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FLASH NOTE
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JLo, 1 year later – a reformist beginning, a long way to go

Short-term outlook is far from brilliant, but reforms support positive view

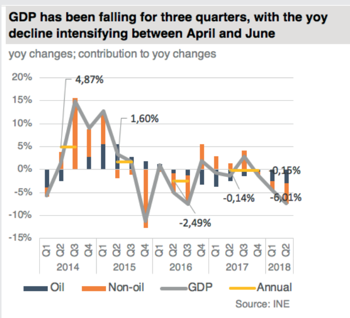
A. DESCRIPTION

1I I João Lourenço has been elected President of Angola on August 23rd of 2017, having served for 13 months and a half now, since September 26th of that same year. We look at how the Angolan economy has been doing under his stewardship, and most of all, we share our expectations following this first year, which has surprised in many ways. Our main conclusion is that, despite a very challenging scenario, his Administration has performed relatively well so far, while embarking on an ambitious reform drive. **Still, perspectives on future oil production mean that a hard road lays ahead, while a continued effort to change the economic environment of the country is badly needed.**

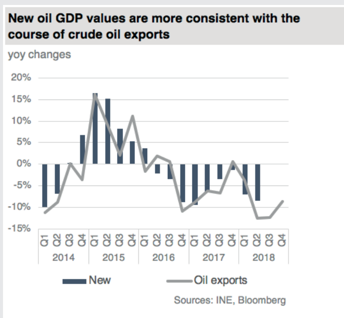
B. ANALYSIS

1 - Having assumed the leadership of Angola in end-September 2017, the economic performance until the end of 2017 is most surely still not influenced by this Administration's policies. Angolan GDP had declined 2.5% in 2016, due to drops in both oil (-2.7%) and non-oil (-2.2%) GDP. However, in 2017, the economy barely dropped (-0.15%): this was a result of a pickup in the non-oil economy (+3.1%), and arguably influenced by the proximity of elections in August 2017; in fact, non-oil GDP grew 4.6% yoy in the first 3 quarters, dropping 1.3% yoy in the quarter following the election - oil GDP continued to decline in 2017 (-5.2% yoy).

2I 2018 is seeing a harsh economic decline, of 6.0% yoy in the first half (H1). Moreover, looking at oil exports programmed until the end of the year, oil GDP will tumble 8-9% this year. Non-oil GDP decreased 5.0% yoy in the first 6 months of the year. The expectation is of a somewhat better performance in the second half of the year, as access to foreign currency has been improving significantly throughout the year; nevertheless, it is hard to imagine that the non-oil economy could compensate for the decline in oil production in 2018. **An above average (but feasible) quarterly growth of the non-oil economy in the second half of the year would still yield a yearly drop in the GDP of about 4%; in short, a recession worse than in 2016 is all but likely.**



GDP has been falling for three quarters, with the yoy decline intensifying between April and June



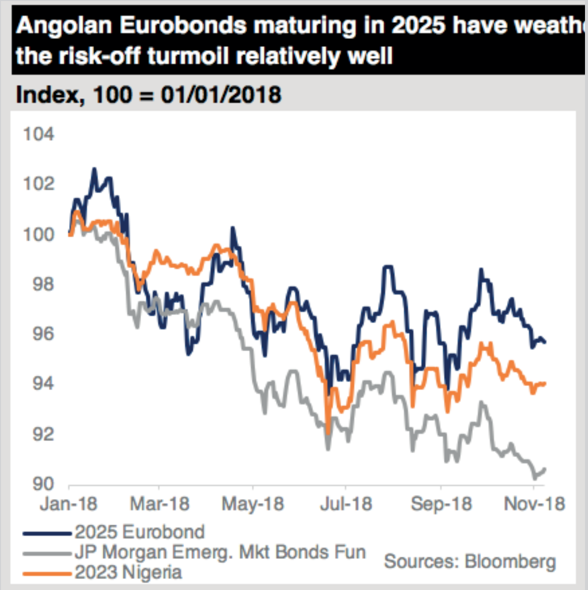
New oil GDP values are more consistent with the course of crude oil exports

The Market View

Emerging market sovereign bonds have suffered in a significant way, mainly due to a risk-off environment brought by rising interest rates from the part of the Federal Reserve.

In that sense, Angolan Eurobonds have kept with that tune, and despite some temporary gains due to higher prices in Brent oil, their performance has been negative since the beginning of 2018.

However, looking at the path of the Angolan 2025's, it seems like investors are less negative on the outlook of the country, as compared to the future for the emerging markets in more general terms.



Moreover, the view also seems slightly more positive when compared with the sovereign which is probably more similar to Angola, Nigeria. One should notice that this occurs in an environment where Nigerian oil output is not experiencing the steep drops seen in the Angolan mature fields.

3| For 2019, we expect the economy to recover, although it is still unclear how strong this recovery will be. The oil economy will certainly not decline as steeply as in 2018, as the first half of 2019 will be benefitting from the production of the first Kaombo FPSO (which started operating in August 2018), and the second half of the year should see the second Kaombo FPSO in operation (there is the possibility that the second FPSO arrives in Q1 2019, but not yet confirmed). Even in a scenario of continued severe decrease of production in mature oil fields, the new production should compensate for at least part of this losses. A climb in production is possible in 2019, but we feel that the drop in number of barrels produced by the mature fields is likely to match or surpass the extra barrels from Kaombo and other smaller projects. **All in all, the oil economy could stagnate or experience some mild growth, possibly helped by LNG exports, which still have room to grow.** The non-oil economy will likely grow, albeit in a weak fashion, very dependent on the fiscal margin that the Administration allocates to public investment, which should fuel growth on the construction sector. At the same time, energy production is also likely to keep growing at a significant pace, as the Laúca dam continues to move towards total capacity – and other electrical projects are concluded. **In summary, while the short-term outlook for the Angolan economy is not particularly brilliant, 2019 will see the beginning of a recovery.**

4l On the other hand, progress towards economic stability in other fronts is well underway. Macroeconomic stability is a loosely defined concept, but in practice it means that the economy is providing with decent economic conditions for business to be conducted. In the case of Angola, there are four main macroeconomic problems (besides growth) that are currently being dealt with, in a relatively successful way, by the Angolan authorities: high inflation, high interest rates, a precarious fiscal situation, and a fragile exchange rate.

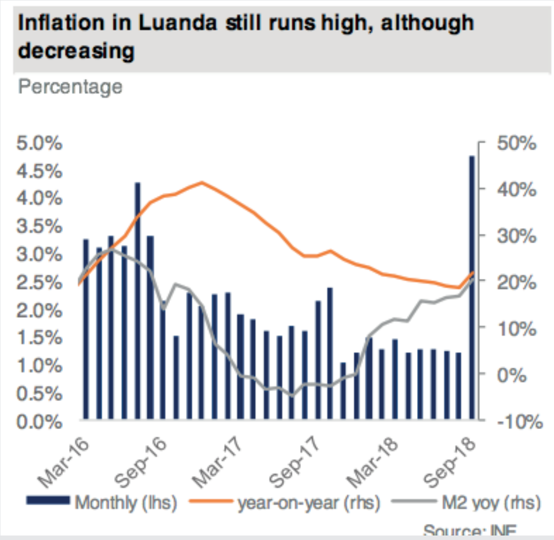
5l Inflation ran significantly high in 2016 and 2017, at an average of around 30% in both years, having reached 41.1% yoy in December 2016, partly as the result of a devaluation of the Kwanza conducted from end-2014 until April 2016. Moreover, following the end of the official devaluation, monthly inflation remained at particularly high levels for the whole of 2016 and most of 2017. In fact, although there was no official devaluation, the Kwanza was depreciating in the parallel market. Arguably, more and more companies started to define their pricing through the black market, thus fuelling further inflation from a weaker exchange rate. **At the same time, monetary policy was made contractionary to counter the rise of inflation, leading to a rise of interest rates – the LUIBOR (interbank overnight rate) stood above 20% since the end of 2016 and for most of 2017.** In turn, this effect was exacerbated by a crowding out of financing by the part of the public sector, further increasing interest rates: **the budget deficit stood at 6.3% of the GDP in 2017, following three previous years of books in the red.** Finally, the fact that the gap between the official and the parallel exchange rate was as large as 135% for 2017 (as an average) meant that the **Kwanza was clearly overvalued, making a future devaluation all but unavoidable.**

6l In face of this grim scenario, the authorities pursued a 4-sided approach that would aim to:

• Reduce spending, in order to relief some of the pressure on interest rates from crowding out;
• Continue to apply a significantly monetary policy, in order to decelerate inflation further;
• Allow for depreciation while it did not hurt the decelerating path of inflation;
• Improve the access to foreign currency, so that the parallel market exchange rate would appreciate.

7l Although the difficulty in bringing down domestic debt interest rates meant that expenditure had to be contained further than expected and some financing obtained externally, the approach was broadly successful:

• Inflation will end 2018 at around 20%, lower than most forecasts;
• The fiscal balance is expected to be positive in 0.6% of GDP, from the estimated deficit of 3.4%;
• Interbank overnight rates are now steadily below 20%, following a beginning of an ease in monetary policy;
• The gap between the official and parallel exchange rate is now at around 26%.



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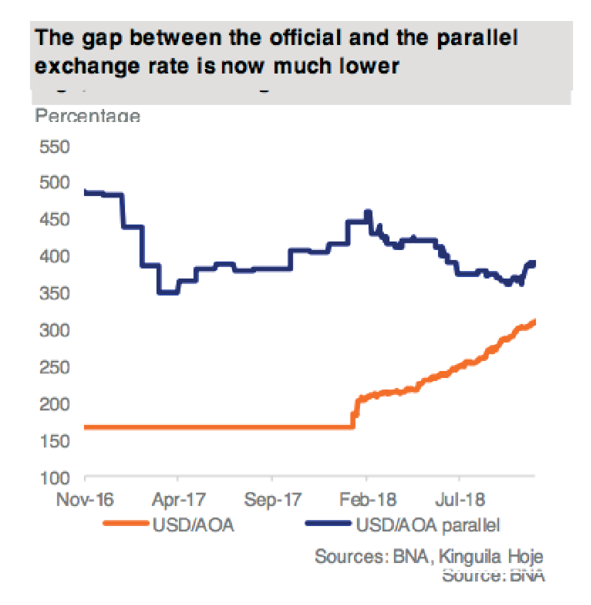
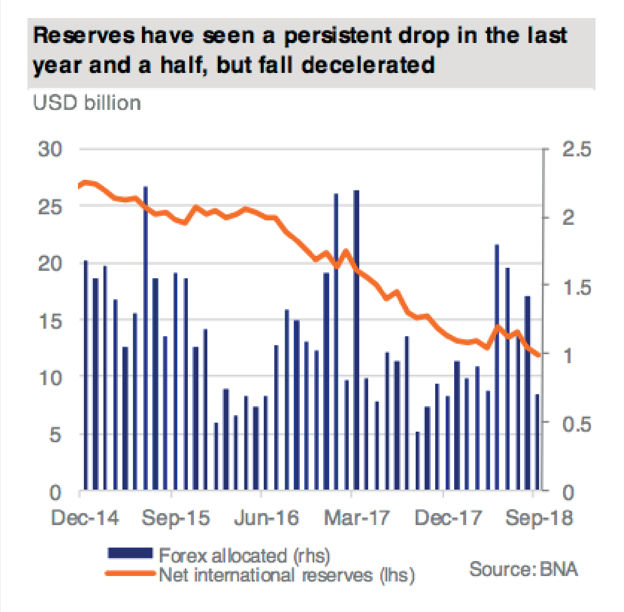
1 Crowding out (in the credit market) occurs when an increase in borrowing by the part of the Government leads to rises in the real interest rate, absorbing the economy's lending capacity and discouraging capital investment by the part of the private sector.





8| In the medium term, due to the lack of investment, the scenario for the oil economy is grim. For example, the IEA forecasts a level of Crude production of 1.29 million barrels per day (mdb) for Angola in 2023, a harsh drop from the about 1.5 mbd expected this year. In that sense, a sustained economic recovery has to come from the non-oil economy. And while a rise in public investment could and should help, the current Angolan fiscal situation means that more firepower will be necessary, from new private investment, Angolan, but mostly foreign. This is where the improvement in the ease of doing business in Angola will matter. In that regard, reform has started, but it must endure, progress, and fruits will be mostly 2-3 years ahead.

9| Several structural reform measures have already taken place, and we list a few:

• **New Private Investment Law:** previously the law required a minimum of 35% of Angolan shareholding for any foreign investment; this is no longer the case;
• **Competition Law:** an anti-monopolistic legislation did not exist prior to this; implementation is still underway, but the general intent of reducing the pervasiveness of monopolies has opened up competition in several markets, including, for example, the fuel distribution market;
• **Relaxing of tourism visa rules;**
• Establishment of a legal framework for the development of natural gas non associated to oil fields;
• **Change of rules in the oil sector:** bureaucracy in the contracting of services by oil operators was reduced, while tax conditions for the exploitation of marginal oil fields have been improved, among other small changes;
• **New diamond trade policy:** previously the law demanded the sale to "preferential customers", new law allows greater freedom for producers;
• **Updated tariff schedule:** apart from simplifying customs procedures, most tariffs were lowered and the import of the broad majority of factors of production is exempt from tariffs;
• **Start of anti-corruption drive:** several high-profile officials and former officials were accused and are being prosecuted in corruption cases.

10| Other measures are already planned, specifically:

• **Privatization scheme:** according to official reports, more than 70 public firms could be up for sale, and the Executive aimed to start the process during 2018;
• **VAT implementation:** a value-added tax will be implemented gradually from July 2019;
Entry into the SADC Free Trade Zone: according to the Trade Secretary, this should be concluded until June 2019;
• **Continued fiscal consolidation:** the Executive expects to continue the stabilization of public finances, expecting a surplus of 1.5% of GDP in 2019.

Doing Business Ranking 2019

According to the World Bank Group Report – Doing Business 2019- Angola is ranked 173rd worldwide in business environment (175th in 2018). In fact, the Ease of Doing Business (EODB) score shows that Angola has increased 2.16 points, scoring now 43.86 (41.49 in 2018). This improvement is mainly due to two factors:

1st- Angola made easier the trading across the borders by introducing the Automated System for Customs Data (ASYCUDA) - the automated customs data management system has improved the electronic submission and processing of documents through the upgrade of the port community system, which has allowed electronic information exchange, between the different parties involved in a trade (import/export), simpler.

2nd- Angola has supplied more reliable power and more transparent tariff information, making the access to electricity easier - the implementation of the System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) to start recording data has helped to improve the regulation and monitoring of power outages.

Doing Business data show that Angola still lacks capacity to resolve insolvency issues, scoring 0/100, because of a weak recovery rate and "no practice" in the indicators for the insolvency framework index; getting credit is another issue in the Angolan economy (score 5/100). However, the country has become a slightly more desirable place to do business. Angola now scores 80.52/100 for starting a business, 69.54/100 for paying taxes, and 68.93/100 for dealing with Construction Permits, which reflects the improvement on documentary compliance time and transparency.

11| Aside from the fact that these reforms will take long to be fully implemented and produce their effects, there are other questions which still remain and put a question mark on how willing will investors be to bet in Angola:

a) IMF: the first question is whether the IMF deal will go through; this is important, not only in terms of the USD 4.5 billion in financing bringing with it, but also due to the continued support for the aforementioned reform drive and a very significant component of help in implementation; **it seems likely to a deal to be struck by year-end, and any indication to the contrary would be a severe disappointment;**
b) Banking sector: dependent on the first question, the resolution of problems in the banking sector – which are mostly due to NPLs in the main public bank – is still a question mark; we know that the process has started, and BPC's credit portfolio has seen a significant drop mid-year, from a likely sale of underperforming assets to Recredit; still, further transparency is needed for a proper evaluation;

c) Access to USD transactions: banking relationships with American banks (and thus transactions in USD) will remain a problem in the short-term – the IMF deal could help in that regard;
d) Structural economic conditions for investment: aside from other relevant reforms not yet planned (insolvency law, property register), there is no real possibility of an economic diversification taking place without proper **electricity production and distribution, water distribution, and a functioning system of transports;** investment is badly necessary in these three areas, but more than that, the authorities need to communicate a clear, reliable and verifiable plan, that allows prospective investors to evaluate when, where and if a project is viable in a specific region of Angola.

C| Conclusion

1| The very short-term outlook is gloomy for Angola, particularly taking into account that real growth rates could well remain below population growth for the foreseeable future. Even in the medium-term, the oil economy will not support growth, and diversification will need to start becoming a reality sooner rather than later. However, a process of reform in the country has started at very healthy and surprising pace, a new pace that will probably be kept with a forthcoming IMF programme. Nevertheless, several questions remain, and the road ahead will be difficult for this Administration, not the least because of a larger freedom which is being felt by the population.
