POLICY BRIEF

CHINA AFRICA RESEARCH INITIATIVE

NO. 61 2021

How Zambia and China Co-Created a Debt "Tragedy of the Commons"

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POLICY POINTS

China's State Council needs to exercise a more effective oversight of debt sustainability for Chinese lending.

The Zambian government has an opportunity under new leadership to provide greater transparency and accountability, through parliamentary review and annual publication of binding loan commitments.

With at least 18 Chinese lenders in Zambia, reaching consensus on burden-sharing under the G20/Paris Club Common Framework is likely to prove exceptionally difficult.

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IN NOVEMBER 2020, ZAMBIA BECAME THE FIRST African country to default on its Eurobonds during the COVID-19 pandemic. The China Africa Research Initiative (CARI) estimates that the Zambian central government and its state-owned enterprises owe Chinese lenders at least US$ 6.6 billion. Although Zambia's debt problems predated the pandemic by a large margin, the country is an important case for understanding the Chinese role in the rise of debt distress in the new millennium.

Given the many rumors about Chinese "debt traps," it is important to emphasize that Zambia is an outlier when it comes to the weight of Chinese loans. CARI estimated that Zambia's loan commitments to all Chinese creditors at the end of 2019 was close to 43 percent of 2019's gross national income (GNI).[1] The average for Africa was 10 percent (all data refers to the African continent).

Instead, Zambia is an extreme case of two "principal-agent" problems – the tragedy of the commons, and moral hazard – in Chinese lending. Chinese companies, creditors, and Zambian politicians co-created Zambia's current insolvency.

- The **tragedy of the commons** occurs when individuals have an incentive to overuse a common resource, and there are no effective government or community regulations to restrict this overuse.[2] In this analogy, public resources become the commons, while unsustainable debt contracts are the "overfishing."
- **Moral hazard** arises in finance when one party to a transaction engages in activities that make it less likely that a loan will be repaid, because of an assumption that it is protected against risk, and the other party will pay for the costs. Frequent bailouts, for example, are said to encourage borrowers to discount the risks of painful defaults.

In Beijing, "fragmented authoritarianism" meant an absence of top-down coordination of firms' and lenders' activities and thus few restraints. China's foreign policy principle of "non-interference in each others' internal affairs" would apply to Zambia's domestic policy space and its other sovereign borrowing, creating additional disincentives for close Chinese monitoring. At the same time, Zambia's political leaders disregarded their own restraints on over-borrowing.

Among all African countries with Chinese loans, Zambia has the second largest number of different Chinese contractors winning Chinese loan-financed projects (29), and the largest number of distinct Chinese lenders (18). Only Angola, which has borrowed four times as much from Chinese lenders, has more contractors, and even Angola has fewer Chinese lenders. This multiplication of stakeholders has created fierce competition for infrastructure contracts in Zambia.

Furthermore, Zambia has had more bailouts by the Paris Club (an informal cartel of official bilateral creditors) and from China than most other African countries. Zambia's history of debt cancellations likely exacerbated moral hazard risks.

ZAMBIA'S CHINESE BORROWING

UNDER THE GOVERNMENT OF Edgar Lungu (2015-2021), as copper prices were falling, Zambia ratcheted up Chinese borrowing (Figure 1), while clamping down on public disclosure. By September 2017, the International Monetary Fund (IMF) had labeled Zambia at "high risk" of debt distress. The Zambian government announced that central government debt to Chinese financiers as of the end of 2020 came to US$ 3.4 billion. However, by carefully comparing commitments, disbursements, and repayments, CARI researchers estimate that total Chinese public and publicly guaranteed debt by the end of August 2021 came to US$ 6.6 billion, nearly twice the figure in Zambia's official publications. Over 70 percent of Chinese loans funded economic infrastructure: transport, electricity, telecoms, and water.

Chinese lending in Zambia does not fit the general pattern across Africa. Figure 2 uses CARI data on Chinese loan commitments to determine which countries have borrowed particularly heavily from Chinese lenders as a percentage of their national income, and relative to their overall indebtedness. Zambia (along with Angola, the Republic of Congo and Djibouti) clearly stands out for the high share of Chinese loans relative to national income (Figure 2).

COORDINATION FAILURES IN CHINA

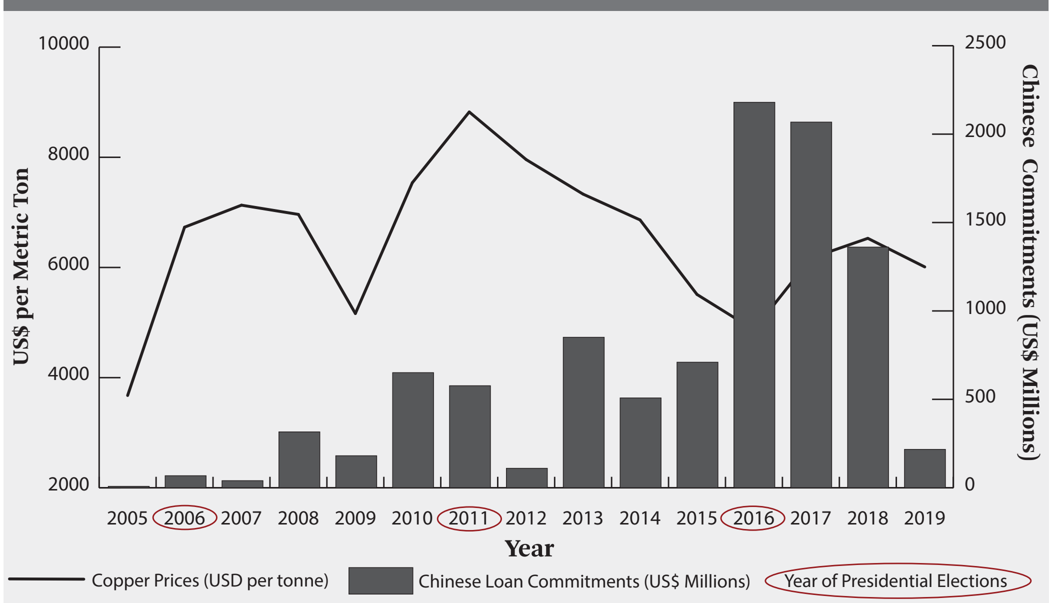
CHINA IS BEST UNDERSTOOD NOT as a monolithic totalitarian system but as a "fragmented authoritarian" model. The coordination challenges this presents show up in a failure of the Chinese system to adequately limit state-backed lending in many risky environments.

In principle, large projects financed by Chinese loans and insured by China's export credit insurance agency Sinosure need to be approved by China's State Council. When a company is developing a contract for a large project and will be seeking finance, it is supposed to get the opinion of China International Contractors Association (CICA).

CICA has 20 days to consult a committee of experts and the Chinese embassy in the country where the project is located. After CICA signs off, the provisional loan plan is submitted to the Ministry of Commerce (MOFCOM), who coordinates with the Ministry of Foreign Affairs (MOFA), and Ministry of Finance (MOF). Together, they submit the proposal to the State Council for approval.

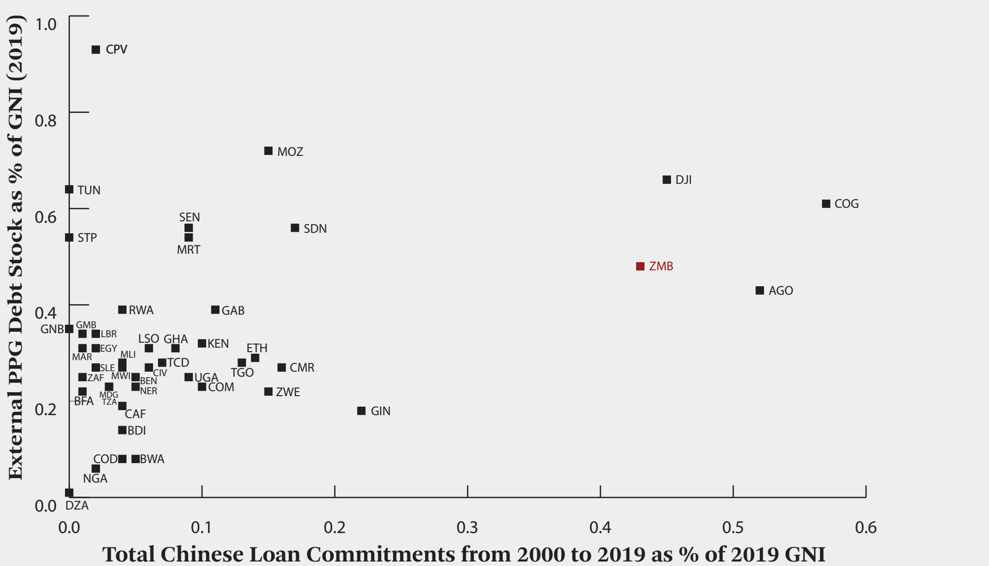
This seems a robust web of oversight, at least for large loans with Sinosure cover, yet the time frame is short, and there are powerful incentives to refrain

Figure 1: Copper Prices, Chinese Loan Commitments, and Zambian Presidential Elections



Source: International Monetary Fund and SAIS-CARI.

Figure 2: External Debt/GNI and Chinese Loan Commitments/GNI (2019)



Source: Chinese loan commitments data are from SAIS-CARI Database, external debt stock data are from World Bank International Debt Statistics, and GNI data are from World Bank Development Indicators Database.

ZAMBIAN DEBT MANAGEMENT COORDINATION CHALLENGES

ON PAPER, ZAMBIA'S PUBLIC investment management rules appear to be close to best practice. Only the Minister of Finance has legal power to contract loans. Article 63 (2), and articles 114 and 207 of Zambia's constitution requires that the government seek parliamentary approval of public and publicly guaranteed debt, including all terms and conditions, before it is contracted.

Yet rules on good debt management in Zambia appear to be regularly flouted. For example, Zambian ministries and departments have sometimes negotiated financing and then made public announcements, pressuring the finance ministry to approve politically popular pledges. A 2020 lawsuit charged that the government had failed to submit loans for parliamentary approval. These problems also appear in two problematic Zambian practices that increased under the Lungu administration: borrowing advance payments, and contractor-facilitated financing.

Borrowing Advance Payments. Export credits commonly require governments to provide an advance payment of 15 percent of the project costs, while the loan accounts for only 85 percent. Zambia has on multiple occasions been unable to come up with the 15 percent advance payment. Sometimes the contractor lent the government the down payment. In several other cases, a second Chinese bank has provided a separate loan to cover the 15 percent payment.

Contractor-Facilitated Financing. Contractor-facilitated financing (CFF) was introduced around 2016 to meet shortfalls in finance for politically popular roads and other construction. These contracts give private companies the responsibility of building, financing, and operating public facilities. The companies are reimbursed over time based on their performance. Although not loans per se, these create contingent liabilities for the government. Because of this, in February 2018, Zambia's cabinet announced that henceforth the government would obtain finance "directly from Chinese banks and not through contractors." Yet CFF contracts were still being signed in 2019.

from throwing a wrench in the works. In 2019, China's MOF unveiled a new debt sustainability framework for projects financed under China's Belt and Road Initiative. Yet the framework was explicitly "non-mandatory."

MULTIPLE ACTORS IN ZAMBIA'S CHINESE-FINANCED BORROWING

Chinese Lenders. Zambia stands out in the CARI China Africa loan data as the country with the highest number of distinct Chinese lenders: 18 different Chinese banks and companies providing credits. Forty-three (88 percent) of the 49 countries in the loan data have five or fewer Chinese creditors. In another five countries (10 percent), including Angola, CARI research has identified between five and ten Chinese creditors. Only Zambia has over 10.

Chinese Contractors. Zambia is also a strong outlier in the number of Chinese contractors winning Chinese loan-financed projects. While Angola, with approximately US$ 43 billion in Chinese loan commitments, has the largest number of separate Chinese contractors (43), Zambia is second with 29. A survey of construction firms across Africa found that Chinese firms held, on average, 34 percent of the local construction business but in Zambia, the Chinese share was 69 percent.

MORAL HAZARD.

ZAMBIA FIRST WON DEBT RELIEF FROM the Paris Club in 1983. Only eight countries (out of 90) have gone to the Paris Club more frequently than Zambia. Our data on Chinese debt relief shows that Zambia is also the African country with the largest amount of Chinese interest-free loan debt cancelled--US$ 392 million--almost twice as much as any other country. Zambia also holds the record for the largest number of separate Chinese interest-free loan debt cancellations since 2000: six.

POLICY RECOMMENDATIONS

1. China's State Council needs to exercise a more effective oversight of debt sustainability for Chinese lending.
2. The Zambian government has an opportunity under new leadership to provide greater transparency and accountability, through parliamentary review and annual publication of binding loan commitments.
3. With at least 18 Chinese lenders in Zambia, reaching consensus on burden-sharing under the G20/Paris Club Common Framework is likely to prove exceptionally difficult. ★

ENDNOTES

1. For an explanation of how Zambia's outstanding debt totals were calculated, see Deborah Brautigam and Yinxuan Wang, "Zambia's Chinese Debt in the Pandemic Era," China Africa Research Initiative Briefing Paper 05/2021, October 2021.
2. References can be found in the working paper on which this policy brief is based: Deborah Brautigam. 2021. "How Zambia and China Co-Created a Debt 'Tragedy of the Commons'". Working Paper No. 2021/51. China Africa Research Initiative, School of Advanced International Studies, Johns Hopkins University, Washington, DC. http://www.sais-cari.org/publications

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Support for this working paper was provided by a grant from Carnegie Corporation of New York. Carnegie Corporation of New York is a philanthropic foundation created by Andrew Carnegie in 1911 to do "real and permanent good in this world."