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ZAMBIA RESEARCH NOTE

Assessing the Road Ahead

Given the economic backdrop of high inflation and collapsing growth, Zambia's eurobonds have remained surprisingly buoyant, with only 49 days remaining until the August 11 elections. A major consideration underpinning this price stability appears to be ***the anticipation of an IMF support package*** *materializing within months of the new government being sworn in.*

We believe that such optimism is misplaced *and* ***sets up the market for a potentially significant price correction***.

⇨ Grain prices as a microcosm of economic imbalance

1) On June 17th the government announced that it was raising the producer price for white maize[1] to Kw 85 bag, "after wide consultations with the Ministry of Finance, Bank of Zambia and technocrats".

As recently as May 26th agriculture minister Given Lubinda had insisted that the administered price would remain at the Kw 75 level set for the 2014-16 crop season so, naturally, Zambia's farmers[2] have welcomed the increase.

2) However, this **13.33% increase amounts to less than two-thirds of the CPI's 21.3% rise over the past year**, implying a significant erosion in farmers' purchasing power.

The government's reluctance to authorize a more meaningful price increase is clearly driven by a concern with exacerbating inflation[3] in the run-up to the elections of August 11. But despite its political expediency, the **decision to subsidize food prices at the expense of Zambia's farmers is fraught with unintended consequences**.

3) As a result of the El Nino related drought afflicting southern Africa, **the country's neighbours are reporting a cumulative grain shortfall of 9.6 million metric tons**. The size of this deficit alone would have guaranteed a strong bid for maize from Zambia, the only country in the region with a grain surplus.[4]

But the impact of this pent-up demand will be considerably magnified by the Zambian authorities' irrational – and ultimately self-defeating – pricing decision.

4) At Kw85 per 50 kg. bag, the newly announced producer price equates to USD 154.48 per MT[5], which represents **less than 60% of the USD 259 price that Zimbabwe is reportedly offering** to import grain from its neighbour[6]. This price differential virtually **guarantees a domestic shortage of maize flour - and a corresponding spike in prices**[7] - as local traders divert Zambian grain to regional markets.

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[1] A major food crop for much of southern and east Africa, the grain is ground into maize flour or 'millie meal', a region-wide staple.
[2] As reported by the *Lusaka Times*, the president of the National Union of Small Scale Farmers' Associations reacted by rejoicing that *'President Lungu has heard the pleas of farmers'*.
[3] Currently running at 21.30% (y/y).
[4] Estimated at approximately 650,000 MT metric tons – i.e. 22% of national demand - based on preliminary indications for the 2015/16 crop.
[5] i.e. Using today's exchange rate of 11.005.
[6] See *"Maize floor increased by K 10"* in *Zambia Reports*, June 17, 2016.
[7] As will be recalled, this is precisely what occurred last March (i.e. during the 'lean season' that immediately precedes the harvest), when aggressive exports of locally produced maize triggered a spike of as much as 60% in the price of millie-meal. See Rhombus research note, *"Too soon to be counting the chickens"*, Apr. 18, 2016.

⇨ Elections loom

5) For the administration of President Lungu the immediate preoccupation, evidently, is to secure a fresh mandate at the **elections which are now less than eight weeks away**. Objectively speaking, the latter **task verges on the herculean**, given the incumbent's record of fiscal profligacy[8] and policy inconsistency[9]. An additional hurdle is the fact that Mr. Lungu himself has been conspicuously absent from campaign rallies for almost a fortnight[10] amid persistent rumours of ill-health[11].

These weaknesses are clearly working to the advantage of the United Party for National Development - the principal opposition party[12], led by Hakainde Hichilema – which has been running a vigorous campaign, drawing large, enthusiastic crowds nationwide.

6) Given these inauspicious circumstances, we **expect to see the incumbent make maximum use of the state apparatus** – including the government–owned broadcast and print media[13] as well as the Electoral Commission[14] - while mobilizing the same panga-wielding mobs[15] that were deployed to attack Lungu's rivals in the 2015 race[11].

However, international observers[16] are unlikely to turn a blind eye on such abuses this time around[17]. In our assessment this new reality creates considerable uncertainty as to the outcome of the August elections and **could set the stage for a period of unprecedented political turbulence**.

⇨ Market outlook

7) It is worth pausing here to assess the extent to which the issues highlighted above are reflected in current asset price levels.

On the one hand, **Zambia's local-currency instruments are flashing strong warning signals**. Hailed in mid-April as the world's best performing currency for the year, the Kwacha has since retreated 15.5%[18] and, at Kw11.005= USD, looks poised to test Kw 11.247[19]. Meanwhile, the most recent statement issued by the Monetary Policy Committee notes with considerable satisfaction that **auction subscription rates have risen to 58.1% and 32.5%**, for Zambia's treasury bills and government bonds, respectively.

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[8] After the 2015 fiscal out-turn of -8.1%, all signs point to an even worse deficit this year. Less than two months into the current fiscal year, the administration submitted a bill to almost triple the borrowing ceiling for external loans (to K160 billion), while more than doubling (to K30 billion) the limit for domestic loans.

[9] As will be recalled, the government compounded the impact of the commodity price collapse on the country's vital mining sector by implementing a regime of onerous mining royalties in Dec. 2014. This catastrophic move, which crippled more than USD 1.5 billion in planned investments and cost thousands of jobs, was significantly amended in Feb. 2016.

[10] During this period, Mr. Lungu has skipped scheduled appearances in Kabwata, Kabwe, Ndola, Mongu and Kasama.

[11] As will be recalled, such no-shows were a recurring feature of his last campaign. See Rhombus research note, *"Election count-down"*, Jan. 6, 2015.

[12] While the Electoral Commission has certified a total of nine candidates for the presidency, the race is shaping up to be as much of a two-man race as was the 2015 election in which the front-runners Lungu and Hichilema received a combined 96% of the total vote.

[13] Reportedly under the instructions of Information minister Chishamba Kambwili, these outlets have since February this year maintained a complete black-out on the main opposition party, the UPND – in terms of both news coverage and even paid advertising.

[14] Now conveniently chaired by Esau Chulu, first cousin of former president Rupiah Banda, whose defection from the opposition MMD to the ruling Patriotic Front in Nov. 2014 was instrumental in securing Lungu's 2015 victory. And, in response to the repeated assaults by PF militants upon UPND members and sympathizers the ECZ has adopted the remarkably 'impartial' stance of threatening to suspend all campaigns.

[15] As if to prove the point, on June 13, a UPND rally in Shiwang'andu (Muchinga province) was attacked by armed thugs in almost exact replay of the incident on Jan. 2, 2015 when the former first lady Maureen Mwanawasa and party chairwoman Mutale Nalumango narrowly escaped being lynched.

[16] In its most recent *Country Report on Human Rights Practices*, the State Department notes with regret that *"Although the results were credible, however, media coverage, police presence, and legal restrictions heavily favored the ruling party and prevented the election from being genuinely fair."*

[17] Last February, in what was widely interpreted as a sharp rebuke against the administration's harassment of the opposition, western members of the diplomatic corps in Lusaka attended a luncheon hosted by UPND leader Hakainde Hichelema.

[18] Vindicating the concerns we shared with CNBC on April 22nd – See *"Zambia's currency boosted by 'prayer' but risks still linger"*, posted to CNBC.com on Apr. 24, 2016.

[19] I.e. corresponding to the fourth Fibonnaci retracement level.

8) By contrast, **Zambia's Eurobonds**, which boast among the highest yields among African sovereigns[20], **have remained defiantly buoyant**. As of their June 20th close, the risk premium on the 2024s and the 2027s had **tightened by a total of 379 b.p. and 361 b.p.**[21], respectively from their mid-February peak. Over the same period, the spread on the EMBI global index narrowed by 101 b.p.

In our view, this **relative exuberance is attributable in large measure to the prospect of an IMF support package** materializing in the immediate aftermath of the upcoming election. First mooted by Treasury Secretary Yamba on 18 March[22], this expectation was reinforced by his remarks following the IMF's Spring session in which he anticipated negotiations taking place "in October and November, with talks at board level set for December."[23]

9) Our own inclination is to take these assurances with a pinch of salt. Based on the scale of Zambia's economic imbalances[24], any agreement on an extended credit facility **(ECF) will almost certainly be contingent on a number of front-loaded adjustment measures**. On this score not even the Zambian authorities appear to be under any illusions. As President Lungu himself declared, less than three weeks after Mr. Yamba's assertion of inevitability, viz.:

"If we find that there are conditionalities which we find acceptable, we will work with them. If not, we will throw them out." [25]

10) It is worth recalling that **more than two years have elapsed since Zambia first played the IMF card**[26] in June 2014, sparking an initial burst of euphoria[27]. The move was repeated 17 months later[28], by which time the Kwacha had plumbed new depths and Eurobond spreads had gapped considerably in the absence of any follow-through on the anticipated deal.

In the light of these **cautionary precedents** and, indeed, the ambivalence of local authorities, we have considerable reservations about any investment strategy that is dependent on an IMF support package. We believe there is an elevated risk that a deal fails to materialize in anything like the time-frame indicated, which would **set the stage for a potentially significant correction in Zambian asset prices**.

[20] Exceeded only by the Mozambique 10.5s of 2023 which carry a selective default rating.

[21] I.e. to yield spreads of 1044 b.p. and 1042 b.p. over Treasuries.

[22] As will be recalled, his statement triggered a 4 point spike in the price of Zambia's Eurobonds with a corresponding spread-tightening of around 100 b.p.

[23] *'With respect to Zambia going on an IMF program, the government is fully resolved, as directed by cabinet. This is inevitable.'* – Statement quoted in "*Zambia Prepares Ground for `Inevitable' Post-Vote IMF Aid*"; posted by *Bloomberg* on Apr. 22, 2015.

[24] On the fiscal side alone, these include the creation of five new government ministries in 2015 (ostensibly a year of fiscal consolidation), and the abrupt cancellation of a round of utility price increases aimed at achieving a measure of cost-recovery. In the area of monetary policy, the central bank's stance is too accommodative, as evidenced by CPI-deflated market rates of barely 2% at a time of steady Kwacha depreciation and the continued under-subscription of auctions for government paper.

[25] As quoted in *"Zambia Will Only Take IMF Bailout If Terms Agreeable, Lungu Says"*; posted by *Bloomberg* on May 13, 2016.

[26] It is worth recalling that this was more than two months before Ghana submitted its own request to the IMF. This paved the way for the opening (November 2014) of formal negotiations that culminated in staff-level agreement on an ECF that was ratified by the IMF Executive Board in April 2015.

[27] On June 6, 2014 the Fund confirmed having received a formal request to open discussions on an economic support programme. The news triggered an immediate rally in the Kwacha which, having lost 19.77% since the start of the year, proceeded to gain 15.1% over the next two weeks. The Eurobonds reacted with almost as much enthusiasm

[28] On Nov. 10, the IMF representative in Lusaka confirmed that a team from Washington D.C. was arriving the next day, *"at the invitation of the authorities and as part of the ongoing dialogue"*. Once again, the Kwacha staged an explosive rally on the news, posting a 41% appreciation over the next two weeks.