

## FLASH NOTE

Nº 13.2019 | 6 Nov 2019

### BNA frees exchange rate, equilibrium possibly at 490-510

Kwanza might become volatile, mandatory reserves at 22% should dry up liquidity

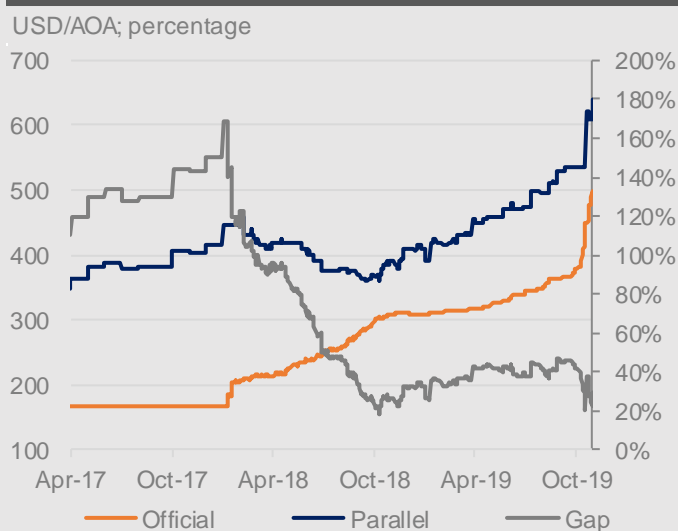
#### A. DESCRIPTION

1| At the extraordinary Monetary Policy Committee meeting of October 23<sup>rd</sup>, the central bank confirmed “the implementation of a floating exchange rate regime in which the exchange rate is freely defined by the market”. The change is in line with the aim of the IMF, which was stressed in the first evaluation of the Programme, which stated that excess foreign exchange demand would only be resolved “when the exchange rate fluctuates freely with each auction.”

2| In fact, BNA has been allowing for a market-determined exchange rate from the 2nd week of October. Consequently, the Kwanza depreciated 23.8% against the Dollar. Year-to-date, the Kwanza has lost 37.9% of its value against the USD until the end of October. Accounting for depreciation since the end of 2017, the Kwanza depreciated 66.6% against the US dollar, being worth only 1/3 of what it was at 31 December 2017 - conversely, the Dollar appreciated 199.0% against the Angolan currency: the same amount in USD can now purchase three times the amount of Kwanzas than before.

3| In order to counter the exchange rate pass-through effect to inflation, the central bank also decided to increase the mandatory reserve ratio in local currency from 17% to 22%. For foreign currency, the ratio remains at 15%. In addition, the central bank also decided to raise the 7-day liquidity absorption rate from 0% to 10%, which is another way of drying up liquidity.

Depreciation in 2019, up to October 30th, was 37.8%; the parallel market followed part of this move



#### B. ANALYSIS

1| According to a previous BNA regulation from the end of 2018 (*Instrutivo nº 19/18*), the exchange rate should have been market determined from then on, through foreign exchange purchase auctions with banks: “bids for foreign currency (...) are accepted in decreasing order of exchange rate, starting from the proposal that offers the highest exchange rate, until the amount available is allocated.” However, the central bank reserved the right to “exclude bids that were understood to be speculative or outside the context of foreign exchange market equilibrium, stability and dynamism”; this caveat allowed the BNA to control the de facto determination of the exchange rate, limiting market mechanisms. The IMF intended (as detailed in Flash Note 7.2019 of June 26th) to end this practice, stating that excess foreign exchange demand would only be resolved “when the exchange

rate changes freely with each auction.” **As of now, the central bank is in fact allowing the exchange rate to be determined by the market through daily auctions for retail banks.**

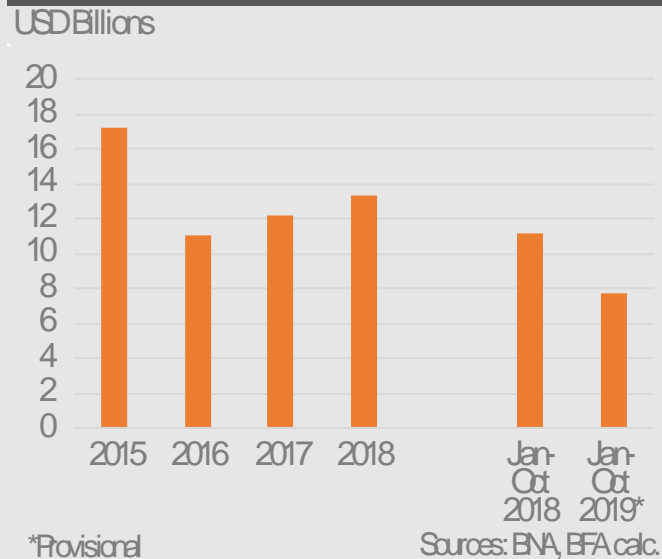
**2| The central bank stated that conditions were now met for the adoption of a floating exchange rate regime,** namely the settlement of foreign exchange arrears, the end of BNA's direct sales of foreign exchange to firms and households and an increase in foreign currency liquidity levels of banks (in order to eliminate “informal restrictions” on foreign currency withdrawals, an objective of the IMF agreement to be completed by December 2019).

**3| In fact, despite the official depreciation from January to the end of September (around 18.5%), the Angolan currency fell more harshly in the parallel market (23.4%) in the same period, widening the gap between the parallel and official market to above 40%.** This is a symptom of continued excess demand for foreign currency compared to existing supply. With the recent Kwanza move, the gap has narrowed again to around 30%. Our view is that this difference is going to decrease, due to both the freer adjustment of the official market and the gradual improvement in the speed of foreign exchange requests by banks.

**4| The purpose of a free exchange rate adjustment is to balance supply and demand by making imports more expensive in local currency, thereby import demand, which in turn decreases demand for foreign currency.** On the other hand, a more depreciated exchange rate would, in theory, make Angolan exports cheaper, increasing foreign demand for Angolan goods, and thus increasing foreign currency supply – however, although oil production might become cheaper with a more depreciated Kwanza (through lower local costs when measured in USD), output levels are completely fixed in the short term, and other products have negligible weight in Angolan exports, meaning that this second effect is nil in the near future. In the medium term, this factor may weigh in to encourage investments to produce goods in Angola, whether exports or import substitution.

**5| Determining the equilibrium exchange rate (which ensures a balance between forex demand and supply) is a subjective task, but a feasible one.** One approach to do this is to look at parallel market behavior. The parallel market exchange rate does not necessarily correspond to the equilibrium exchange rate. On the one hand, any freely determined exchange rate may deviate from the equilibrium exchange rate for long periods due to erroneous expectations which should eventually be corrected. On the other hand, the parallel market is illegal, thus the associated exchange rate contains a premium that compensates the risk of operating outside the law. That is, assuming that the expectations that inform the parallel market are correct, **the exchange rate in that market should be a ceiling for the equilibrium exchange rate – this is, it is likely that the equilibrium rate is thus more appreciated than the parallel rate.** According to Kinguila Hoje, the USD/AOA buy rate stood at 535 at the beginning of the 2nd week of October. However, on October 30th, the USD/AOA traded at 640. **It should be noted that from this point on, with the liberalization of the banks' selling margin (it was capped at 2% above the central bank sell rate), the parallel exchange rate should be compared with the banks' sell rate to calculate the gap between the markets.**

**ForEx sales are significantly lower than in 2015, and sharply fell in 2019 compared to 2018**



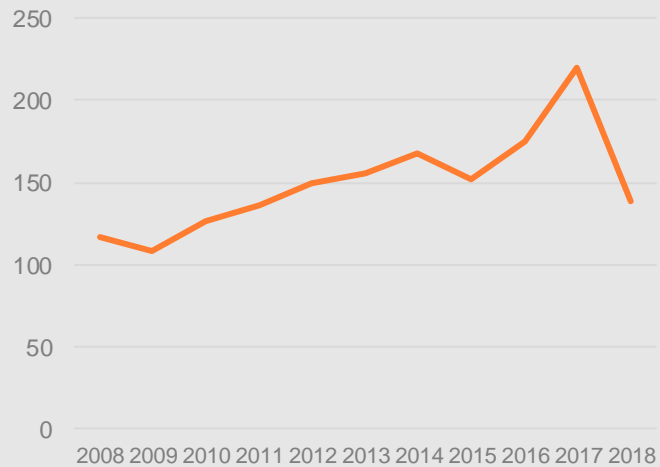
## 6| The reasoning above is nonetheless a market perspective of the path of the Kwanza. A look at the economic fundamentals can provide other insights.

One hypothesis is to look at the Real Effective Exchange Rate (REER), which serves to assess the country's international competitiveness in relation to its trading partners, taking inflation into account along with the exchange rate. The steady rise in this indicator in recent years, particularly in 2017 (due to high inflation that was not accompanied by depreciation) was pointed by the IMF as a symptom of the overvaluation of the Kwanza. Looking at this indicator, to reach the lowest level since the end of 2007, we would have the USD/AOA pair at the end of the year at 509.

On the other hand, the most important factor for an equilibrium value of the Kwanza is if it allows for stability (or a surplus) in Angola's external accounts. This stability is assessed by the evolution of the Balance of Payments, which showed a deficit of USD 3.9 billion in 2018 according to the IMF, while expectations for 2019 are closer to balanced accounts. Even though there is a time lag in the production and release of these statistics, one can gauge the evolution of external accounts by changes in International Reserves - ignoring measurement errors, the positive or negative balance in the Balance of Payments is directly reflected in the evolution of Reserves. At this point, what we can say for sure is that the rate of decline of Net International Reserves has been much slower in 2019, indicating that the exchange rate is closer to its equilibrium level. In fact, NIRs fell by USD 62 million per month between January and September 2019; in the same period of 2018, the average monthly drop was USD 183 million. **It is our view that the current exchange rate level will allow for a stabilization of NIRs until the end of 2019 (or early 2020, depending on the timing of the expected Eurobond**

### At the end of 2017, REER pointed to a large overvaluation of the Kwanza against the USD

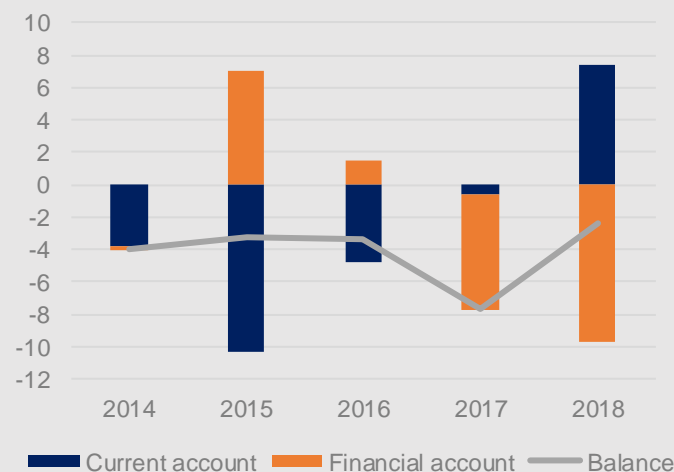
REER at the end of each year: 2007 = 100



Source: BFA calc.

### Angola posted Balance of Payments significant deficits in recent years

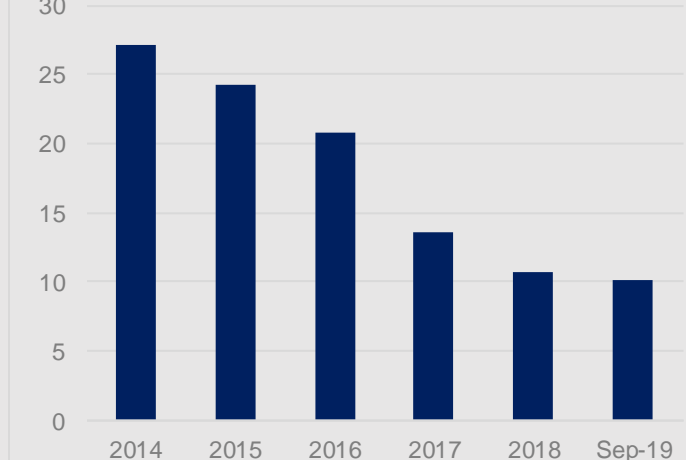
USD Billions



Sources: IMF, BNA

### Following years of decline due to external account imbalances, net international reserves stabilized

USD Billions



Source: BNA

**issuance**). Moreover, a slight rise (until the end of the year) from the current statistical series low of USD 10.1 billion is quite possible.

**7| Given all this information, how can we understand the divergence between the assessment of economic fundamentals, which indicates that we may have already reached the equilibrium exchange rate, and the market view (through the parallel exchange rate) that points to an exchange rate between USD/AOA 570-640 at the end of the year?**

In our view, the market is operating on the wrong premise that economic fundamentals changed significantly between early October and the present day. In fact, in a country like Angola, where macroeconomic analysis is scarce, it is realistic to conceive that the change the BNA's course of action, allowing market liberalization, is interpreted as a reaction to a change in economic conditions. **Moreover, the fact that the communication to the market took place only two weeks after the beginning of the movement may have fuelled this interpretation.**

**8| In fact, the economic fundamentals for the future of Angola's external equilibrium are gloomy:** in particular, the continued decline in oil production will require very significant amounts of FDI (in and out of the oil sector) in conjunction with increased other exports, and a reduction in imports to ensure the balance of Angolan external accounts, especially from 2022 onwards. **However, the outlook for this decline did not change in October;** similarly, the price of Brent or the outlook for its evolution, or any other factor of significant relevance to the sector, saw no significant changes.

**9| Tendo estas questões em conta, acreditamos que o câmbio de equilíbrio face ao USD para o presente momento estará numa banda próxima aos valores actualmente negociados actualmente:** entre os USD/AOA 490-510, o que será consistente com a satisfação das necessidades cambiais de Angola, correspondendo a um equilíbrio (e possível superávit) da balança de pagamentos angolana, reflectindo-se numa estabilização (e possível crescimento) do nível de Reservas Internacionais Líquidas.

**Taking these issues into account, we believe that the equilibrium exchange rate against the USD for the present moment will be in a band close to the values traded last week:** between USD/AOA 490-510, which will be consistent with the satisfaction of Angola's exchange needs, corresponding to a balance (and possible surplus) of the Angolan Balance of Payments, reflected in a stabilization (and possible growth) of the level of Net International Reserves.

## **C. CONCLUSION**

**1| BNA effectively is allowing the exchange rate to be freely determined through daily foreign currency auctions, (Dollar and Euro auctions).** On the other hand, only general purpose auctions are being held again, with auctions for letters of credit being the only exception.

**2| This liberalization resulted, until October 30th, in a 23.8% depreciation in that month, with the Kwanza losing 37.8% of its value against the Dollar from January 1<sup>st</sup> to the end of October.** The parallel market followed part of this depreciation, with Kwanza losing 16.4% against the US Dollar in October, according to Kinguila Hoje.

**3| Although the market outlook of a more depreciated exchange rate, a look at Angola's economic fundamentals points to a USD/AOA already close to equilibrium exchange rate, given the REER and Angola's external accounts.** Still, one cannot ignore that the exchange rate might go through a process of overshooting and remain, for a temporary period, more depreciated than what is adequate, appreciating afterwards.

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