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Debt Overhang and Small Business Growth in Zambia: Historical Dynamics, Transmission Mechanisms, and Policy Pathways

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Abstract

Zambia's recurring encounters with sovereign debt distress, spanning the structural adjustment era of the 1980s and 1990s, the Heavily Indebted Poor Countries (HIPC) completion of 2005, a second wave of debt accumulation from 2011 to 2020, and the Eurobond default of November 2020, have produced lasting macroeconomic scars that extend well beyond the public sector balance sheet. This paper examines how successive debt overhangs have impaired the growth trajectory of Zambia's small and medium enterprise (SME) sector through four principal channels: (i) fiscal crowding out of private sector credit, (ii) persistently high lending rates driven by elevated policy rates and the risk premium embedded in government borrowing, (iii) currency depreciation and imported input cost inflation, and (iv) the contraction of public expenditure that would otherwise generate demand for SME goods and services. The paper further introduces a fifth, underanalysed transmission channel: the structural failure of monetary policy to transmit to the segment of the financial system, non-bank financial institutions, microfinance institutions, savings and credit cooperatives, and salary-backed lenders, that most directly serves SMEs and lower-income borrowers. This segment, which mobilises substantial public deposits and dominates SME and household lending in volume terms, operates on fixed-rate pricing models that are largely decoupled from the Bank of Zambia's Monetary Policy Rate. Borrowers in this segment therefore derive no benefit from monetary policy easing, regardless of the scale or frequency of rate reductions. The paper documents the significant post-distress macroeconomic recovery of 2025 and 2026, including declining inflation, successive monetary policy rate cuts to 13.25 percent, falling government securities yields, record foreign exchange reserves, and the landmark June 2026 Eurobond buyback, and assesses the extent to which these gains have, and have not yet, translated into improved SME financing conditions. It argues that while macroeconomic direction is favourable, the structural architecture of SME credit access remains deeply inadequate, and proposes a targeted policy agenda to convert macroeconomic momentum into firm-level investment and employment.

1. Introduction

The relationship between sovereign debt and private sector development has generated substantial scholarly attention since the seminal contributions of Myers (1977) on debt overhang and Jensen and Meckling (1976) on agency costs of debt. At the macroeconomic level, Reinhart and Rogoff (2010) identified a non-linear relationship between public debt and growth, suggesting that beyond certain thresholds, debt accumulation becomes self-defeating. For developing economies, the costs of debt overhang are especially acute because institutional buffers which are deep capital markets, well-capitalised development finance institutions, and diversified export bases, remain underdeveloped hence amplifying the transmission of fiscal stress into the real economy.

Zambia represents a compelling and instructive case study of recurring debt overhang in sub-Saharan Africa. Since independence in 1964, the country has experienced at least three distinct episodes of severe public debt distress: the copper price collapse and external shock period of the 1970s-1990s, the post-HIPC relapse driven by infrastructure borrowing and Eurobond issuance from 2012-2020, and the COVID-19-accelerated default of November 2020, which locked the country out of international capital markets for approximately four years. Each episode has left visible imprints on the macroeconomic environment within which Zambia's small and medium enterprises must operate.

SMEs constitute the backbone of Zambia's non-mining economy. They account for the overwhelming majority of registered businesses, contribute substantially to formal and informal employment, and represent the primary vehicle through which economic diversification beyond copper extraction might be achieved. Yet the SME sector has chronically underperformed its potential, constrained by a credit market in which government borrowing competes aggressively with private sector demand and in which commercial banks have systematically under-served the SME segment.

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A distinctive analytical contribution of this paper is the identification of a structural monetary policy transmission failure that has received insufficient attention in the Zambian development finance literature. The Bank of Zambia's Monetary Policy Rate, adjusted progressively from a crisis peak to 13.25 percent by May 2026, signals the cost of money to commercial banks that anchor their lending rates to interbank market conditions. However, a substantial and largely unremarked segment of Zambia's financial system operates entirely outside this transmission mechanism. Non-bank financial institutions (NBFIs), microfinance institutions (MFIs), savings and credit cooperatives (SACCOs), and salary-backed lenders collectively mobilise public deposits and extend credit to SMEs and households at fixed rates that are set administratively or contractually, without reference to the monetary policy rate. When the MPC cuts the policy rate, borrowers in this segment, who are disproportionately the SMEs and individuals the development agenda most seeks to reach, receive no benefit whatsoever. The monetary easing is, from their perspective, invisible.

The paper further examines the significant post-distress recovery gains registered in 2025 and 2026. By mid-2026, Zambia's macroeconomic landscape had shifted materially: inflation returned to the Bank of Zambia's 6 to 8 percent target band, the monetary policy rate had been progressively cut to 13.25 percent, 91-day Treasury bill yields had fallen to approximately 10.75 percent, and the landmark Eurobond buyback of June 2026, retiring the US$1.36 billion 2053 bond through a combination of AfDB concessional financing and own resources, with US$275 million committed to grid resilience, demonstrated proactive and sophisticated liability management. Yet despite these gains, structural barriers to SME credit remain, and deliberate policy interventions are urgently required to translate macroeconomic recovery into firm-level opportunity.

The remainder of the paper is organised as follows. Section 2 reviews theoretical and empirical literature. Section 3 traces the historical evolution of Zambia's debt challenges. Section 4 analyses the transmission mechanisms from debt overhang to SME growth constraints. Section 5 introduces the monetary policy transmission failure as a distinct structural impediment. Section 6 examines the 2025-2026 post-distress recovery. Section 7 presents policy recommendations and Section 8 concludes.

2 Theoretical and Empirical Framework

2.1 The Debt Overhang Hypothesis

The concept of debt overhang was initially developed in the context of corporate finance by Myers (1977), who demonstrated that when a firm's existing debt obligations are sufficiently large, equity holders may be unwilling to invest in new, positive net present value projects, since the returns would accrue principally to creditors rather than shareholders. At the sovereign level, Krugman (1988) and Sachs (1989) extended this framework to show that when a country's debt stock is expected to exceed its repayment capacity with high probability, the expected debt service acts as a tax on future output, discouraging both domestic and foreign investment.

Reinhart and Rogoff (2010) provided influential empirical support for the debt-growth nexus, finding that public debt levels above 90 percent of GDP are associated with significantly lower median growth rates in advanced economies, with even lower thresholds applicable to emerging and developing economies. Subsequent work by Caner, Grennes, and Koehler-Geib (2010) identified a threshold of approximately 77 percent of GDP for developing countries, beyond which debt accumulation becomes negatively associated with economic growth. In the African context, Ndoricimpa (2017) confirmed the non-linearity of the debt-growth relationship, while Kobayashi (2015) highlighted the particular role of debt overhang in depressing productive investment.

For Zambia specifically, Daka, Phiri and Phiri (2017) demonstrated that foreign debt produced a short-term positive effect on growth but that long-term debt accumulation was negatively associated with growth. Studies covering the 1970-2017 period found evidence of a non-linear relationship between sovereign debt accumulation and growth in Zambia, with rising debt-to-GDP ratios above 40 percent negatively correlated with economic performance.

2.2 Monetary Policy Transmission in Shallow Financial Systems

The textbook model of monetary policy transmission assumes that a central bank's policy rate adjustments propagate through the interbank market to commercial bank deposit and lending rates, and thence to borrower investment decisions and aggregate demand. This transmission chain is well-documented in developed economies with deep interbank markets, active secondary bond markets, and predominantly variable-rate lending. In developing economies with shallow financial systems, however, the chain is routinely interrupted at multiple points. Mishra, Montiel and Spilimbergo (2012) systematically documented the weakness of monetary policy transmission in low-income countries, attributing it to structural characteristics including concentrated banking systems, thin interbank markets, high levels of government securities in bank portfolios, and the dominance of non-bank financial intermediaries outside the monetary transmission mechanism.

For Zambia, the African Development Bank's analysis of the bank lending channel of monetary policy transmission identified significant lags and incomplete pass-through from the policy rate to commercial bank lending rates, attributable to the dominance of government securities in bank balance sheets and the consequent anchoring of cost of funds to Treasury bill auctions rather than to the MPC signal. Analysis published by Canary Compass (2025) confirmed that Zambia's genuine kwacha-originated private credit stands at only 7.4 percent of GDP, and that commercial banks hold government securities equivalent to 51 percent of their local currency deposits, a structural configuration that means monetary policy signals propagate first and most fully to bank balance sheets already dominated by government paper, rather than to private sector lending rates.

The problem this paper highlights is a further tier of transmission failure that sits below the commercial banking system. Even accepting the partial and lagged transmission from the MPC rate to commercial bank lending rates, a substantial volume of SME and household credit is extended not by commercial banks but by non-bank financial institutions, microfinance institutions, cooperatives, and salary-backed lenders, entities that are structurally and contractually insulated from the monetary policy signal entirely.

2.3 SME Finance Constraints in African Context

The broader literature on SME finance in sub-Saharan Africa highlights the structural character of credit constraints facing small firms. Beck, Demirguc-Kunt, and Maksimovic (2005) established that financing obstacles are particularly binding for small firms in developing economies, constraining their investment, growth, and employment generation. Antwi et al. (2013) and Rahman et al. (2019) similarly identified inaccessibility to capital as the most frequently cited barrier to SME contributions to national growth. In Zambia, Banda (2024) documented that SME credit constraints encompass inadequate collateral, limited borrowing capacity, high interest rates and processing fees, and stringent procedural requirements, barriers that are significantly amplified during periods of debt overhang, when the aggregate availability of credit to the private sector declines and its cost rises.

3 Historical Periodisation of Zambia's Debt Overhang

3.1 The First Debt Crisis: Structural Adjustment and the Lost Decades (1975-2005)

Zambia's initial encounter with sovereign debt distress originated in the collapse of copper prices in the mid-1970s. Through the 1980s and 1990s, Zambia's external debt grew to levels that were ultimately unsustainable. By 1998, Zambia's external debt had reached an extraordinary 207 percent of Gross National Income and 715 percent of export income, ratios that placed the country among the most heavily indebted nations in the world. Debt repayments during this period consumed between US$160 million and US$250 million per year, a sum exceeding total government expenditure on health and education combined. The macroeconomic consequence was a prolonged period of fiscal austerity, currency depreciation, elevated inflation, and suppressed public investment that created deeply hostile conditions for private enterprise.

Zambia reached the HIPC completion point in April 2005, achieving the cancellation of approximately US$6.6 billion in debt obligations, a watershed moment that restored debt ratios to manageable levels and freed substantial fiscal resources for social investment. For SMEs, the HIPC completion implied a potentially improved fiscal environment, though the depth of the preceding structural damage to formal and informal enterprise meant that recovery would be gradual.

3.2 The Second Debt Accumulation Cycle: Infrastructure Borrowing and Eurobond Issuance (2011-2020)

Zambia's post-HIPC recovery coincided with a commodity supercycle that drove copper prices to historic highs between 2006 and 2012. Buoyed by strong export revenues, Zambia's debt-to-GDP ratio declined to approximately 22 percent by 2011. In 2012, Zambia successfully issued its first Eurobond, a US$750 million instrument that attracted bids worth more than 15 times the amount offered. However, fiscal expenditure expanded rapidly, driven by ambitious infrastructure investment alongside a growing public sector wage bill, generating successive deficits. A second Eurobond of US$1 billion followed in 2014 and a third of US$1.25 billion in 2015. By 2016, Zambia's debt-to-GNI ratio had reached 74.9 percent and the IMF had classified the country as at high risk of debt distress.

Total public debt grew from approximately US$4.25 billion in 2010 to US$30 billion by 2020, an increase of over 600 percent within a single decade. As debt service costs consumed an ever-growing share of government revenue, fiscal space for productive expenditure contracted. Severe droughts in 2018-19 compounded these pressures, and the Zambian kwacha became the world's second-worst performing currency in 2019. For SMEs importing raw materials, equipment, or finished goods, the currency collapse directly elevated costs and reduced competitiveness.

3.3 Default and Restructuring (2020-2024)

In November 2020, Zambia defaulted on a US$42.5 million Eurobond coupon payment, becoming the first African country to default on sovereign debt during the COVID-19 pandemic era. Credit rating agencies immediately downgraded Zambia to default status. In February 2021, Zambia formally applied for debt restructuring under the G20 Common Framework. The process proved protracted, spanning approximately 3.5 years. In March 2024, Zambia agreed to restructure its US$3 billion in Eurobonds, creating two new longer-dated instruments, including a US$1.36 billion bond maturing in 2053. The IMF Extended Credit Facility arrangement, totalling US$1.7 billion over six reviews completed in 2025, provided a structural anchor for fiscal reform.

4 Transmission Mechanisms from Debt Overhang to SME Growth

4.1 Credit Market Crowding Out

The most direct mechanism through which Zambia's debt overhang has suppressed SME growth is the displacement of private sector credit by government borrowing. Following the 2020 default and exclusion from international capital markets, the Zambian government became entirely dependent on the domestic financial system to fund its budget deficit. The resulting issuance of Treasury bills and government bonds at yields of 16 to 17 percent, or higher during the most acute phase, provided commercial banks with an asymmetrically attractive alternative to SME lending. Government securities carried zero credit risk from a capital adequacy perspective, offered attractive yields, maintained high liquidity, and required minimal monitoring. SME lending, by contrast, required significant credit assessment, collateral management, and recovery infrastructure while carrying higher default probabilities.

Analysis of Zambia's banking system reveals the structural depth of this problem. By 2017-2018, approximately half of kwacha deposits were allocated to government securities, a ratio that persisted through the debt distress period. The top twenty borrowers in the commercial banking system took 60 to 65 percent of the aggregate loan book, with a significant further share allocated to salary-backed lending to civil servants, effectively a secured claim on the government payroll. This left genuinely productive SME lending as a residual and relatively small component of bank portfolios. The practical consequence for Zambian SMEs was that credit, when available at all, was priced at rates exceeding 40 percent per annum, levels incompatible with the business models of most enterprises in Zambia's thin-margin trade, agriculture, and services sectors.

4.2 Interest Rate Transmission Through the Commercial Banking System

Beyond the quantum of credit available, the price of credit has represented a distinct barrier. The Bank of Zambia's monetary policy rate, elevated to contain inflation during periods of currency weakness and fiscal pressure, set a floor for commercial lending rates far above the cost of capital at which SMEs could generate investable returns. When the IMF conditionality associated with the Extended Credit Facility required maintenance of high interest rates, reaching 26 percent at the policy rate level in 2022, the transmission into commercial lending rates effectively priced out the vast majority of Zambia's formal SME sector.

Critically, even within the commercial banking system, the transmission of policy rate changes to lending rates has been demonstrably incomplete. Canary Compass (2025) documented that non-retail deposits in Zambia move largely independently of the policy rate, responding more to liquidity and sovereign funding pressures reflected in Treasury bill auctions. Since cost of funds anchors itself in the bill market rather than in the policy rate signal, lending rates cannot fall meaningfully unless the cost of funds falls, and the cost of funds falls only when government domestic borrowing requirements decline. This structural feature significantly attenuates the credit access benefit to SME borrowers of any given monetary policy rate reduction.

4.3 Currency Depreciation and Import Cost Inflation

Zambia's debt overhang has been associated with persistent kwacha depreciation, reflecting deteriorating external debt service capacity, declining foreign exchange reserves, and commodity price volatility. For SMEs dependent on imported inputs, the depreciation of the kwacha directly elevated operating costs and compressed margins. Unlike larger enterprises with access to hedging instruments or dollar-denominated revenues, most Zambian SMEs bear currency risk entirely on their income statements. The 2019 episode, the kwacha ranking as the second-worst performing global currency, was particularly damaging for SMEs engaged in manufacturing, construction supply, and retail trade. The subsequent inflationary pressures, which drove headline inflation above 20 percent and food price inflation above 18.6 percent at various points during the crisis, further eroded household purchasing power and compressed consumer demand for SME goods and services.

4.4 Fiscal Expenditure Contraction and Demand Effects

As debt service obligations consumed a growing share of government revenue, the resources available for public investment in infrastructure, healthcare, education, and social protection declined. For SMEs, these expenditure contractions matter in two respects. First, public infrastructure, roads, electricity supply, water systems, directly affects the cost structure and operational viability of small businesses. Zambia's power outages and road deterioration during the fiscal austerity periods imposed real cost increases on SMEs. Second, the contraction of public sector wages, transfers, and social spending reduces household purchasing power and aggregate demand, reducing revenue for the SMEs that serve household consumption needs. In Zambia, where a significant share of formal employment is in the public sector and where salary-backed lending represents a major consumer finance channel, fiscal austerity translates directly into reduced consumer spending.

5 The Structural Failure of Monetary Policy Transmission: The Non-Bank Segment

The four transmission channels documented in Section 4 are largely familiar in the macroeconomic literature on debt overhang and private sector development. This section introduces a fifth and distinctly under-analysed structural impediment: the fundamental disconnection between the Bank of Zambia's monetary policy rate and the lending rates charged by the non-bank financial intermediaries that constitute the dominant credit channel for Zambia's SMEs and lower-income households.

5.1 The Architecture of Zambia's Non-Bank Lending Sector

Zambia's financial sector comprises two structurally distinct credit market tiers. The first tier consists of commercial banks, eighteen licensed institutions as of the period under review, that fund themselves primarily through customer deposits, access the interbank market for liquidity management, and broadly anchor their lending rates, with significant lags and only partial pass-through, to market signals including Treasury bill yields and the Bank of Zambia's policy rate. This tier primarily serves larger corporates, public sector employees through salary-backed products, and a limited subset of formalised SMEs that can meet collateral and documentation requirements.

The second tier consists of approx.. 117 registered non-bank financial institutions, including 35 microfinance institutions, two building societies, one savings and credit institution, leasing and finance companies, and a substantial number of informal or semi-formal savings and credit cooperatives (SACCOs). Beyond these registered entities, numerous unregistered lending institutions, employer-based loan schemes, and salary-based lenders operate in the market, each mobilising deposits or collective savings and deploying them as credit. This second tier serves the overwhelming majority of Zambia's SME borrowers, lower-income households, civil servants seeking supplementary credit, and informal economy participants who cannot access commercial banking products. In volume terms, the non-bank segment constitutes the primary credit channel for the segment of the population that monetary policy is most urgently needed to reach.

5.2 Fixed-Rate Lending and the Decoupling from Monetary Policy

The defining structural characteristic of the non-bank lending segment, and the one that produces the monetary policy transmission failure this section addresses, is the prevalence of fixed-rate lending that is set administratively or contractually without reference to the Bank of Zambia's policy rate. Microfinance institutions, SACCOs, and salary-backed lenders typically price their loan products at a fixed monthly or annual rate that reflects their cost of funds (largely fixed-rate deposits or member contributions), their operating costs (which are substantial for high-touch, high-volume, small-ticket lending), their credit risk provisions, and their required margins. Once a loan is originated at a stated rate, that rate does not adjust in response to changes in the monetary policy environment.

This fixed-rate characteristic is not inherently problematic in isolation, fixed-rate lending provides payment certainty to borrowers during periods of rising rates. The problem is systemic and asymmetric: it operates entirely to the detriment of borrowers. When the monetary policy rate rises, as it did sharply from 2022 through 2024, fixed-rate NBFI and SACCO borrowers do not benefit from their fixed rates being locked below rising market rates because lenders immediately originate new loans at higher fixed rates reflecting the new cost environment. Existing borrowers are trapped at whatever rate they originally contracted, and when they need to roll over or renew, they refinance at the new, higher fixed rates. Conversely, when the monetary policy rate falls, as it has done from November 2025 through mid-2026, new borrowers continue to receive loans priced at fixed rates that embed the full risk premium and cost structure of the crisis period, because lenders have no mechanism or regulatory incentive to reprice their products downward in response to monetary easing. The consequence is a structural one-way ratchet: monetary tightening transmits into the non-bank segment through repricing of new originations, but monetary easing does not.

5.3 The Scale of the Transmission Gap and Its Consequences for SMEs

The practical magnitude of this transmission failure is significant, and its regulatory history is instructive. In January 2013, the Bank of Zambia introduced interest rate ceilings on non-bank financial institutions, setting a maximum effective annual lending rate of 42 percent for MFI-designated NBFIs and 30 percent for other non-bank financial institutions, in direct response to documented instances of pre-ceiling MFI rates exceeding 100 percent per annum. However, empirical evidence rapidly revealed that the caps had severe unintended consequences. Research by Quirk (2023), using a difference-in-difference methodology, found that lenders bound by the interest rate restrictions reduced loan volumes by 53 percent compared to unconstrained lenders, and that lenders priced furthest above the cap reduced lending by up to 60 percent. Critically, lenders responded by shifting interest income into fees by 20 percentage points, a structural distortion that persisted even after the restrictions were lifted. Faced with evidence of severe credit market contraction that effectively withdrew access from the most vulnerable borrowers, the Bank of Zambia abolished the interest rate ceilings in 2015. Since their removal, no binding regulatory upper limit on NBFI lending rates has been in place. The non-bank lending segment has therefore operated in a largely unregulated pricing environment for over a decade, with no ceiling constraining rates upward and, critically, no mechanism linking rates downward to the monetary policy rate. Effective annual rates charged by MFIs and salary-backed lenders commonly remain in the range of 30 to 60 percent or above, depending on the institution and product structure, irrespective of prevailing monetary policy conditions. When the Bank of Zambia reduces the MPR by 75 basis points, a borrower paying 48 percent per annum from a salary-backed NBFI lender continues to pay 48 percent per annum. The rate cut, from this borrower's perspective, is entirely invisible.

For Zambian SMEs, this transmission failure has direct implications for investment capacity and growth. A small manufacturing or agribusiness enterprise that finances working capital through an MFI or a SACCO at 36 percent per annum cannot reduce its financing cost by switching to a commercial bank, because the commercial bank will not lend to it, it lacks the collateral, the audited financials, or the credit history that commercial bank underwriting requires. The SME is therefore captive to a non-bank lending segment that is structurally impervious to monetary policy signals. When the government and the Bank of Zambia announce progressive monetary policy rate reductions as evidence of improving conditions for business, the announcement is accurate for the commercial bank segment, it is largely irrelevant for the non-bank segment that most SMEs depend upon. This creates a gap between macroeconomic policy communication and the lived experience of SME borrowers that is deeply problematic for both policy credibility and for the actual pace of SME recovery during the current post-distress period.

5.4 Regulatory and Institutional Dimensions of the Problem

The monetary policy transmission failure in the non-bank segment is not simply a market outcome; it has regulatory and institutional dimensions. The Bank of Zambia's 2013 to 2015 interest rate ceiling experiment provides a cautionary lesson. The caps were introduced with legitimate consumer protection intent but produced severe credit market contraction, drove lenders to recoup income through opaque fee structures, and were ultimately abolished as the cure proved worse than the disease. The post-2015 environment of deregulated NBFI pricing has restored loan volumes but at the cost of any regulatory mechanism that might link NBFI lending costs to the broader monetary policy environment. The result is a structurally unregulated pricing segment that intermediates public deposits and extends credit to the most financially excluded borrowers, while operating entirely outside the monetary policy transmission chain. Three features sustain this disconnection. First, the cost of funds for non-bank lenders, primarily fixed-rate member deposits in cooperatives or fixed-rate wholesale borrowing by MFIs, does not respond to changes in the interbank rate or the MPR because these institutions do not primarily participate in the interbank money market; their funding reprices only slowly and partially in response to broader market rate movements. Second, the operating cost structures of MFIs and SACCOs, high relative to commercial banks due to the small ticket size, geographic dispersion, and intensive monitoring requirements of their borrower portfolios, create a genuine cost floor below which lending rates cannot fall without threatening institutional viability. Third, competitive pressure in the non-bank lending segment is insufficient to drive product repricing in response to monetary easing, because borrowers lack the mobility, information, and alternative access that would discipline lender pricing. The challenge for policy is therefore not to reimpose blunt rate ceilings, which evidence has shown to be counterproductive, but to design more sophisticated linkage mechanisms that transmit the direction of monetary policy into the non-bank segment without triggering the credit market contraction that discredited the earlier ceiling regime.

The IMF's 2024 Article IV Consultation documentation noted that NBFIs in Zambia charged higher interest rates than banks but were observed to be more active in passing on interest rate reductions than commercial banks in certain contexts. This observation, while partially reassuring about the direction of adjustment, does not resolve the structural problem: even if NBFIs eventually adjust their rates in the direction of monetary easing, the adjustment is significantly delayed, partially transmitted, and, critically, not binding on fixed-rate products already outstanding. The IMF further stressed the need to strengthen monetary policy transmission to anchor inflation expectations and supported efforts to deepen financial markets, an implicit acknowledgement that the current transmission architecture is inadequate.

6 The Post-Distress Recovery: Gains Registered in 2025 and 2026

Zambia's macroeconomic environment in 2025 and into the first half of 2026 presents a markedly different picture from the distress years of 2020 to 2023. A confluence of deliberate policy measures, successful multilateral engagement, improved fiscal performance, and favourable external conditions, particularly copper prices hitting record highs above US$13,000 per metric ton in early 2026, has produced the most favourable macroeconomic environment for SME recovery in over a decade.

6.1 Inflation Reduction and Price Stability

Inflation control has been one of the most striking features of Zambia's post-distress recovery. After peaking during the acute crisis period, headline inflation declined steadily through 2025. The Bank of Zambia's MPC statement of February 2026 confirmed that inflation fell from 12.3 percent in September 2025 to 11.2 percent in December 2025, before declining further to 9.4 percent in January 2026. By April 2026, inflation had fallen to 6.8 percent, returning to the Bank of Zambia's 6 to 8 percent target band for the first time since before the debt crisis. The IMF's post-ECF staff visit confirmed the target band achievement and projected an average of approximately 8.5 percent for 2026. The African Development Bank projected a further easing to 9.3 percent over the full year as revised figures embed drought-related base effects, declining further to 7.2 percent in 2027.

The drivers of inflation reduction have been structural and policy-based. A record maize harvest in the 2024-25 agricultural season drove food prices down after the drought-induced shortfalls of 2023-24. Kwacha appreciation, with the kwacha emerging as the best-performing currency in Africa in 2026, lowered the cost of imported goods. Continued monetary tightening, with the Bank of Zambia maintaining the policy rate at 14.5 percent through mid-2025 while inflation remained above target, demonstrated commitment to price stability that anchored expectations.

6.2 Monetary Policy Rate Reductions and Declining Government Securities Yields

The progressive easing of monetary policy from late 2025 onward represents a direct positive development for the SME credit cost trajectory. The Bank of Zambia reduced the Monetary Policy Rate by 25 basis points in November 2025, its first cut since August 2020, then by a further 75 basis points to 13.5 percent in February 2026, and by a further 25 basis points to 13.25 percent at its May 2026 MPC meeting. The central bank's projections anticipate inflation averaging 6.8 percent in 2026, suggesting room for continued cautious easing.

Government securities yields have followed the monetary policy rate downward. The 10-year government bond yield declined to 18.22 percent by late October 2025, the lowest since November 2017, representing a decline of 624 basis points over twelve months. Short-term government securities experienced even sharper yield compression: 91-day Treasury bill yields fell to 10.75 percent in April 2026, down materially from crisis-era peaks. This yield compression is important for the SME credit market because it reduces the opportunity cost to commercial banks of lending to the private sector rather than holding government securities. However, and this is the critical qualification, the benefit accrues to commercial bank SME borrowers. The far larger NBFI-served borrower population experiences no direct yield compression benefit, for the structural reasons documented in Section 5.

6.3 GDP Growth and Fiscal Improvement

Zambia's GDP growth trajectory has recovered meaningfully from the contraction of the early default years. Real GDP grew at 5.4 percent in 2023, though the 2023-24 drought interrupted this trajectory, resulting in growth of approximately 3.8 percent in 2024. With the restoration of the maize harvest and improved energy availability, the IMF initially projected 5.2 percent growth for 2025, though this was revised to 3.8 percent by the African Development Bank in May 2026 as ICT, trade, and finance sectors underperformed. Looking ahead, the AfDB projects 5.0 percent growth in 2026 and 6.3 percent in 2027 as energy infrastructure investment begins to yield productivity dividends.

The fiscal position has improved substantially. The primary fiscal surplus reached 3.1 percent of GDP in 2025, enabling a reduction in domestic borrowing requirements that is beginning to ease crowding out pressures. Government debt fell sharply from 133.4 percent of GDP in 2023 to approximately 87.6 percent in 2025, following debt restructuring. Foreign exchange reserves rose to US$6.4 billion by May 2026, covering 4.4 months of imports, supporting kwacha stability and reducing the import cost inflation burden on SMEs.

6.4 The Eurobond Buyback: A Landmark Liability Management Transaction

The most significant single debt management action in Zambia's post-restructuring period occurred in May to June 2026, when the government launched and successfully completed a tender offer to buy back its US$1.36 billion Eurobond maturing in 2053. This bond, created during the 2024 debt restructuring, contained a step-up coupon provision: it carried an interest rate of 0.5 percent annually until the IMF's Composite Indicator reached a debt-carrying capacity threshold of 2.69, at which point the coupon would jump to 7.5 percent and annual interest costs would exceed US$100 million. With the Composite Indicator hovering near 2.6 and Fitch Ratings reconstructing the same indicator at 2.69 using April 2026 World Economic Outlook data, the contingent liability was material.

On 29 May 2026, the government launched a cash tender offer to repurchase the full outstanding bond at approximately 78 cents on the dollar, a total transaction cost of approximately US$1.15 billion, financed through a US$600 million concessional AfDB loan and approximately US$546 million from Zambia's own foreign exchange reserves. By 10 June 2026, holders of 97.85 percent of the bond's outstanding principal had validly tendered, triggering a clean-up provision that allowed full redemption. In a pioneering innovation, the government committed US$275 million of debt service savings to a 15-year National Grid Resilience Programme, the world's first debt-for-development swap focused specifically on energy infrastructure, backed by the AfDB and widely acknowledged as a potential template for other African post-restructuring sovereigns.

For SMEs, the buyback significance is multi-layered. It eliminates a contingent step-up liability that, had it crystallised, would have absorbed fiscal resources otherwise available for SME-support programmes. The investment of savings into energy infrastructure addresses one of the most persistent structural cost burdens on Zambian SMEs: the unreliable and expensive electricity supply that has forced enterprises to invest in costly backup generation. The transaction also signals proactive financial management that improves the investment climate within which SMEs operate.

6.5 Near-Completion of Debt Restructuring and Improved Sovereign Standing

As of mid-2026, the IMF confirmed that debt restructuring agreements cover approximately 94 percent of the restructuring perimeter. S&P Global upgraded Zambia's long-term foreign currency sovereign credit rating to CCC+ from Selective Default, citing copper production growth of 17.8 percent in the first half of 2025 and improved fiscal performance. Foreign exchange reserves at record levels covering over 4.4 months of import cover reduce the risk of disorderly kwacha depreciation, providing a foundation of exchange rate stability that SMEs require to plan and invest with confidence. Discussions for an IMF successor programme focused on growth-oriented reforms are underway, with a potential announcement in the second half of 2026.

6.6 What Has Not Yet Changed: The Unfinished Transmission

Notwithstanding the significant macroeconomic gains documented above, it would be premature to conclude that the post-distress recovery has fully translated into an improved SME credit environment. Commercial lending rates remain far above the levels at which the majority of Zambian SMEs can viably borrow. The transmission of monetary policy rate reductions to SME lending rates has been partial and slow. Government securities yields, while declining, remain attractive enough that banks have not fundamentally rebalanced their portfolios toward private sector credit. Credit guarantee mechanisms remain undercapitalised. And, most significantly for the argument of this paper, the monetary policy rate reductions that headlined Zambia's macroeconomic recovery remain effectively invisible to the hundreds of thousands of SME and household borrowers served by the non-bank financial sector, whose fixed-rate, administratively priced loans continue at unchanged rates regardless of how many times the MPC votes to reduce the policy rate.

7 Conclusion and Recommendations

7.1 Conclusion

This paper has traced the multi-decade arc of Zambia's engagement with sovereign debt overhang and documented its structural consequences for SME development. Three distinct episodes of debt distress, the lost decades of structural adjustment, the post-HIPC relapse of 2011-2020, and the COVID-era default, have each generated macroeconomic conditions that systematically constrained SME access to affordable credit, elevated input costs through currency depreciation, and compressed aggregate demand through fiscal austerity.

A distinctive contribution of this paper is its identification and analysis of a fifth transmission channel: the structural failure of monetary policy to reach the non-bank financial institutions, microfinance institutions, savings cooperatives, and salary-backed lenders that constitute the primary credit channel for the majority of Zambian SMEs and lower-income borrowers. This segment, which mobilises substantial public deposits and extends credit to borrowers that the commercial banking system cannot or will not reach, operates on fixed-rate pricing models that are structurally decoupled from the Bank of Zambia's monetary policy rate. When the MPC reduces the policy rate, as it has done progressively from November 2025 to May 2026, cutting from 14.5 percent to 13.25 percent, the borrowers most in need of relief receive none. The monetary easing is, from their perspective, a policy event that takes place in a different economy.

The post-distress recovery of 2025-2026 has been genuine and in several respects remarkable. Inflation has returned to the 6 to 8 percent target band. Government securities yields have declined by over 600 basis points in twelve months. The fiscal position registered a primary surplus of 3.1 percent of GDP. Foreign exchange reserves stand at record levels. And the June 2026 Eurobond buyback, retiring the US$1.36 billion 2053 bond and committing US$275 million to grid resilience in the world's first debt-for-development swap focused specifically on energy infrastructure, demonstrates proactive and sophisticated liability management that positions Zambia as a credible model for other post-restructuring African sovereigns.

Yet the paper's central argument is that macroeconomic recovery is necessary but insufficient for SME recovery. The structural architecture that determines whether improved macroeconomic conditions translate into expanded SME credit access has not changed materially. More can and must be done. The Bank of Zambia should introduce a regulatory framework requiring NBFIs and MFIs to periodically reprice lending products in line with monetary policy changes, backed by a published sector reference rate that enables borrower comparison and regulatory benchmarking. ZCGS requires further capitalization and extended utilisation. The debt-for-development template should be extended to an SME Development Fund. Credit bureau coverage must expand to extensively capture the mobile and informal economy. And Zambia's structural dependence on copper, the ultimate driver of its recurring debt vulnerabilities, must be addressed through deliberate economic diversification.

The recovery window is open. Whether it translates into durable SME development depends on whether Zambia's policymakers choose to use the fiscal and institutional space that the recovery has created for structural reform, or allow the opportunity to pass, as the post-HIPC window was allowed to pass, without the deeper changes that could break Zambia's cycle of debt vulnerability and private sector under-development.

7.2 Policy Recommendations

The macroeconomic improvements of 2025-2026 have created a policy window that has not existed for Zambia in over a decade. The fiscal surplus, declining domestic borrowing requirements, strengthened foreign exchange reserves, and recovering investor confidence collectively provide policy instruments that were unavailable during the crisis years. The central challenge is whether this window will be used to address the structural SME credit constraints, including the monetary policy transmission failure documented in Section 5, or whether the opportunity will be allowed to pass without the institutional reforms needed to translate recovery into diversified enterprise development.

Reform the Regulatory Framework for Non-Bank Lending Rate Transmission

The history of Zambia's 2013 to 2015 interest rate ceiling experiment provides an essential constraint on how the monetary policy transmission failure in the non-bank segment should be addressed. Blunt rate caps imposed without reference to institutional cost structures caused a 53 percent reduction in NBFI loan volumes, drove lenders to shift income into opaque fees, and were ultimately abandoned. Any policy response to the transmission failure must therefore be designed to transmit the direction of monetary policy into the NBFI segment without reimposing the credit market contraction that discredited the earlier ceiling regime. The Bank of Zambia should pursue a three-part linkage framework. First, it should establish and publish a sector-specific Indicative Non-Bank Reference Rate (INBRR), set monthly, that reflects the MPR plus a standardised allowance for NBFI operating costs and risk, providing a transparent benchmark without mandating its adoption. Second, the Bank of Zambia should require all licensed NBFIs and MFIs to disclose, in their product literature and at loan origination, the prevailing INBRR alongside their own effective annual rate, enabling borrowers to assess the spread they are paying above the reference benchmark. Third, the Bank of Zambia should use its supervisory powers to engage any institution consistently pricing materially above the INBRR without documented cost justification, treating persistent divergence as a potential indicator of market conduct risk warranting supervisory scrutiny. This framework creates market transparency and supervisory accountability without mandating rate floors that proved economically damaging.

The INBRR framework is deliberately non-coercive at the individual transaction level, addressing the core flaw of the 2013 ceiling regime. It does not set a maximum rate, impose mandatory repricing on existing contracts, or threaten institutional viability by compressing margins below sustainable cost floors. Instead, it creates information infrastructure that enables market discipline and regulatory oversight to complement each other. For borrowers, published reference rates reduce the information asymmetry that currently prevents SMEs from assessing whether the rate they are offered reflects legitimate cost structures or excessive margins. For regulators, systematic disclosure creates an audit trail that allows supervisory engagement to be targeted at institutions whose pricing cannot be justified by documented cost structures, rather than applied bluntly across the sector. For the broader policy objective, even partial transmission of monetary easing signals into the non-bank segment, achieved through market transparency rather than price controls, would materially improve the effectiveness of monetary policy as a tool for SME recovery in the post-distress environment.

Introduce Variable-Rate Reference Benchmarks for the NBFI Sector

Complementary to the repricing obligation, the Bank of Zambia should establish and publish a sector-specific reference lending rate for the NBFI and MFI market, analogous to the Kenya Banks' Reference Rate or India's Marginal Cost of Funds-based Lending Rate (MCLR) framework, that translates the MPR into a sector-appropriate floor rate, incorporating an allowance for the higher operating costs and risk profiles of non-bank lenders. Publishing this reference rate monthly, with transparent methodology, would provide both a benchmark against which regulators can assess NBFI lending rate reasonableness, and an information tool that enables borrowers to identify lenders whose rates are materially above the reference benchmark. Over time, published reference rates create competitive pressure that complements regulatory requirements and reduces the information asymmetry between lenders and SME borrowers who currently have no means of assessing whether the rate they are being offered reflects legitimate cost structures or excessive margins.

Actively Manage the Transmission of Monetary Easing to Commercial Bank SME Rates

Within the commercial banking segment, the Bank of Zambia should complement rate cuts with a structured disclosure framework requiring commercial banks to report quarterly on the differential between their average SME lending rates and the policy rate, the proportion of their loan portfolio allocated to SMEs, and year-on-year changes in both indicators. Public disclosure of this data would create reputational and competitive pressure on banks to narrow spreads and expand SME lending. Additionally, the Bank of Zambia should consider differentiated reserve requirements or capital adequacy treatment for verified SME loan portfolios, analogous to approaches adopted in Kenya, Ghana, and India, that create a prudential incentive for banks to increase SME credit allocation alongside macroeconomic stabilisation.

Substantially Recapitalise and Operationally Transform the Zambia Credit Guarantee Scheme

The Zambia Credit Guarantee Scheme Limited (ZCGS) is structurally the most direct policy lever available to expand SME credit access without waiting for commercial banks to spontaneously rebalance their portfolios. In its current form, ZCGS is insufficiently capitalised to materially affect the risk-return calculus of commercial bank lending. The government, in partnership with the AfDB, the IFC, and other development finance institutions, should pursue a structured recapitalisation of ZCGS that brings its guarantee capacity to a level comparable with peer schemes in Kenya, Rwanda, and South Africa. Alongside further capitalisation, ZCGS's operational model should be modernised: streamlined guarantee issuance timelines, clear default claims processing protocols, and digitised application interfaces would reduce transaction cost friction that has historically deterred both lenders and SME borrowers from accessing guarantee products.

Redirect Bond Buyback Savings to an SME Development Fund

The government's debt-for-development swap that retired the 2053 Eurobond and committed US$275 million to grid resilience is a creative precedent that should be systematically extended. As Zambia continues to manage its debt maturity profile proactively and generates ongoing debt service savings, a proportion of those savings should be explicitly ring-fenced for an SME Development Fund, capitalised at not less than US$100 million over five years, that provides concessional working capital and term finance to SMEs in targeted productive sectors. Agriculture processing, light manufacturing, construction supply, and digital services represent sectors in which SME development would simultaneously advance economic diversification and reduce copper dependence.

Strengthen Credit Information Infrastructure

The inadequacy of Zambia's credit information ecosystem is a structural barrier to SME lending that macroeconomic recovery does not automatically address. The Zambia National Financial Inclusion Strategy II (NFIS II) already treats stronger credit infrastructure as a national priority, calling for an integrated digital data warehouse and better use of alternative information to support MSME and household lending. The gap is one of implementation. The Bank of Zambia should accelerate the extension of mandatory credit bureau reporting to mobile money lenders, microfinance institutions, and NBFIs, dramatically broadening the pool of credit data available for SME assessment. Alternative data-based credit scoring models that leverage mobile money transaction histories, utility payment records, and tax compliance data should be developed and piloted, generating credit scores for SMEs that lack formal financial statements.

Address Structural Economic Dependence on Copper

The deepest policy recommendation is structural and long-term. Zambia's recurring debt crises are fundamentally traceable to the economy's dependence on copper, a commodity whose price volatility creates recurring fiscal shocks that manifest, in sequence, as currency depreciation, inflation, monetary tightening, and crowding out. Each element of this transmission eventually impairs SME growth. The diversification of Zambia's revenue and export base, through deliberate investment in agro-processing, manufacturing, tourism, and digital economy sectors, would reduce the economic system's sensitivity to copper price cycles and create a more resilient foundation for sustained SME development. The post-restructuring recovery window, supported by a fiscal surplus and strengthened reserves, provides the most favourable starting conditions for diversification investment that Zambia has enjoyed since the post-HIPC period. The government should resist the temptation to use this window primarily for consumption expenditure or short-cycle electoral spending and instead prioritise productive investments that generate the economic diversification Zambia requires.

Declaration of Competing Interests

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