Mozambique: main economic developments

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Brief notes of our visit to Maputo

Taking into account the relevance of a more local view when evaluating the latest developments on the Mozambican economy, we visited Maputo for several days, in anticipation of our next country report. In a nutshell, we were able to confirm the tighter restrictions faced by the country in 2016, triggered by the fall in commodity prices since mid-2014, among other negative developments with an adverse impact on economic confidence. Despite some improvements at the end of the past year, driven by the rebound of Vale's coal exports, the Metical's appreciation, and the benefits of a highly restrictive monetary measures, the institutions and firms interviewed continue to highlight various weaknesses in the Mozambican economy. Among others, locals referred the weak judicial system, red tape, infrastructure bottlenecks and shortage of skilled labour. In addition to these structural factors, current weaknesses were underscored: difficult access to financing (given the high interest rates and tight credit restrictions), Government liquidity constraints, and lack of confidence by international donors. Having said this, it is our conviction that Mozambique has passed the worst point of the recent crisis and that authorities have been taking the most adequate measures in terms of economic policy in order to deal with this challenging situation.

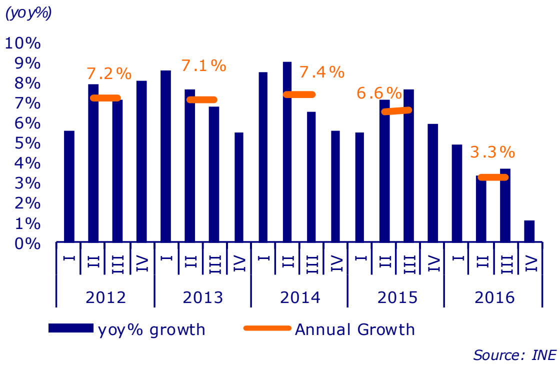
In 2017, expectations are of a recovery and a broadly more positive and sustainable trend, although economic growth is most likely to come short of the solid pace observed in the past. At the same time, the country should face various challenges during this year: negotiation of the deal with creditors to restructure part of the external debt; reaching an agreement with the IMF for a new program; gradual elimination of fuel subsidies; subsiding, but still mildly active political and military tensions; uncertain evolution of commodity prices in international markets; maintenance of a scenario with liquidity restraints for the Mozambican State; still uncertain timing of the final investment decisions in gas projects; recovery of international credibility, in particular from the donors' community point of view. However, it is important to note some positive signs, namely the recent Bank of Mozambique's decision: the Central Bank decided to adopt a less restrictive monetary policy, given the more benign evolution of both inflation and the exchange rate. Additionally, exports continue to perform well, increasing almost 35% yoy in Q1 2017, boosting the net international reserves to levels superior to USD 2 billion in the first week of April.

1. Main developments in 2016

2016 was marked by a sharp economic deceleration in Mozambique. In fact, economic growth slowed down to 3.3% in 2016, from 6.6% in 2015, driven by lower commodity prices, a drop in foreign direct investment, adverse climate conditions and the depreciation of the Metical.

Fiscal consolidation, forced by the Government's liquidity constraints (on account of the freeze in financial support by international donors), had a similarly negative effect on economic activity. The suspension of financial assistance by international donors happened in two different moments: (i) in the first instance, at end-February, in line with the charges of human rights abuses by Mozambique; (ii) in April, the disclosure of an additional amount of public external debt acted as a spark, with an impact of around USD 1.4 billion, deteriorating the confidence of donors in the country. This last decision was a relevant turning point for the Mozambican situation.

Economic activity slowed down significantly in 2016.



Source: INE

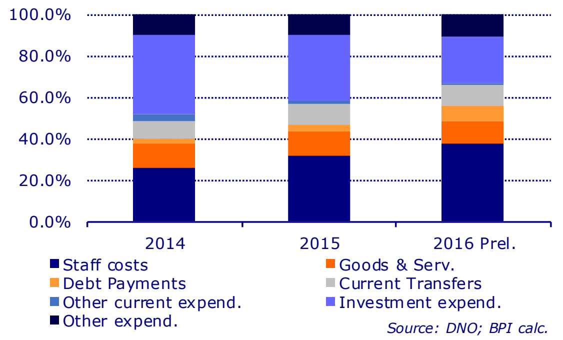
Grants have a significant importance to the State Budget of Mozambique. In 1996/97, the direct State Budget support by the donors' community financed 60% of the gap between Government revenue and expenditure (the rest of the deficit being financed by internal and external credit and surpluses from previous years); more recently, this share decreased to 30%/40%. Donor funding assumed three different forms: (i) direct State Budget support; (ii) program aid; (iii) support to individual projects. The Nordic countries have an important role in the direct state budget support; USA, on the other hand, give more financial assistance to projects. According to official bodies, the freeze in donors' support affected mainly the first two forms. Given the lower flows of financial support, the Government revised the initial State Budget for 2016, reflecting these liquidity constraints for the whole year. In this way, public expenditure reduction assumed a mandatory nature: ongoing projects remained in course, while others which had not started yet were suspended. However, some sectors were less affected than others, namely energy, agriculture, tourism and infrastructures, considered priority sectors.

The disclosure of additional external public debt, the ensuing impact on confidence and withdrawal of donors, added to the downward pressure which was already felt on the currency. The freeze in financial support from donors, lower foreign direct investment and a drop in prices of the main exported commodities caused a large decrease in foreign exchange inflows. In fact, the Bank of Mozambique reported net international reserves of USD 1.66 billion in October, a minimum since 2009, while in the same month of 2015 these amounted to USD 2.18 billion. Foreign exchange shortages, reflected in the daily activity of the banking sector, constrained the ability of firms to import goods and led banks to create "waiting lists".

Due to the structure of the Mozambican economy, which relies heavily on imports, the depreciation of the Metical was swiftly reflected in higher consumer prices. In fact, there was a significant acceleration in inflation, from late 2015 through 2016, with the rise in prices averaging 20%, fostering the loss of purchase power by the population. Additionally, climbing political and military tensions, conditioning the movement of people and goods, diminished the availability of several products and induced supply side pressures. At the same time, adverse climate conditions also exerted pressure on the inflation rate, due to a decrease in the availability of food.

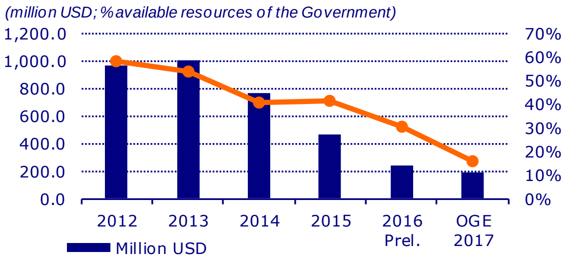
To counter the shortage of foreign currency, the drop of the Metical and the consequent surge in prices, the Bank of Mozambique adopted a highly restrictive monetary policy over 2016. Confidence in the authorities was low, in a scenario prone to speculation: bets in September and October were on the significant depreciation of the domestic currency. With the change of Governor in the Bank of Mozambique in September, the behavior of the central bank changed, assuming a different, more aggressive course which helped to curb speculation on the currency. The effects of the more restrictive monetary policy were positive, reducing liquidity, increasing interest rates and refraining credit growth. At the end of the year, the Metical started to appreciate. Among other measures, the increase of the required reserves coefficient stimulated the sale of foreign exchange, to respond to the need of constitution of reserves in domestic currency. The Government's approval of an external audit to the three main public enterprises (EMATUM, MAM and Proindicus) also contributed positively for the exchange rate's recovery. Considering this framework, the peak of the crisis should have occurred by the end of Q3 2016, and now the tendency is of normalization, albeit gradual and with various risk factors in the near term.

Debt burden reflects the weight of external debt and currency depreciation.

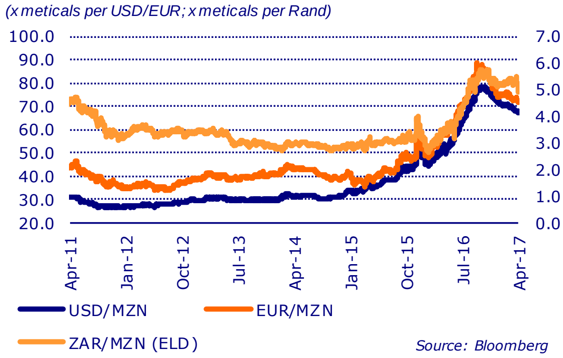


Source: DNO; BPI calc.

Grants decreased, in line with the withdrawal of international donors.

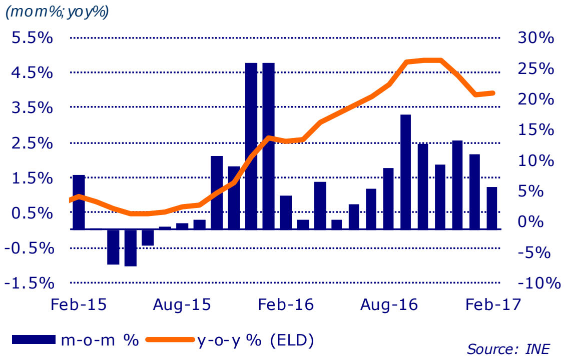


Metical was under pressure in 2016; recently, it recorded a reverse trajectory.



Source: Bloomberg

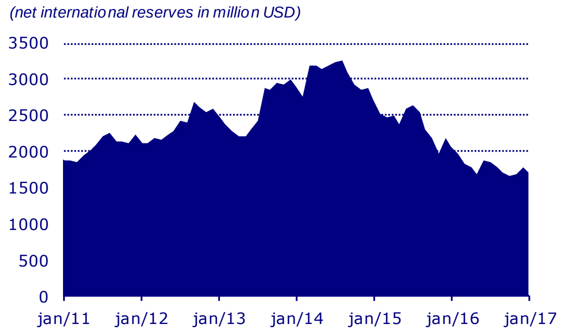
Inflationary pressures started to follow a descending trend at end-2016.



Source: INE

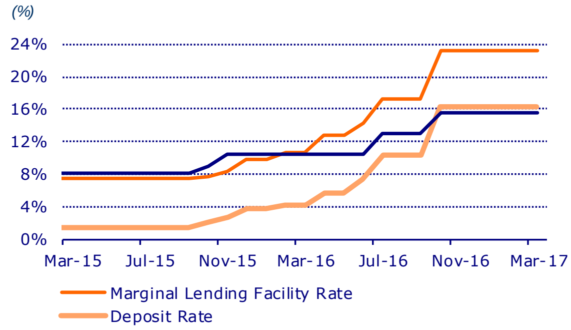
The restrictive monetary policy has naturally caused a substantial increase in interest rates. In fact, the highest rates in credit operations, reported by the Bank of Mozambique, recorded 31.7% on average in 2016; the minimum rates registered 16.3%, on average. The subsequent financial environment was naturally more restrictive for corporations: financing was available only at high cost and, at the same time, the banking sector augmented required guarantees. The increase in the minimum reserves also diminished the amount of credit available to the economy. In addition, firms felt difficulties related with the more restrictive fiscal policy, as the Government had to reduce sharply its expenditure. Overall, there is the perception that these factors affected mostly small and medium-sized enterprises, given its higher dependence on bank credit to get financing and due to the impact of a slowdown in their activity; although there is no official figures on this phenomena, anecdotal evidence suggests that these companies were, in many cases, forced to reduce staff. Admittedly, larger companies should had not been so negatively impacted due to their lesser dependence on banking credit and also because these firms have typically better negotiating capacity, thus obtaining relatively better financing conditions. Given the restrictive economic scenario described and the very adverse economic and financial conditions, the quality in credit should have deteriorated, in line with the sharp increase in interest rates, the slowdown in activity and the liquidity constraints of the Mozambican Government; according to the most recent official data from the Bank of Mozambique, the NPL ratio stood at 5.7% by January 2017 and the short term trend is expected to continue to be adverse, although very gradual.

Shortage of foreign exchange led the Central Bank to increase the required reserves coefficient in 2016.



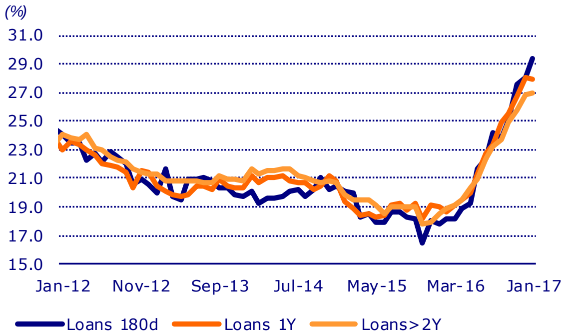
Source: Bank of Mozambique

Monetary Policy rates



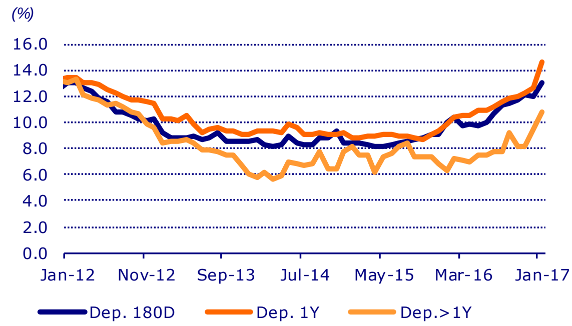
Source: Bank of Mozambique

Average of interest rates on bank loans, by term



Source: Bank of Mozambique

Average of interest rates on deposits, by term



Source: Bank of Mozambique

2. Outlook for 2017

The end of 2016 was marked by the beginning of a turnaround of the economic environment, although economic growth data still pointed towards a strong deceleration of activity in the last quarter of the year. The change in monetary policy stance last Autumn, together with the decisive actions regarding the official budget, towards a more restrictive stance, were both crucial to reverse expectations, induce deceleration of the inflation rate and stabilize the currency. The recovery of exports and specifically the increase registered in coal production since mid-2016 have also been determinant for the economic turnaround and more equilibrated external flows. Indeed, for the year as a whole, Vale Mozambique, that explores the Moatize coal field, recorded a 0.5 million tones (Mt) increase in its production to 5.5 Mt, still below the 10 Mt target announced for 2016. In Q4, production fell by 0.6 Mt in comparison with Q3, in line with the constraints on the import of explosives and restraints in the railroad traffics on the Sena line and Nacala corridor. However, the operations were re-established in December and January, reaching a monthly record of 0.8 Mt in the first month of this year. According to preliminary data, coal exports increased 115% qoq in Q4 to USD 309.6 million, the highest value recorded in the historical series of the Bank of Mozambique. At the same time, it should be noted that the **trade balance recorded a surplus for the first time in the last quarter of 2016**.

The Bank of Mozambique decided to introduce new measures in the first monetary policy meeting of the year, namely the introduction of a benchmark monetary policy rate as of April 15. According to the central bank, this measure intends to bring closer the existing rates practiced in the market. This reference rate will be used in the interventions of the Central Bank in the interbank money market to control liquidity. **At the same time, the Bank of Mozambique launched a reference exchange rate, already in force since April 3.** This rate should result from the exchange rate used by commercial banks in operations with their customers and results from the simple average of the average exchange rates calculated in three moments of each working day: 9:30 a.m., 12:30 p.m. and 3:30 p.m.. **More recently, in April's monetary policy meeting, the Central Bank approved the new interbank MIMO rate (mentioned above) at 21.75%, and decided to decrease the marginal lending facility rate by 50 basis points to 22.75%, signaling the more favorable environment and better balanced flows regarding the currency.** Additionally, the central bank announced that the constitution of required reserves should be made on a 30-days base on average, instead of a daily base, and determined that the minimum share of capital for larger banks should increase to MT 1.7 billion, from MT 70 million at this moment, being the increase made in the next three years. Additionally, the central bank increased the minimum solvency ratio to 12%, from 8% previously, also with a gradual approach regarding implementation. It is still uncertain what will be the impact on financial institutions resultant from these measures. Indeed, **considered as a whole, the package of measures will certainly contribute to strengthen the banking system** while the progressive implementation stance will probably avoid major ruptures, inducing instead, a rational approach to the market prospects of multiple banking institutions that now participate in the market.

Inflationary pressures began to show a downward trend, reflecting the appreciation of the Metical against USD and base effects. This scenario should continue throughout the year, considering the ongoing reversal of currency shortage problems, and climate conditions seem favorable for agricultural production; furthermore, the exchange rate evolution should contribute to smaller import prices, with a favorable impact on the inflation rate; finally, the suspension of political and military tensions also supports this scenario, stimulating mobility and helping to curb supply constraints. On the negative side, the aim to withdraw fuel subsidies, already under way, could impose an upward pressure on the inflation rate, depending also on the progressiveness of the process.

Fiscal policy will remain constrained by the reduction of external financing whereas public administration as a whole will continue to face several challenges. Authorities want to stimulate economic growth, by promoting certain sectors considered as crucial, including agriculture, tourism, energy and infrastructure related projects. However, there are several constraints. In the case of agriculture, the difficulties include the lack of logistics chains, weak infrastructures to drain production, absence of irrigation techniques, poor quality of inputs and the lack of a skilled workforce. At the same time, Government will have to deal with the scarcity of resources, both tax revenues and grants; thus, the effective control of public expenditure will continue to be crucial. Still, the government has been implementing several measures to widen the tax base: for example, it started to computerize processes in various areas, which could contribute to the decrease of the informal economy and an increase in the tax base. At the same time, measures have been taken to seal products (tobacco and non-alcoholic beverages), increase monitoring, introduce tax machines (cash registers) and the possibility to pay taxes using the banking system. Although the budget for 2017 has been elaborated on a more realistic basis than what had happened in 2016, it nevertheless entails some fiscal risks:

- the lack of control of the wage bill;
- debt servicing and the risk of further currency depreciation;
- possible liabilities arising from state-owned enterprises.

On the other hand, the reduction of subsidies – fuels and bread – should accommodate some of these pressures.

3. Conclusion

The short-term outlook for the Mozambican economy has certainly improved and the bottom of the cycle should be behind us. However, the scenario is still constrained by various risks and conditional on the occurrence of certain events. Although the State is trying to regain the trust of its international partners, the Executive missed an interest payment of USD 60 million on its sovereign bond due 2023 (Ex-EMATUM) and Proindicus missed a payment of USD 119 million in March 2017, while two separate negotiations take place: with debt creditors, to achieve debt restructuring, and with the IMF to design a new financing and technical support program. Developments regarding these two issues will be determining investor perception towards the country and the sovereign, along with the public release of the conclusions of the external auditing process to the hidden debts (expected by the end of April).

Another risk factor is related to the expected elimination of fuel subsidies; indeed, public transportation (the so-called "chapas") cost is a sensitive theme for lower-income Mozambicans, as it represents an important share of their incomes. An increase in the prices of "chapas" would increase the cost of living for the poorest and may cause the increase of social tensions. However, authorities are very aware of this problem and have been studying several possible forms to minimize this side-effect. The Government is analyzing the possibility of mitigating this withdrawal, using, for example, subsidies applied directly to the licensed "chapas", or granting social cards (more difficult to implement in our view). Note that there has already been a reduction in the number of "chapas" in circulation and the increase in fuel could exacerbate this decrease.

Regarding official grants, apparently it does not seem to be plausible to expect the former situation to come back. As a first step, authorities will have to regain international credibility so that donors may feel more comfortable in conceding aid to the country. However, in the future, grants should not support directly the budget but instead, they should be directed to projects, ensuring better monitoring and control. In a scenario of sustained reduction of external financing and donations, it is crucial that the Government develops strategies to broaden its tax base, improve public sector efficiency and reduce non-productive expenditure, considering also the need to promote fiscal consolidation, reduce debt but also simulate the economy.

Considering a longer horizon, the outlook for the country remains favorable. Projects related to natural resources appear to have gained a renewed momentum with the entry of ExxonMobil into Area 4. In the case of the offshore base, only the decision of the Chinese partner, China National Petroleum Corporation (CNPC) is lacking in order to proceed with the construction of the floating platform to be produced in South Korea. The final investment decision is expected to be completed in the first half of this year and the platform should be ready and operational by 2022; its production capacity is expected to reach 3.2 million tons per year. This project, in the Coral field, is the one most under way, being also considered the easier to put into operation; other onshore areas, which include the Mamba field and Area 1, are more difficult to implement and therefore more demanding in terms of investment analysis and requirements.

The difficulties experienced in 2016 and its future consequences may have a lasting impact on several sectors of the society: expectations are that the Government will operate with fewer resources, promoting its more efficient use; this should be achieved by promoting measures to broaden the tax base, attempting also to combat the informality of the economy and incentivizing other sectors of the economy (in order to diversify the economy and create more jobs); on the business side, firms that survive this crisis are expected to be more robust in the future, through cost reduction, improvements in governance and a better weighing of their business strategy; in the case of the financial sector, the adjustment period should induce stronger institutions, further cost control and an improved credit risk management.

In sum, the potential of the country continues to be substantial despite the recent slip, given its natural wealth (not only mineral and gas reserves, but also the soil quality and abundance of water), the size and potential growth of its population, and also due to its geographic positioning. In this way, this crisis can be seen as a window of opportunity, fostering a more sustainable growth path and generating well-being for the population.

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