ECONOMIC AND FINANCIAL RESEARCH
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Mozambique intends to restructure its public debt

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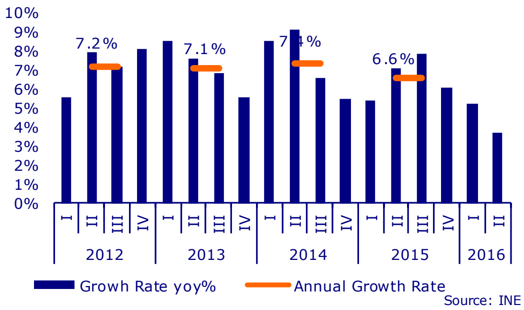
The challenging economic environment in Mozambique deteriorated during 2016: commodity prices remain lower, the domestic currency has been depreciating continuously, the lower confidence of economic agents has restricted foreign direct investment in the country, factors which aggravate the shortage of foreign exchange reserves, making inflationary pressures worse. The main international institutions have worsened their forecasts for the main macroeconomic aggregates; moreover, the recent disclosure of additional external public debt put the Government debt in unsustainable levels and led international donors to freeze the financial support to the country. In this way, and demonstrating that Mozambique is unable to comply with the debt service, the Ministry of Finance published a support document to the external public debt restructuring negotiations, and, thus, benefiting from the IMF financial support. The good news is that this could be the beginning of a more positive scenario for Mozambique, if this process proves to be successful.

Economic Growth decelerated during 2016

The Mozambican economy has been affected by a huge set of adverse factors, which led to an economic deceleration since 2015. Some of these factors have worsened during 2016, which has led some international institutions to revise downwards their projections for the main macroeconomic aggregates. Among these institutions, the IMF and EIU are the most pessimistic, anticipating 3.7% and 3.6% growth rates, respectively. More recently, the Mozambican Government significantly lowered its forecast for economic growth this year, from 7.0% in the initial State Budget for 2016, to 3.9% inscribed in the State Budget (SB) for 2017. Taking into consideration the data published until this moment (4.5% growth rate in the 1H 2016 vs 6.2% in the same period of 2015), this new outlook drawn by the Government is more realistic and in line with our projection for the performance of the economic activity for the rest of the year.

Economic activity has decelerated since mid-2015

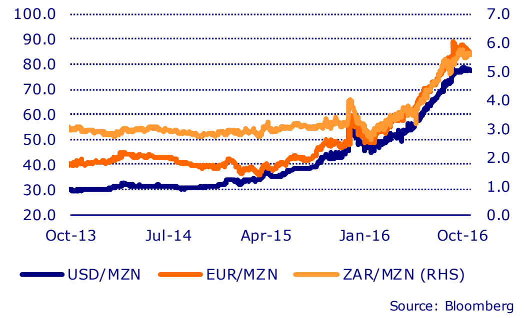
(yoy%; annual rate)



The lower prices for the main exported raw materials, such as aluminum and coal, caused a decrease in export revenues, and, at the same time, made domestic and foreign investment less attractive, particularly the investment based on natural resources. Additionally, **delays in Liquefied Natural Gas (LNG) projects also suspended the implementation of some support services**, which is visible in the reduction of foreign direct investment (FDI). In fact, according to the Bank of Mozambique, FDI dropped 11% on a year-on-year basis in the first half of 2016. However, it is important to note the favorable performance in the FDI related to the megaprojects, with a 32% yoy increase in 1H 2016.

Metical has been under pressure, explained by diverse factors

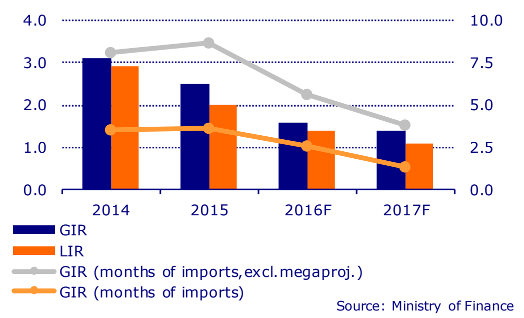
(x meticals per USD/EUR/ZAR)



The effects from the "El Niño" phenomenon, namely the droughts and floods which affected different regions of the country, have constrained the agricultural production. According to the EIU, it is expected that droughts end in the next rainy season in October-December. Nevertheless, this should not be sufficient to recover the crops lost this year. Considering that the next harvest is not expected until March/April 2017 and that 1.5 million Mozambicans are in a food insecure situation (the UN believes that this value is underestimated and pointed to 2.5 million), the shortage of food should intensify the inflationary pressures in the next months.

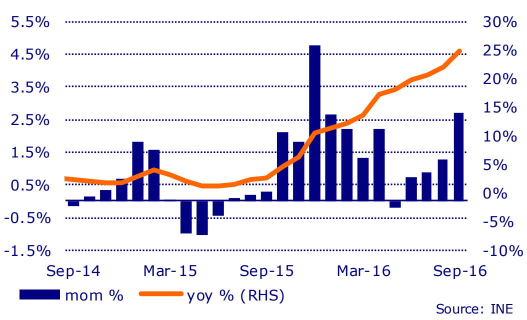
Net and Liquid International Reserves

(billion USD; months of imports)



Additionally, it is important to note **the depreciation that the domestic currency is suffering,** 70% against USD since the beginning of the year. The explanation for this is founded on an insufficient foreign exchange reserves supply for the demand in the economy for goods and services imports, together with the reduction in export revenues, the lower foreign investment flows and the freeze of financial support from the international donors (including the IMF). **This decrease in foreign exchange reserves has put pressure on the exchange rate and the amount of international reserves.** According to the Bank of Mozambique, the amount of reserves reached USD 1.7 billion in September, which compares unfavorably with the maximum of USD 3.3 billion in mid-2014.

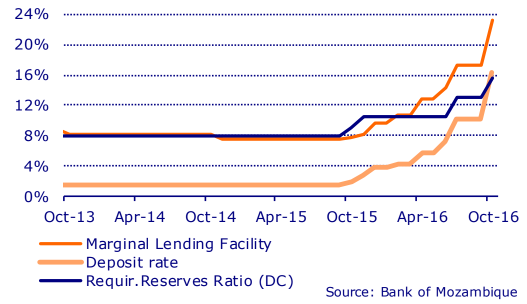
Inflationary pressures intensify, in the context of drought and depreciation of the Metical



The military and political tensions do not help to improve the confidence that Mozambique needs to attract foreign direct investment. This has been one of the factors responsible for the restricted movement of goods and services, putting pressure on the inflation rate. At the same time, despite the attempt of peace agreements, the Nacala corridor was attacked recently by Renamo, according to local news. This corridor is used by firm Vale and it is an important instrument to coal exports from Moatize mine.

The acceleration of the inflation rate in the last months (in September, the annual inflation rate increased by 2.97 percentage points to 24.9%) led the real interest rates in the country into negative territory. This performance, as well as the excess of liquidity in the economy, the need for a more transparent process of exchange rate formation and the deterioration of international reserves, were the factors behind the decisions taken by the Central Bank in the last October's monetary policy meeting: (i) increase the marginal lending facility rate by 600 basis points (b.p.) to 23.25%; (ii) rise the deposit rate by 600 b.p. to 16.25%; (iii) soar the required reserves ratio in domestic and external currency by 250 b.p. and 50 b.p., respectively, to 15.5% in both cases, starting in November 22; (iv) mandatory commercial bank's report about the exchange rates used in the transactions with the public, three times a day, starting immediately; (v) limiting the access of commercial banks to the resources provided by the marginal lending facility; (vi) ensure that the monetary base does not exceed MT 103.2 billion.

BoM increased significantly the monetary policy rates



▫ State Budget for 2017: the consolidation effort seems weaker than expected.

The proposal of State Budget for 2017 (SB 2017) assumes a more favorable economic environment than the context observed during 2016. The Government expects an acceleration in the real GDP growth rate to 5.5% in 2017, from 3.9% anticipated for this year. At the same time, prices should increase at a slower pace, though still expected to rise at double-digit levels (15.5%). This more optimistic scenario is explained by a peaceful context expected by the Government, a background more favorable to the foreign direct investment, an improvement in the current account and a recovery in confidence of international financial partners. The fiscal policy for 2017 is based on three objectives: (i) fiscal consolidation; (ii) more effectiveness in raising domestic revenues; (iii) proper allocation of resources, in order to increase the disposal of goods and services essential for the population and investment.

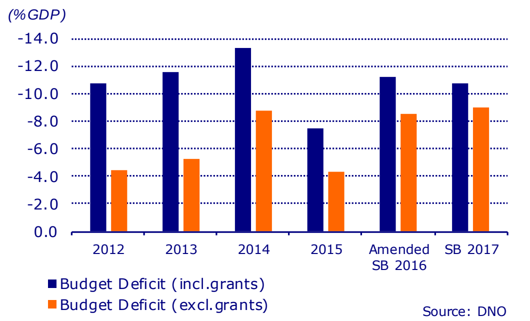
Macroeconomic Assumptions for the State Budget 2017

	2015	2016 F	2017 F
Nominal GDP (billion MT)	589.3	694.5	802.9
Real GDP growth rate	6.6%	3.9%	5.5%
Inflation rate (aver.per.)	3.6%	18.0%	15.5%
Liq.International Reserves (months of imports)	4.1	3.0	3.1
Exports (billion USD)	3.4	3.2	3.5
Population (million)	25.7	26.4	27.1

Source: State Budget for 2017.

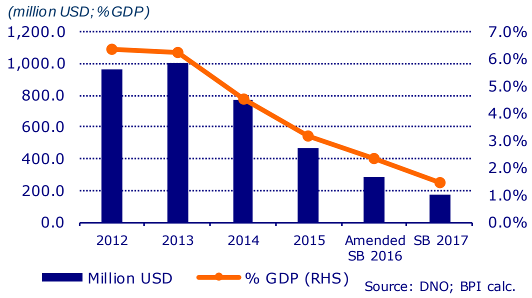
It is expected that total revenues increase almost 13% in comparison to the Revised State Budget for 2016. The tax revenues should continue to represent the high majority of Government revenues, expecting an 8% increase, reflecting an improvement in tax burden (through the revision of customs tariff and the VAT code, and more control, especially in the case of firms related with natural resources). However, and taking into account the fragile economic context, it is expected that corporate income taxes drop by almost 9% in comparison to this year.

Evolution of budget deficit (excluding and including grants)



The total expenditure should increase almost 12% in 2017, when compared to this year. The main driver of this is the significantly increase with interest by 78%, mainly due to the depreciation of the domestic currency and the great external component of debt (around 80% of total debt). The Government expects that the ratio of interest spending in percentage of GDP may increase from 2.2% in 2016 to 3.4% in the next one. **Despite the aim of expenditure restraint, it is possible to see an increase in staff costs and in goods & services.** In the first case, the Mozambican Executive mentioned the intention to reduce the number of new hires in the public sector, except in some priority sectors (education, health and agriculture).

Evolution of Grants



Source: DNO; BPI calc.

Note: BPI calculations, considering the average of exchange rate. For 2016 and 2017, we used the EIU's forecasts.

The budget deficit in 2017, before grants, should improve in comparison to this year; however, and considering a 23% drop in grants anticipated by the Executive, a deterioration in deficit is expected (after considering this heading) from 8.6% in 2016 to 9.0% in 2017.

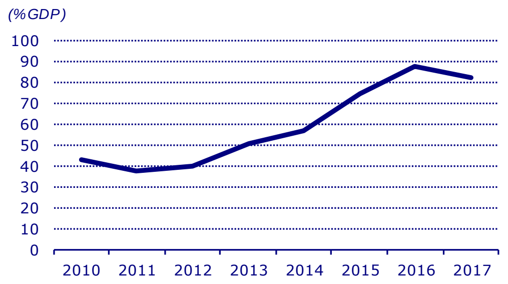
- **Discussion with commercial creditors for a debt restructuring**.

The Mozambican Executive intends to initiate discussions with commercial creditors (loan and bond holders), in line with the need to restructure the external public debt and secure its sustainability, essential to agree on a new financing program with the IMF. In this regard, document which serves as a support to the presentation to creditors was released, in line with the values of transparency and the efforts of a collaborative approach, which we consider a positive signal in the relationship between Mozambique and its creditors.

This document is based on a more pessimistic economic outlook than anticipated in the State Budget for 2017. In fact, in the text, the Ministry of Finance anticipates a 3.7% growth rate for this year. **Additionally, the Ministry called the attention for the deterioration of external position, as well as the increasing pressure on public finances.** The factors underlying it include the suspension of financing from the IMF, the freeze of financial support from the international partners and the climb of gross public debt (in this document, it is expected that public debt may reach 130% of GDP at end-2016, including the liabilities related to MAM and Proindicus). **For the short and medium term, the risks are negative**: (i) further depreciation of the Metical, which made the country more vulnerable to the exchange rate shocks, given the great weight of external debt on total public debt and the heavy reliance on imports; (ii) risks around the potential contingent liabilities for the Government, from four state-owned enterprises (M-Cel, LAM, Petromoz e EDM); (iii) further delays in fuel reforms may represent an additional risk given the high levels; (iv) instability in the financial sector (Moza Bank suffered an intervention process recently).

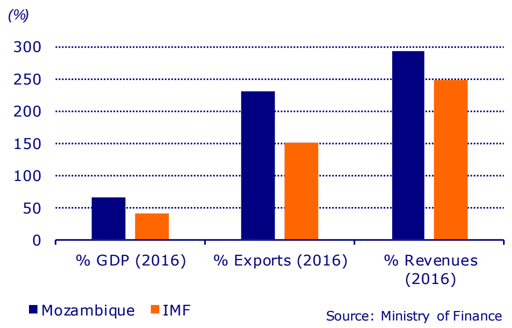
According to this document, the Government should not be able to fulfill with the debt service in 2017. In fact, the capacity for external public and publicly guaranteed commercial debt service (considering the primary budget balance, domestic and external financing, interests and fuel subsidy arrears from 2016) should reach MT 25.5 billion in 2017. However, the bilateral and multilateral debt service should reach MT 26.2 billion in this period. In this regard, and considering the intention to apply to the IMF for an additional financing, the Mozambican Government called the attention for the need to restructure a portion of external debt for making it

Gross Public Debt has surged significantly



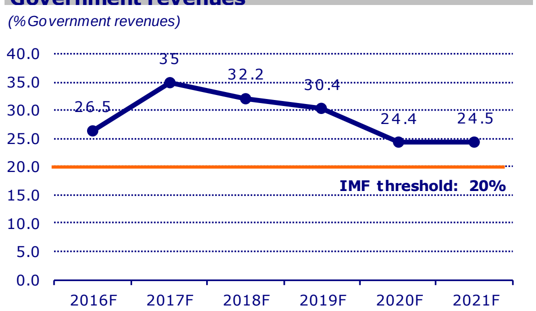
Source: IMF

PV of Public and Publicly Guaranteed (PPG) external debt and the IMF thresholds for lower-income countries



Source: Ministry of Finance

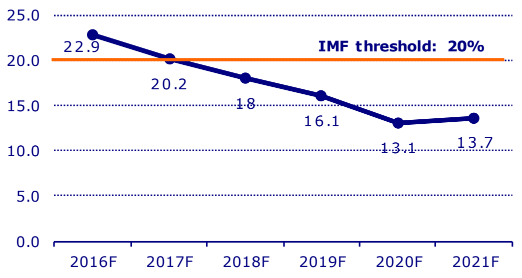
External PPG debt service in percentage of Government revenues



Source: Ministry of Finance

sustainable. **According to the Government, at this moment, the country breached all the IMF's thresholds for a sustainable debt, and it should not reverse the situation in the medium term.** The sustainability of debt is an essential factor to proceed with conversations with the IMF, as well as the already initiated independent audit to the EMATUM, Proindicus and MAM (perceived as positive by Moody's). The debt restructuring, which should include these three firms, may assume a haircut form, a maturity extension (possibly for after 2021, when it is expected that liquefied natural gas exploitation initiate) or a combination of the two possibilities. The other option includes the refusal by the investors and the execution of the guarantees, which we consider less likely. In this scenario, and considering the Government's inability to fulfill its responsibilities, the recognition of huge losses for the creditors is implicit. Taking into account a J.P.Morgan research, commercial creditors only own a 17% of overall external public debt, which means that even if this debt was fully write-off, the country would not reach the 40% threshold for the external public and publicly guaranteed debt-to-GDP ratio defined by the IMF (50.3% according to the J.P.Morgan calculations).

External PPG debt service in percentage of exports



Source: Ministry of Finance

The timetable defined by the Mozambican Government for the debt restructuring seems ambitious, but still possible. The aim is to reach an agreement with the IMF in the beginning of 2017 for a new financing program, which means an approval for a proposed debt resolution by the creditors in December.

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