt issues for decision making.

In the medium to long term, there is need to setup an independent National Debt Office that should be an agency of government to handle all issues of government borrowing policies.
4.8 Co-ordination between monetary policy and debt policy
Debt and monetary policy coordination is an important requirement when the central bank is directly involved in developing a bond market.\[^{20}\] This coordination is necessary because of potentially conflicting objectives of debt management and monetary policy, whereby the former focuses on cost/risk trade off to minimise the borrowing cost to government while the later on price stability. Government securities in Zambia are issued for purposes of financing the budget gap and for monetary policy. The coordination between debt management and monetary policy in Zambia has operated quite well since the inception of the auction system. The Bank of Zambia decides on the amounts and the instruments to use in financing the budget and monetary policy implementation.

The Bank of Zambia has a liquidity forecasting division, which forecasts the liquidity position of the banking system on a daily basis. On the basis of the daily, weekly and monthly forecasts, the Bank of Zambia makes decisions on how much liquidity to withdraw through its daily Open Market Operations and through issuance of excess Treasury bills. The entire excess Treasury bills issued over and above the maturing Treasury bills are credited to the sterilisation account, maintained by the Bank of Zambia. The government has no direct access to this account. The Bank of Zambia only uses this account in cases where there is an auction failure and the government is not in a position to divert funds from the budget to pay for the maturing Treasury bills. The government has at times utilised funds from this account to finance cash shortfalls at the beginning of each month and such funds are refunded when the revenues have been collected by month end.

**Comment**
Because of the dominance of the Bank of Zambia in the issuance of government securities, it has become difficult over time to separate debt management from liquidity management. This creates conflict of interest between the aims and operations of public debt management and monetary policy in open market operations.

**Recommendation**
There is need to clarify the different roles the Ministry of finance and the Bank of Zambia will have in the debt management process. In addition, the Ministry and the Bank of Zambia should clearly clarify the different roles of debt management and monetary policy when it comes to government securities operations. These should not only be contained in the laws but also operational guidelines. Further, the Bank of Zambia should continue to operate the auctions of the government securities.

4.9 Issuing techniques
There are basically four techniques for selling Treasury bills in primary market (1) predetermined public subscription, in which bills are sold at a predetermined price for relatively short subscription period (2) tap sales at predetermined price, differing from(1)

\[^{20}\] Improving liquidity in government bond market: what can be done?, M. S Mohanty, BIS papers number 11, page 54
because the subscription period is unlimited (continuous sales) (3) private placement (4) auctions.  

Of the four methods above, the Bank of Zambia had to adopt the auction system of selling Treasury bills as opposed to the tap sales, that is, on a continuous basis in 1993 and 1995 for bonds. A crucial aspect of auction designing is the mechanism for determining the price paid by the bidders. From the first auction of the Treasury bills the Bank of Zambia adopted a multiple price auction in which the bidder pays the price they have bid. Under this mechanism bids are arranged from the lowest yield (high price) to the highest yield (lowest price).

4.9.1 Treasury bills
Since 15th January 1993, the market for Treasury bills has been open to the general public to purchase Treasury bills directly from the Bank of Zambia. The following are the procedures:

- The maturity period of the Treasury bills are 91, 182 and 273 days
- Multiple pricing
- Minimum face value per bid is K30, 000, 000.00 (US$6, 000.00)
- Invitation to the general public is through the national press.
- Successful bidders pay the price tendered
- The Bank of Zambia maintains records in a book entry system (BES) as no physical certificates are issued
- Auctions are held once a week
- Day count conversion is Actual/365
- Bids should contain the volume and the price

The information for up coming auctions is delivered via different media. This information is delivered through adverts the national daily papers, posted on the BoZ website and the Reuters. The Treasury bills auctions are held once a week on Thursday and settlement is the following Monday, that is, T + 3.

4.9.2 Government bonds selling
The government bonds issued in the market are fixed coupon bonds. To further increase the number of long term dated government securities with the following features:

- The bonds are coupon paying instruments and the coupon rates are set a few percentage points above the Treasury bills yield rate.
- Minimum face value per bid is K30, 000, 000.00 (US$6, 000.00)
- Invitation to the general public is through the national press.
- Successful bidders pay the price tendered
- The Bank of Zambia maintains records in a book entry system (BES) no physical certificates issued
- Coupon interest is paid semi annually.

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21 Coordinating Public debt and monetary management IMF Document.
22 Bank of Zambia circular SCH/CB/1/93 to commercial banks and general public dated 13th January 1993
Day count conversion: Actual/365
Auctions held once a month.
Bids should contain the volume and the yield rate

The information for upcoming auctions is delivered via different media. This information is delivered through adverts in the national daily papers, posted on the BoZ website and the Reuters. The government bonds auctions are held once a month on Fridays and settlement is the following Monday, that is, T + 2.

The results of the Treasury bills and bonds auctions are announced in a similar manner the auctions, that is, through the different media. The following information is made public after every primary auction of government securities:

- Amount of bills/bonds offered per maturity category;
- Amount bid be each maturity category;
- Amount allocated per each maturity category;
- Cut off bid price per each maturity category;
- Range of successful yield rates;
- Range of unsuccessful yield rates; and
- Weighted average yield rates per each maturity category.

The Bank of Zambia also participates in the government securities market on its own books through the provision of rediscount facilities to all holders of Treasury bills. The Bank of Zambia can also buy bonds through its interaction with the market in the open market operations (OMO). The central bank mainly engages in repurchase and reverse repurchase transactions.

**Comment**
The auction technique of receiving physical bids has remained in place since the introduction of the auctions in Zambia. With improvements in technology, its time we adopt an electronic bidding system that will be faster and secure. This would also improve the time lag in which results can also be communicated to all participants.

**Recommendation**
The Bank of Zambia and the market participants should work on measures that would make electronic bidding be possible for both Treasury bills and bonds.

**4.10 Planning and borrowing policy**
The current situation is that borrowing operations are based on the amount of government securities that need to be rolled over and any new projected government borrowing. The new borrowings are factored into on a quarterly basis based on the expected budget deficit to be in each quarter. These types of operations make it difficult to meet government requirements particularly in times when the money market is in a tight liquidity position.
Comment
In order for a debt agency to undertake a good borrowing plan, a good cash flow projection has to be undertaken by the government through the Ministry of Finance and national Planning. A good borrowing plan can only be implemented and work to the expectation of the authority if the government is able to inform the central bank in advance the government’s borrowing requirements.

The effective management of selling operations tries to reconcile two objectives:
- To realize quantitative borrowing targets and
- To obtain the lowest possible issue cost under given circumstances

Recommendation
In order for this objective to be fulfilled, the Ministry of Finance and National Planning shall be required to produce yearly, quarterly, monthly and weekly cash flow projections. These projections will help the central bank to build in the amounts required by the government in the amounts to borrow when determining the auction size.

Accurate borrowing requirement forecasts must be produced on a yearly, monthly and daily basis and be made public, at least the yearly and monthly forecasts. A policy for how to finance a certain borrowing requirement must be produced and made public.

4.11 Price making in the government securities market
Currently, there is no formal arrangement for price making in the government securities market. This is mainly on account of the openness of the selling of government securities. Auctions of government securities are open to the general public. The auctions are open even to foreign investors. Given the fact that the auctions are open to the general public, secondary market trading has for some time now been very low. The Bank of Zambia issued guidelines in 1998 for secondary market trading in government bonds through the stock exchange; however the number and volumes of the secondary market trades have been low.

The Bank of Zambia has been striving at increasing the number of participants in the government securities market since 1999. In the quest to develop the secondary market of government securities, in 1996, it was decided that only commercial banks be allowed to participate on the auction. This policy of restricting the primary market to commercial banks only created a captive market. Commercial banks never traded the securities bought at the auctions to the wider market, they continued with the policy of buy and hold.

Recognising the fact that a wider investor base improves the government securities market liquidity not because of the size but because having a large number of investors with diverse risk profiles enables market competition; the policy was changed in 1999, thus allowing all non-bank financial institutions to participate directly at the primary auctions of both bonds and treasury bills.
Comment
The financial market in general and the secondary market in government securities in particular must be developed. The secondary market in government securities is being hindered in Zambia due to a number of reasons.

- High concentration of holding of the securities by commercial banks. Banks have continued to be the main holders of securities.
- High liquidity levels in the banking system.
- High core liquid assets ratio requirements: Banks in Zambia are required to maintain liquid assets as a percentage of deposit liabilities with the public. The high core liquid assets ratio hinders banks from actively managing their portfolios.

4.12 Trading arrangements
Proper and transparent trading arrangements play an important role in the development of the securities market. It has been well recognised that trading arrangements and the degree of market transparency have an important influence on the price discovery process and market liquidity. In Zambia the government securities trading arrangements have undergone some changes and need more policy changes to enhance the development of the secondary market of government securities.

Secondary market trading arrangements for Treasury bills is mainly over the counter transactions (OTC) there is no centralised place like an exchange to trade these instruments currently.

Secondary market trading in government bonds are through the stock exchange. This market is mainly order driven. The commercial banks act as brokers in government bond secondary market operations. Any commercial bank in need of purchasing or selling government bonds in the secondary market is required to send in paper form an order indicating the amount of bonds and the price to the stock exchange. The stock exchange will match sales and purchases that have come at the same prices and a transaction is executed.

All secondary market transactions are cleared and settled the same day, thus T+0. Both the securities and cash settlements are through the commercial banks current accounts at the Bank of Zambia. This system has worked very well since the start of listing and trading in bonds at the stock exchange.

Chart 1 shows the amount and number of trades recorded at the stock exchange for the government bonds. The data obtained from the LuSE indicate that secondary market trading has been increasing in both the number of trades and the actual volumes of bonds traded to reach a peak in 2003. Both volume and number of trades have declined substantially in 2004 and 2005.

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23 BIS papers number 11, Improving liquidity in government bonds markets: what can be done?, page 72
The chart above clearly shows that the amount of bonds traded on the secondary market has substantially increased between 2001 and 2002 by about 130% even though the total number of trades reduced by 4 percent.

**Comment**

Secondary market trading in government bonds though traded through the exchange has not performed to the expectation of the Bank and the Exchange. This mainly attributed to the fact that only commercial banks are allowed to operate as brokers in government bonds at the exchange. Most commercial banks purchase and hold securities until maturity as the bonds have been taken to be investments.

Withholding tax on income earned on government securities complicates the pricing the securities in the secondary market. In most cases, withholding tax is paid by the holder of the security on maturity date. Issues to consider here is whether the market participants would want each holder of the security to pay the portion of the tax for the period the security was held or not. Currently, there is no market consensus on the tax treatment for securities traded in the secondary market. Further, there is tax differential treatment between Treasury bills and bonds, where Treasury bills are taxed at 25% for individuals and bonds at 15%.

Securities lending/borrowing by the central bank plays an important role in developing a liquid bond market. This requires permitting market participants to short sell a security and at the same time enabling them to borrow the short security temporarily from its owner with a contractual obligation to redeliver at a later date. Securities lending operations promote liquidity in the bond market by preventing settlement failures and increasing arbitrage opportunities. Another benefit of securities lending to our market will be that it will provide opportunity to the institutional investors to earn additional income from their idle security holdings.
Recommendation
It is recommended that the secondary market trading arrangements need to be reviewed as follows:

a) Broad based consultations should be done that will involve all the stakeholders. These consultations should culminate into the formation of the Bond Dealers Association in Zambia. The consultations should involve, the Bank of Zambia, LuSE, Securities and Exchange Commission (SEC), Bankers Association of Zambia, Pension funds, insurance companies, and brokers.

b) The Bank of Zambia in consultation with market players should agree on the code of conduct to use in the securities market.

c) The pricing mechanism in the secondary market should be agreed upon by all market participants. All market participants need to agree on the pricing mechanism and formulae.

d) The Bank of Zambia should publicise the prices, volumes and number of trades that have taken place at the stock exchange. This information will enhance the secondary market trading in government bonds. Given that our secondary market in bonds is order driven, the Bank of Zambia should provide post trade prices as done in Malaysia, where in 1997 the bond information and dissemination system was centralized in which the terms of a bond issue, prices details of trade done, tender results and ratings are provided to the market participants. They even went further to interface the information provider to Reuters and Bloomberg systems.24

e) Further to the publication of post trade prices, the BOZ should consult the Bankers Association of Zambia on the introduction of fair prices for the bonds in the secondary market. In most other countries such as South Africa, Singapore and India the traders in bonds have formed the Bonds Dealers Associations. These associations are responsible at drawing up the code of conduct in these markets. Further, the associations are also responsible for the drawing of rules on arriving at the fair prices of the bonds. The BOZ could also advocate for the formation of the Bonds Dealers Association of Zambia in order to promote secondary market bonds trading.

f) The market should adopt Delivery Versus Payment (DVP). The Bank of Zambia should explore ways in which the main players such as commercial banks can electronically send transfer instructions to BOZ, so that both funds and securities are transferred simultaneously. If implemented it would be in line with the international best practice of DVP. This may even work well with the implementation of the Real Time Gross Settlement (RTGS) project. Further, to the achieving DVP, the market participants should agree, all trades that take place in the morning should continue to be settled on T+0 basis while trades executed in the afternoon should be settled on a T+1 basis.

24 Ibid, Page 8
g) Quoting a price of a security in the secondary market, the buyer of the security should be paid the amount of tax that accrued on income earned by the seller as the final holder of the security will pay the tax as if has held the security from the issue date to the maturity date. Further, it is recommended that the government should consider reducing the tax rate on the Treasury bills to 15% in line with tax rate on the bonds.

h) A primary dealership system is introduced to create liquidity in the government securities. The primary dealers should be mandated to quote two-way pricing. Further, the market participants should be encouraged to trade online using systems such as the Reuters that is currently used for the foreign exchange trading.

i) Securities lending/borrowing by the central bank plays an important role in developing a liquid bond market. This requires permitting market participants to short sell a security and at the same time enabling them to borrow the short security temporarily from its owner with a contractual obligation to redeliver at a later date. Securities lending operations promote liquidity in the bond market by preventing settlement failures and increasing arbitrage opportunities. Another benefit of securities lending to our market will be that it will provide opportunity to the institutional investors to earn additional income from their idle security holdings.

This policy of securities lending would require all market participants to put in place risk management policies in place. Further, the Bank of Zambia will also be required to develop guidelines on how securities lending operations shall be undertaken in collaboration with the market participants. This policy would work well given that we are about to implement the real time gross settlement system. This policy of securities lending will require the following to be put in place:

♦ Strong securities market regulations
♦ Which participants will be allowed to short sell securities
♦ Which securities can be traded in these operations, the longer dated government bonds being proposed for issuance in this paper could qualify.

4.13 Clearing, settlement and custody of government securities transactions

Current status
The BoZ has securities depository, that is, a book entry system that is used for the auctioning, maintenance and management of government securities records. The Book Entry System (BES) carries clearing and settlement of government securities transactions. The depository has been in operation since 1997. The book entry system is used to maintain records for both Treasury bills and bonds. In addition, the LuSE also has a securities depository that is used for the maintenance of records for all the stocks of companies listed and quoted at the exchange. Government bonds are also listed at the depository at LuSE to facilitate secondary market trading. Since 1997, all government securities have been dematerialised and are held in electronic form at the BoZ. Prior to 1997 all government securities were issued and held in paper form.
Membership in the depository at BoZ is open to everybody, that is, organisations and individuals can hold an account or accounts after completing application forms for becoming a member of the BES. While that at LuSE, membership is restricted to brokers and commercial banks. All individuals and organisations that purchase bonds are registered under each commercial bank as indicated in the application for becoming a member of the BES. Commercial banks can hold three types of accounts in the BES. The first account was for own trading portfolio, second account was for holdings on behalf of clients and the third account was for holding accounts for the securities the institution could pledge to other members of the BES and Central bank.

All cash settlements for government securities purchased on the primary market are through commercial bank current accounts at the central bank. In order to pay for government securities bought by the general public, the commercial banks provide letters authorising the central bank to debit their current account in circumstances where their customer is succeeds at the auction. For bids from the commercial banks themselves, they authorise the central bank to debit their current account if successful. Treasury bills settlement in the primary market is T + 4 and government bonds is T + 3. In the secondary market, settlement of securities and cash in both Treasury bills and bonds is T + 0.

The depository at the BoZ is subject to annual audits by both internal and external auditors. It is also subject to annual reviews by global custodians to ensure that the operations of the depository are in line with the international best practices.

Comment
A modern, efficient securities settlement system is a principal component of the infrastructure necessary for the development of securities market in general and the government securities market in particular. The settlement system is one of the prerequisites of a sound securities market.

Recommendations
Even though the legal framework recognises the different forms in which government securities can be issued and held. There is need to pass new law that will govern the operation of the depositories at the BoZ and LuSE. The government should enact the draft Securities Depository bill in law. This law will address issues pertaining to legal features of the securities accounts at the BoZ depository and LuSE.

5.0 Development of the corporate rate bonds market

Current status
For a long time, most private companies in Zambia have relied on loans for capital. This can be explained by the fact that the financial system in Zambia has been dominated by the commercial banks. The first ever private security was issued by Farmers House to raise funds for capital projects. Since that bond, three more private enterprises have issued corporate securities. In Zambia there are prospects of developing the corporate bond market. While the government securities market has been developing, other debt markets are

25 Developing a government bond market, A hand book by IMF and World Bank, Page 245
painfully missing. The introduction of other debt instruments would increase the array of instruments available on the market.

Comment
The issuance of debt securities by private sector entities has considerable public policy benefits. Such securities help the private sector contribute to economic development through more efficient reallocation of capital. A well developed private sector debt market will benefit the economy as it will (i) defuse stress on the banking system by diversifying credit risk (ii) supply long term capital for long term projects (iii) provide long term investment products for long term savings (iv) endow financial products with flexibility to meet specific investor requirements (v) reallocate capital more efficiently.

In Zambia, there are several factors for the few private sector debt instruments in the market some of which are:

- The *macroeconomic situation* has not been favourable for the development of fixed income none government debt instrument market. This is mainly attributed to the high and variable inflation averaging about 25% the last ten years. The nominal interest rates on government instruments have also remained high averaging 40%.

- *Structural problems* have also played a role. There are no rating agencies and appropriate hedging instruments that would make corporate bonds less risky. There is lack of liquidity and benchmark instrument would lead to significant issuance costs and pricing problems.

- *Heavy reliance on bank loans*: Most corporate institutions have for a long time now been heavily dependant on bank loan and overdrafts

Recommendations
To address some of the above the following should be considered:

- Primary dealership system – requirement of a minimum amount to bid
- Two way pricing by all primary market dealers
- Maintain the current system in government securities market, but require two way pricing
- Reduce core liquid assets ratio
- Improve government cash management
- Guidelines for private debt securities market development – Minimum capital requirement, disclosure of utilization of funds raised, sources of repayment, minimum size of the issue, underwriting requirements, debt – equity ratio of not more than 2-1, Rating agency, development of code of conduct for corporate bond market.
- Guidelines for the custodians

6.0 Conclusion

A financial system is made up of different institutions, commercial banks, non-bank institutions and the central bank. Each of these institutions plays a different role in the development of the securities market. The development of capital markets and government securities market play important roles in the economy. Capital markets provide long term funds for long term projects while at the same time provide investors with instruments to diversify their investments.

The Government securities market plays a major role in the development of the securities market. Government securities are used as benchmark or reference instruments when pricing the private sector debt instruments. For the government securities market to operate efficiently there is need to have a clear legal basis for the issuance of government paper, objectives for borrowing, stable macroeconomic environment, an efficient payment system to enable clearing and settlement of cash and securities, sound fiscal policies, an active money market for effective monetary policy transmission and a clear tax policy on income earned on financial instruments.

The government securities market in Zambia has undergone a number of changes since the financial sector liberalisation started. The introduction of the auctions in 1993 for Treasury bills and 1995 for government bonds has continued to have interest rates on these instruments to be market determined. Government bonds were listed on the LuSE to facilitate secondary market trading. There are currently private debt instruments in issue on the market.

In order to take our government securities market to greater heights, the ministry of Finance and national Planning in collaboration with the central bank (BoZ) should enhance the market through the implementation of the various recommendations outlined in this paper.
Appendix

Summary of recommendations

1. In order to develop the government securities market further, the Zambian government should continue to strive at achieving and maintaining macroeconomic stability through prudent fiscal and monetary policies. The macroeconomic situation is a necessary precondition, and for this the government needs a tighter budget and a clear commitment to pursue market solutions in borrowing, and not rely on captive sources of financing. In the last two years most of the macroeconomic variables look to be stabilising, inflation has been coming down; the exchange rate has remained stable.

2. The government needs to draw up a clear debt management strategy given the unsustainability of the debt situation. The strategy should generally be the guide in management of the debt and specifically the management of the domestic debt given that the external debt is being dealt under the HIPC initiative.

3. The government domestic debt stock made up of both Treasury bills and bonds has been rising but most of this debt is short term. In order to restructure the government domestic debt, the government should increase the maturity profile of the domestic debt. In order for the government to undertake domestic debt management, there is an urgent need to develop a comprehensive domestic debt policy.

4. In line with the recommendation 3 above the government should continue to lengthen the maturity structure as it has done in the past and introduce much longer dated instrument. On the bonds, the government should introduce 7, 10 and 15 years bonds into the market.

5. Laws governing the government securities be modernised to take into account the developments in the market. Even though the legal framework recognises the different forms in which government securities can be issued and held. There is need to pass new law that will govern the operation of the depositories at the BoZ and LuSE. The government should enact the draft Securities Depository bill in law. This law will address issues pertaining to legal features of the securities accounts at the BoZ depository and LuSE.

6. It is recommended that parliament should provide a clear objective for debt management and a clear framework for delegation of power, the Parliament should decide on:

- the objective of debt management that should include
  - to meet government’s borrowing requirements;
  - to minimise government cost of borrowing while taking into account risks;
  - to facilitate the development of the secondary market in government securities;
- to facilitate co-ordination between government debt management and monetary policy management.

- that the Government or any other body appointed by it has the right to borrow on behalf of the Republic for the following purposes:
  - approved expenditures (including on-lending to local governments),
  - redemption of government debt,
  - repurchase of government debt, and
  - a margin for liquidity purposes.

7. The Government should be responsible to set limits and guidelines for the debt management operations. The Government delegates to the Minister the power to engage in transactions on behalf of the republic within these limits and guidelines. The Ministers should in turn delegate it further in the organization. By delegating power in this way a more efficient organization would emerge that could take quick decisions and be held responsible for those decisions. The Minister should report back to the Government regarding the transactions being carried out under his mandate.

8. It is recommended that the secondary market trading arrangements need to be reviewed.
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