Standard Bank
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Flash Note

Africa | FI & FX

Mozambique: metical gains may reverse

- **The metical**, trading at 55.5 to the USD at the time of writing, **has gained** 35% ytd, or 22.2% y/y, after closing 2020 at 74.9. **The metical will however likely reverse some of these gains** as exporters have started to put on hold FX conversions and importers returned to the market as they benefited from recent metical gains.
- Therefore, FX liquidity supply/demand dynamics as well as negative sentiment and economic fundamentals **imply unsustainable FX rates** given the historical large current account (C/A) deficit and the diminished outlook for foreign direct investment (FDI) inflows, at least for this year, after a series of terror attacks on Palma since 24 Mar.
- Even considering a relatively low level FDI this year, **we still see the C/A deficit accelerating** towards 29.8% of GDP, from USD4.5bn in 2020, or 27.3% of GDP, as **imports will likely grow faster than exports**.
- Taking into account increased forecast risk and uncertainty related to (i) ongoing security challenges; (ii) policy response uncertainty; (iii) Covid-19; and (iv) climate events, our scenario analysis now sees the **USD/MZN pair closing the year around 60.7 in the bull scenario, 62.4 in the base, and at 70.1 in the bear scenario**. This lowers year-end inflation in the base case to 7.1% y/y, from 7.6% y/y, with **the GDP recovery expected to remain low**, at annual growth of just 1.6% y/y.
- **Numerous factors contributed to the stellar, though counter-intuitive, performance of the metical over the past few weeks**. Here, we include (i) the 300bps policy rate hike last Jan, which further eased import demand; (ii) expectations that Bank of Mozambique (BOM) would support the market by selling foreign currency (FCY) to help stabilize the metical, a clear change from the policy stance in 2020 when the USD/MZN was allowed to rise almost in a straight line through the year as a shock absorber for balance of payments (BOP) pressures and to help protect FX reserves; (iii) importers delaying payments to benefit from the daily appreciation of the metical; (iv) foreign direct investment (FDI) inflows emanating from the resources sector; (v) limited space on commercial banks' balance sheets to store excess FX liquidity given the net open position limit of 20% of capital to cover underlying currency risk; (vi) BOM not buying excess FX liquidity.
- In the last few days, **the USD/MZN pair started to stabilize** as exporters seem reluctant to continue to sell FX at rates below 60, and with importers starting to catch up to pre-empt a rapid correction of FX rates. **However, the magnitude of such FX rate correction remains uncertain.** In the short term, BOM could lend some stability to the MZN by absorbing excess FX liquidity or by supplying whenever the market is short – but this too remains uncertain given the recent trends.
- After all, **FX reserves remain relatively comfortable** at USD4bn, which covers over 6-m of imports. Given the relatively small size of the FX market, it does not require BOM to intervene with large amounts of FX to help stabilize FX rates but it does require flexibility in the approach.
- **We still see FX reserves declining by 7.3% y/y this year**, to USD3.7bn by Dec, from USD4bn currently. The import cover ratio is expected to fall to 5.6 months, from around 6.4 currently. **FX reserves have held quite stable while the MZN appreciated; clearly, there have been limited FX sales from BOM**.

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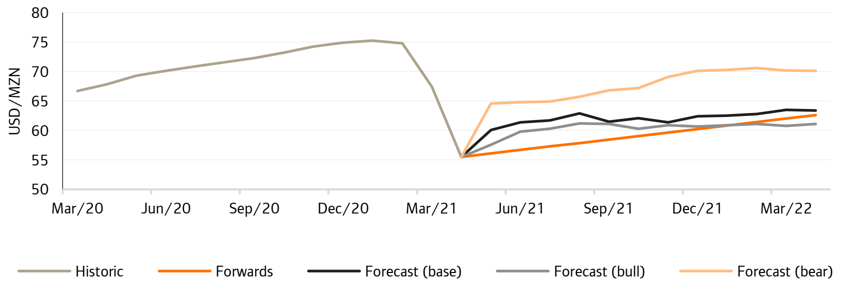
- **FX derivatives** (forward and swap contracts) are now allowed after 30 days' elapse since the publication of the governmental official gazette on 16 Mar of BOM regulations regarding those products. **This too could stabilize the MZN.**
- Our chart below shows that for the 3 to 9 months bracket, importers could take advantage of forward contracts to hedge their FX risk, considering the FX rate forecasts across our base, bull and bear scenarios.
- We believe that **low inflation** through 2020, which had averaged 3.1% y/y, **allowed BOM to take a rigid stance on FX reserves management and tolerate MZN depreciation last year**. The rapid rise in headline inflation since the beginning of the year, last reported at 5.8% y/y in Mar, from 3.5% y/y Dec 2020, was the main driver of the policy rate hike in Jan 20, with MZN appreciation fueling expectations that inflation will remain in single digits.
- The government had managed to avoid an increase in the price of bread, targeted for 1 Apr, as previous FX rates had driven up the cost of imported wheat/flour, which now has been corrected, supporting the stability of the price of bread. Given the current levels of Brent crude above USD/60bbl, an increase in local fuel prices would have been required had the MZN not appreciated.
- **The BOM clearly has a vested interest in seeing a relatively strong MZN to help keep imported inflation low**. The question is: how low it can be sustained given the diminished FDI outlook? Also, Mozambique's export sector competitiveness needs to be addressed for sustainability reasons.
- A humanitarian situation has developed in Cabo Delgado in the wake of numerous terror attacks since 2017, with thousands of families requiring urgent assistance, which, together with security response requirements, **will intensify fiscal pressures**. The likely result here is the **rise in net lending to the government**, which grew by 166% y/y in Feb, **crowding out private sector credit growth.**
- Given subdued aggregate demand and low investment, the rise in prime lending rate to the current level of 18.9%, from 15.5% last Jan, will likely **prevent a further acceleration of local currency private sector credit growth**, last reported at 10.1% y/y in Feb 2021.

USD/MZN: forwards versus forecasts



Source: Banco de Moçambique; Standard Bank Research

Medium-term economic growth base scenario

	Q1:21	Q2:21	Q3:21	Q4:21	Q1:22	Q2:22	Q3:22	Q4:22	Q1:23	Q2:23	Q3:23	Q4:23	Q1:24	Q2:24	Q3:24	Q4:24
GDP (% y/y) pa	-0.4	3.2	2.0	1.6	2.3	2.5	2.4	2.4	3.2	3.4	3.3	3.3	3.7	3.6	3.5	3.6
CPI (% y/y) pe	5.8	7.0	7.8	7.1	5.6	4.4	5.2	6.2	6.4	6.7	6.4	6.7	6.3	6.5	6.7	6.5
MIMO rate (%) pe	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25	13.25
3-m rate (%) pe	13.3	13.3	13.3	13.3	13.2	13.1	13.0	12.9	13.0	13.1	13.1	13.2	13.2	13.2	13.2	13.2
6-m rate (%) pe	13.3	13.4	13.4	13.3	13.4	13.3	13.1	13.1	13.1	13.2	13.3	13.3	13.3	13.3	13.3	13.3
USD/MZN pe	67.5	61.4	61.5	62.4	63.5	63.9	63.4	64.3	64.2	65.4	64.9	65.1	65.7	65.6	66.1	66.3

Source: Banco de Moçambique; Instituto Nacional de Estatística de Moçambique; Bloomberg; Ministério da Economia e Finanças; Standard Bank Research

Notes: pa-period average; pe-period end

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