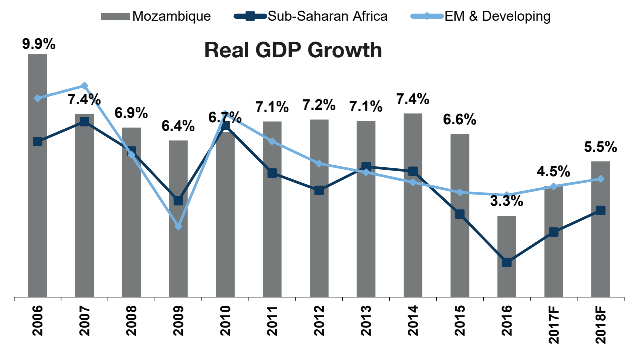
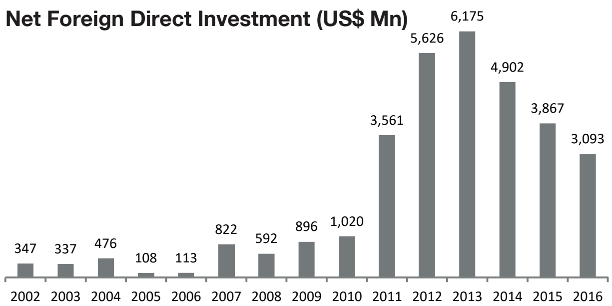
MOZAMBIQUE: THE NEW ECONOMIC REALITY

By **Tiago Bossa Dionisio,** Chief Economist, Eaglestone Advisory, S.A.

Mozambique's international reputation suffered a serious blow after the revelation that the country had contracted previously undisclosed public debts worth nearly 10% of its GDP in April 2016. This news had not only an impact on public debt levels (gross debt rose to nearly 115% of GDP last year from 88% in 2015), but also led to the interruption of international aid flows, a sharp 20% YoY drop in foreign direct investment levels and a marked deceleration in economic activity in the country in 2016. Specifically, real GDP growth slowed to 3.3% from 6.6% in 2015 (and an annual average of 7.4% recorded in 2005-15). Although this is still above the average of 1.4% in Sub-Saharan Africa in 2016, this growth performance is a 15-year low for Mozambique. The hidden debt revelation also contributed to a sharp depreciation of the metical (the local currency), further accelerating inflation levels to multi-year highs above 26% in November 2016.

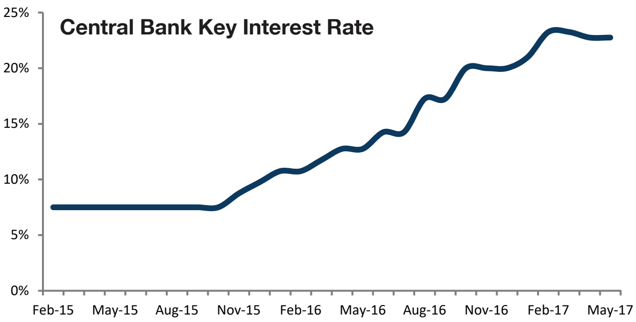


Sources: IMF and Eaglestone Securities.



Source: Banco de Moçambique

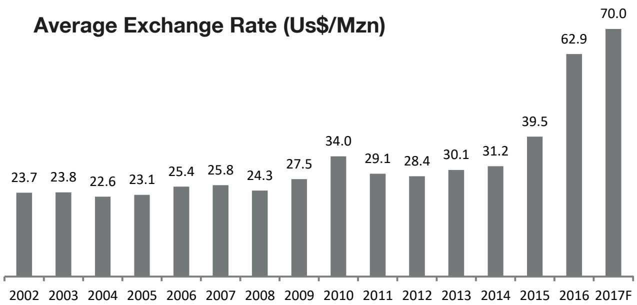
Against this backdrop, the Mozambican authorities have been faced with the herculean challenge of restoring macroeconomic stability in the country during the last year. In the second half of 2016, the government announced a revised 2016 budget, lowering revenue projections and adjusting spending plans. Later in the year, the local authorities alleged to creditors that they could not meet repayment obligations, saying that this would only be feasible when revenues from the gas sector begin to flow into public coffers. This was confirmed in early 2017 when Mozambique missed two loan payments contracted by two state-owned companies, with a third one just missed last month. Meanwhile, at the same time, the central bank aggressively raised its key interest rate by 1,050 basis points in the last year to 23.25% (from only 7.5% in mid-2015) in order to tackle the rising inflationary pressures, only lowering the rate to 22.75% in the last April meeting. The Banco de Moçambique also increased the mandatory reserve requirement for local and foreign currency holdings by unifying both rates at 15.5%.



Source: Banco de Moçambique

Economic activity is only expected to recover slightly to 4.5% in 2017, with growth likely to be almost entirely driven by the minerals sector, and 5.5% next year (the IMF's latest forecasts). Mozambique is likely to continue to face economic headwinds arising from the need for fiscal austerity, but also still unresolved issues related to foreign-exchange shortages and multi-year high inflation. Foreign reserves at the central bank have recently increased to more comfortable levels, approaching four months of imports, and the metical has appreciated nearly 20% against the USD and 15% against the ZAR in the first months of 2017 on the back of higher export earnings and monetary tightening. This is helping to gradually rebalance the foreign-exchange market and ease inflationary pressures. It is unlikely that the local currency will continue to appreciate significantly throughout the year though, as weak capital inflows and sizeable fiscal and external account deficits could exert downward pressure on the metical. Still, higher global coal prices and the improvement in foreign reserves will help the central bank to support the metical in the foreseeable future.

Meanwhile, attentions in the near term should remain on the outcome of the international audit on the country's debt accounts (expected to be published shortly) and whether Mozambique is able to normalise its relations with the IMF. The government is likely to attempt to secure a new economic program from the Fund, but



Sources: Banco de Moçambique and Eaglestone Securities.

discussions will be difficult for the local authorities, as they will depend on the debt audit results and the progress made in the negotiations with private creditors on a proposed debt restructuring scheme. If successful, this should lead to the resumption of international aid flows that will help to further stabilize the local economy as well as support development projects.

Mozambique is one of the most promising countries in Sub-Saharan Africa with a successful track-record in implementing large-scale projects (most of which financed by multilateral institutions and international banks) and a friendly legal framework, namely for foreign investors. Mining has been responsible for a significant part of the foreign direct investment that has entered the country in recent years. Large investments have initially been made in the coal sector, but more recently attentions have turned to the vast natural gas reserves in the Rovuma basin, in the north of the country. This has boosted other sectors such as construction, utilities and real estate.

The natural gas sector will make a substantial contribution to economic growth and exports as well as bring in significant fiscal receipts in the long-term. Both Italy's Eni and Anadarko from the US currently have plans to develop liquefied natural gas (LNG) export facilities in the country. These are not expected to come on stream before 2022, but development work will support growth from 2018. A crucial step in this direction was taken in May when the government approved the project financing arrangements for the LNG offshore project in the Rovuma Basin. This puts Eni, the project developer, on course to reach a final investment decision by the end of 2017.

Although the LNG sector is not expected to transform Mozambique's finances any time soon, it will relieve some of the short-term pressure. Earlier this year, Eni sold a 25% stake in one of its gas fields in the country to ExxonMobil for US$2.8 billion. The transaction is expected to translate into US$350 million (or roughly 3% of GDP) in capital gains tax for the public coffers and is likely to be reflected in the 2018 fiscal accounts.

Mozambique's future fortunes will also depend on its political outlook. The country is currently living a period of truce between the ruling party (Frelimo) and the main opposition party (Renamo) after both recently agreed to a cease fire. The latest news suggests that this cease fire could become permanent, as Frelimo could agree to Renamo's demands for greater regional autonomy. The other issue raised by the opposition has to do with military matters such as the reintegration of Renamo armed forces into Mozambican troops and the separation between political parties and the armed forces. We believe the permanent end to political hostilities between Frelimo and Renamo would be very positive for the country, as it would help improve donor relations and reignite much needed foreign investment inflows.

The next presidential, legislative and provincial elections are scheduled for 2019 while the next municipal elections are due in 2018. Frelimo is likely to continue to dominate the presidential and legislative polls, namely due to its stronghold at the central level. However, provincial and municipal elections could be more contested considering Renamo's intentions to increase its presence at the local level.

All in all, Mozambique's new economic reality presents several challenges for the local authorities, especially in the aftermath of the hidden debt scandal. The policy measures implemented over the last 12 months have had some positive results, as these helped to stabilise the local currency, lower inflation and improve foreign reserve levels. The government's re-commitment to the peace process with Renamo is also a step in the right direction that could help improve donor relations and bring back to the country much needed international aid. However, the task of restoring confidence levels, both domestically and overseas, is not over yet. A lot seems to depend on the outcome of the debt audit and on whether Mozambique will be able to come to an agreement with bondholders about a restructuring scheme.

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Contributor's Profile

Tiago Bossa Dionisio joined EAGLESTONE in 2013. He has over 15 years' experience in investment banking, namely at Banco Português de Investimento (BPI) and later at Espírito Santo Investment Bank (ESIB).

Before joining EAGLESTONE, Tiago was part of ESIB's Project Finance team for two years. Prior to that, Tiago was a sell-side analyst covering the main listed Iberian banks for eight years both at ESIB and BPI. Before that, he was a macro research analyst at BPI for three years responsible for covering Portugal, Spain and several Latin America countries, including Brazil and Argentina.