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Alternative Strategies for Public Debt Issuance in Zimbabwe: Is there a Trade off?[1]

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Introduction

As part of managing a debt portfolio, debt managers face the complex task of choosing a debt strategy that minimises the cost of debt, subject to a prudent degree of risk. This is particularly so because public debt management decisions depend on numerous random factors, which are not under the control of the debt manager. These factors include the future behaviour of interest rates, exchange rates, commodity prices and other macroeconomic aggregates. However, choosing the optimal composition of public debt in terms of maturity, instruments and currency remain the main challenge confronting policymakers faced with high public debt. Against this backdrop, this paper simulates the optimal composition of debt using Zimbabwe as a case study.

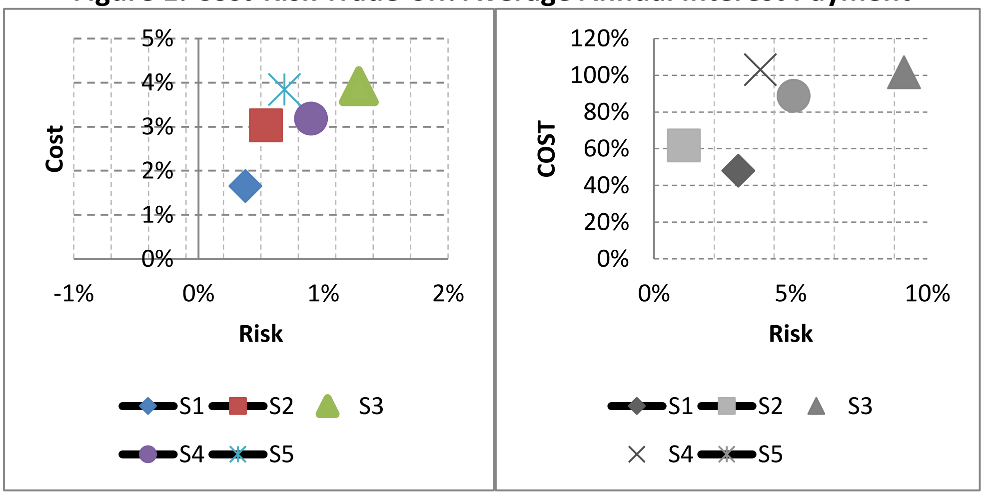
Methodology

The assessment was based on four strategies that can be pursued by the Zimbabwean government: Strategy 1 (S1), reliance on highly concessional external debt; Strategy 2 (S2), pursue domestic market development; Strategy 3 (S3), large proportion of commercial external borrowing, Strategy 4 (S4), complements (S3) with international bond issuance; and Strategy 5 (S5), is a well balance strategy. The optimal composition of public debt was derived by simulating the future debt servicing cost and variability of debt service based on assumptions about Zimbabwe's macroeconomic outlook and its perspectives on borrowing options going forward

Results and Analysis

The results are shown in figure below:

Figure 1: Cost-Risk Trade-off: Average Annual Interest Payment



Source: Researchers own computation

[1] Disclaimer: The views expressed in this paper are those of the author and do not necessarily coincide with those of the Reserve Bank of Zimbabwe or Nelson Mandela Metropolitan University, Port Elizabeth.
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The results from the scatter diagram suggest that the strategy which is mainly composed of concessional external debt (S1) to be the preferred public debt composition using the average annual interest expenditure to GDP as a cost measure. However, the results using the net present value of public debt to GDP as a cost measure show a trade-off between a debt strategy with more concessional external debt and the one with more domestic debt (S2). While the strategy with more concessional external debt remain preferable from a cost perspective, it proved to be riskier than a debt composition with more domestic borrowing for market development purposes. The other strategies are calibrated to be high risk strategies, due to a combination of the impact of a shock in interest rates and exchange rate. The risk from a shock in interest rates is lower for strategies with more concessional loans, since they are normally contracted at fixed interest rates, compared to non-concessional loans which are largely contracted at variable interest rates.

Overall, the simulation analysis shows the strategy which maximizes the recourse to concessional debt, should be the preferred public debt strategy for Zimbabwe in the medium term as long as authorities can expedite the re-engagement process with international financial institutions. However, given the sustained limited access to external concessional loans and the slow process of re-engagement with traditional creditors, the domestic market development strategy could be re-evaluated, particularly if the country's fiscal position strengthens, providing some scope to absorb the additional interest costs from domestic debt issuance.

Policy Implications and Recommendation

The results in this paper support the notion that developing economies are exposed to exchange rate risk since they are not in a position to borrow abroad in their own currency. This phenomenon has been referred to as the "original sin". This underscores the need for development of domestic debt markets. However, the switch to domestic borrowing, presents important trade-offs that needs to be taken into consideration. Domestic borrowing can improve the efficiency of the allocation of national savings if mobilised resources are used to fund public investment. In the case of Zimbabwe, increasing the proportion of domestic debt may not be feasible under the multi-currency regime given the country's limited ability to influence monetary aggregates. The market development can only become feasible if the country's fiscal position strengthens, providing some scope to absorb the higher interest cost. The strategy of increasing the share of the domestic debt in public debt also requires the country to pursue prudent macroeconomic policies to help reduce the cost, by reducing the credit risk premium. There is also the need to create sufficient fiscal space to accommodate the higher costs. Mechanisms should also be put in place to ensure proper coordination between public debt management and other macroeconomic policies.

Although, in practice it is difficult to establish the optimal public debt strategy with a high degree of accuracy, the results from this study provide information that would allow cost-risk comparisons of public debt issuance and increases knowledge of the options and constraints facing debt management operations in Zimbabwe. The analysis can also be used to illustrate the medium to long-term conditions under which prospective public debt issuance strategies would lead to desirable outcomes of minimising costs subject to a prudent degree of risk. This is necessary to avoid the costly errors of accumulating public debt to unsustainable levels.