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ZAMBIA RESEARCH NOTE

Too soon to be counting the chickens

Over the last six weeks, Zambian assets have posted by far the best performance in the frontier markets, with the Kwacha appreciating by 22.5% and the country's benchmark eurobonds tightening by an average of 220 b.p. But ***these spectacular gains are likely to prove fleeting, since the credit fundamentals have actually deteriorated in the interim***[1].

1) March's 22.24% print for annual inflation marked the first deceleration reported in seven months and was therefore greeted as a sign that the intense price pressures choking the economy are at last receding. But **the official statistics raise more questions than they answer**.

2) According to the central statistics office **food prices**, which make up 53.49% of the overall CPI basket, rose by only 0.5% during the month. This nudged the **year-on-year rate for this category down to 26.2% from 26.4%** the previous month.

However, this official picture of quiescent food prices clashes with the reality on the ground. In fact, an acute shortage of maize[2] has driven the cost of the staple mealie-meal **from an average of ZMW 83.49 at end-February to between ZMW 130 and 140 per 25 kg bag**[3] a month later.

3) Yet the table of national average prices for selected items that appears in **the most recent inflation report shows the improbable price of ZMW 85.25 for this item**. If we replace this value with the observed price of ZMW 130, the **year/year change in food prices spikes to 34.56%**[4].

Substituting this result into the equation, CPI = 0.53485 x $\Delta Px_{(food)}$ + 0.0.46515 x $\Delta Px_{(non\text{-}food)}$ produces **a year/year inflation rate of 26.81%**, creating an additional head-wind for the currency.

4) T**he Kwacha's 22.5% gain over the last six weeks therefore warrants close scrutiny** - particularly since real interest rates have declined from +0.82% to -2.31% during this period. As the World Bank's senior economist for Zambia observed recently,

"It's a positive sign to see the appreciation of the Kwacha; it gives more confidence in the economy. But again ***we have to be careful and look at what is causing the rapid appreciation****."*[5]

5) Rather than reflecting any substantive improvement in Zambia's credit fundamentals, the currency's performance is **probably attributable to a series of technical events**[6], primarily:

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[1] The one bright spot: prices for Zambia's copper exports have been improving, but only by 5.4% during the period in question.

[2] El Nino related drought conditions have led to a drastic shortfall in agricultural production throughout southern Africa, forcing such countries as the DRC, Malawi, Mozambique and Zimbabwe to resort to importing maize. A significant, if as yet unquantified tonnage has been exported from Zambia by traders – often operating in collusion with government officials – looking to capitalize on the black-market prices that the product commands in these grain-starved countries. Hence the shift in Zambia's supply-curve and the resulting impact on prices.

[3] In a recent interview broadcast on *Joy-FM*, Geoffrey Mwamba (vice president of the opposition UPND), the surge in mealie-meal prices to "between K120 and K150 per 25 kg bag", a situation which he blamed on mismanagement by President Lungu.

[4] The food sub-index consists of 18 items, of which the first two are varieties of mealie-meal.

[5] Interview on *Africa Pulse*, as quoted in *"Kwacha gain positive sign – WB"* published by *Times of Zambia*, Apr. 11, 2016.

[6] Proceeds from Zambia's ill-advised maize exports may turn out to have been an additional factor.

- a **precautionary unwinding of defensive USD positions** ahead of the IMF's spring session;
- a **draw-down of USD deposits** by local residents[7], in response to the growing shortage of Kwacha liquidity arising from the payment arrears being accumulated by the government[8].

6) Asked to comment on the currency's recent performance, while in Washington D.C. for the IMF/World Bank meetings last week, finance minister Chikwanda merely observed that, *"... **There had been a lot of speculation (against the Kwacha)** prior to the assurances from the mining sector of continued mining activities."*[9]

This was hardly a reassuring explanation of the **Kwacha's explosive run that has now retraced 63% of its steep 2015 depreciation**[10] and should therefore be regarded as susceptible to reversal.

7) Meanwhile, **the IMF has now formally rebutted the notion** that negotiations on a funded programme are to be concluded this month[11], viz.:

"(W)e don't see the full preparation of a program** [that the Zambians would want to take forward] **until the fourth quarter of this year, after the elections."[12]

To the extent that the expectation of an imminent deal has helped fuel the exuberant bid for Zambia's Eurobonds have enjoyed of late[13], the Fund's statement represents **a major reality check that skews the risk/reward balance firmly to the downside**.

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[7] As will be recalled, S&P's most recent ratings statement estimated that approximately 49% of all deposits I the banking system were held in USD.

[8] Arising in respect of civil servant salaries and supplier invoices, these payment arrears reflect the problems that Zambia is experiencing in financing its ballooning fiscal deficit. Based on the PF government's approach in the run-up to the 2015 election, these difficulties are likely to have been exacerbated by a series of unbudgeted outlays designed to win votes.

[9] Press statement issued by Zambia's embassy in Washington D.C., as reproduced in *"Appreciation of the Kwacha due to interventions on the monetary side of the economy - Chikwanda"* in *Lusaka Times*, Apr. 13, 2016.

[10] N.B. the fourth Fibonacci retracement level was at ZMW 9.44 vs. USD.

[11] Floated by the Zambian authorities last month, this proposition always struck us as an absolute canard. See research note, *"The market shrugs off the IMF's warning"*.

[12] Response by the Director of the IMF's African Department during Apr. 15, 2016 press briefing, as reported in *Transcript of African Department Press Briefing*, published Apr. 16, 2016.

[13] All three bonds tightened by approximately 105 b.p. in the two hours after Treasury secretary Fredson Yamba mischievously 'notified', the media on March 18th, that the relevant negotiations would be finalized during the IMF's Spring session