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THE IMPACT OF Mozambique's hidden debt service payments

MOZAMBIQUE'S SCANDAL REGARDING PREVIOUSLY HIDDEN PUBLIC DEBT HAS SEVERELY AFFECTED THE MACROECONOMIC VARIABLES OF ITS ECONOMY. GIVEN THAT DEBT SERVICE PAYMENTS ARE NOW COMING DUE IN LARGE AMOUNTS THAT HAD NOT BEEN PREVIOUSLY PROGRAMMED, THE GOVERNMENT'S ECONOMIC POLICY IS BEING THROWN INTO DISARRAY IN THE FISCAL, MONETARY, AND REAL SECTORS. THIS NOTE TRACES THE IMPACT OF THIS DISASTER ON DEPRECIATION; INFLATION; AND ISSUING MONEY.

I. The economic impact **of a falling exchange rate**

A fall in the exchange rate is known as depreciation in the case of a floating exchange rate regime, as exists in Mozambique (as opposed to a fixed exchange rate regime). Mozambique's floating exchange rate adjusts on a daily basis (sometimes only by a fraction of a Metical), and it could appreciate (gain value) or depreciate (lose value). When it depreciates, the Metical is worth less compared to the currencies of other countries, notably the US dollar.

When there is depreciation and more Meticais are needed per US dollar, the immediate effect is that imports will become more expensive, and exports will become cheaper. Therefore, in principle, a depreciation of the Metical makes Mozambican goods (not only exports but also so-called non-tradables, like restaurants that attract tourists) more competitive, because domestically-produced goods are demanded relatively more by locals as well as by foreigners since they have become relatively cheaper compared to goods produced abroad. However, as shown below, the debt scandal has wiped out any of the benefits of depreciation, since it has destroyed confidence in the Government's economic policies.

At the microeconomic level, with depreciation the man on the street is paying more for imported goods. Imports (excluding imports for megaprojects, which respond to a different dynamic) accounted in 2014 for 38% of GDP, which is substantial and means that the impact of higher prices of imported goods is being felt throughout most areas of consumption. A consequence of this is that people will start purchasing less since their income is limited; this, in turn, means their standard of living will suffer.

The higher cost of imports is exacerbated by the impact of the depreciation-caused inflation on locally produced goods: to the extent that such goods use imported inputs, their prices will increase as well, and demand for them will also decrease. There also is a demonstration effect: even if locally produced goods do not use, or use only few, imported inputs, their prices are also bound to increase because producers will take advantage of the upward creep in prices of similar goods that have a greater import component.

At the macroeconomic level, higher import prices will cause demand to fall across the economy. This will reduce demand for foreign exchange, but it will also lead to a reduction in economic growth (GDP will grow by less), because higher prices of inputs will make companies produce less overall. The fall in aggregate demand will help improve the current account balance of payments (and therefore reduce the pressure on the exchange rate), but it affects the real sector because of a lower growth rate.[1]

But there is an even worse effect: both the companies that import and those that produce local goods with imported inputs will sell less. At the extreme, they may not be able to cover their costs anymore since consumers, given their inelastic income, will quickly cut back on purchases if prices rise too fast. This will affect employment as those companies that are producing less will start to lay off workers. As a consequence, there is an additional negative effect on GDP growth, and on the standard of living, as people lose jobs.

Finally, there is effect of falling confidence, which clearly is the case now in Mozambique. The secretive handling by the Government of its external financial transactions (starting already with the EMATUM loan of 2013) has now increased to crisis proportions, where economic agents do not believe that the Government can soon return the economy to a macroeconomic equilibrium. This has been exacerbated by donors suspending all budget support to the Government. With a lack of confidence, the demand for foreign exchange will increase no matter what government policies are announced, as economic players do not give credence to the Government's commitment to better policies. By expecting a further deterioration of the availability of foreign exchange, more is demanded than is actually needed for operational purposes, and with speculation setting in, depreciation may even accelerate beyond economic fundamentals.

II. Manifestations of inflation

The additional debt service payments that the Government needs to make have caused the Metical to depreciate. As shown above, depreciation results in higher prices of imported goods as well as of locally produced goods, and therefore increases overall inflation. Thus, at present, inflation in Mozambique is driven overwhelmingly by exchange rate depreciation. Inflation can also be driven by other factors, such as increases in salaries or removal of subsidies, notably of petroleum products; however, that is not the case currently in Mozambique.

Inflation is considered a "regressive tax", because it affects all economic agents in the same way. Poor segments of society have to deal with the same rate of inflation as do the rich segments.

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However, since poor people have less financial resources, they suffer more.[2]

The sudden need by the Government for more foreign exchange, as a result of its unprogrammed debt service payments, is causing depreciation of the Metical and an increase in inflation, which creates a direct link to the common people. Through no fault of their own, they suddenly face an effective decrease in their income, because the things they buy cost more.

Inflation for the twelve months May 2015 to May 2016 has reached 18.3%, compared to 1.3% for the twelve months May 2014 to May 2015. Because the payments on the debt are bound to be higher in the second half of 2016, inflation is expected to increase further in 2016.

[1] Assuming that the demand for exports and imports is elastic. The Marshall-Lerner condition states that a depreciation improves the current account deficit if the price elasticity of demand (PED) of exports plus imports is greater than 1: PED x + PED m >1.

[2] A "progressive tax" would put a heavier burden on the rich segments of society, and is often favored in the tax systems of developed countries.

III. Issuing money

Money is created ("pumped into the economy") in two ways: by the Central Bank, when it gives credit to the Government for financing the budget deficit, and by commercial banks, when they give loans.[3] When a bank makes a loan, it credits the customer's bank account with the amount of the loan. At that moment, new money is created.
Obviously, commercial banks have immense power if they can create money at will. This power is controlled in 2 ways: structurally, by regulations as to the amount of loans banks can give based on their capital and deposits (including by a central bank tool that requires banks to freeze some deposits with the Central Bank, called "reserve requirements"); and operationally, by adjusting the relative cost of making loans through interest rates.
In Mozambique, in the 12 months from April 2015 to April 2016, the Central Bank accounts show that domestic credit (virtually equal to the increase in money) increased by 86,4 MMT (44%), with the Government accounting for 54,3 MMT and the private sector for 32,2 MMT.
The day by day control of the growth of money is one of the key functions of the Central Bank because of the effect issuing money has on inflation and the exchange rate. Central Banks often "anchor" their monetary policies on an inflation target. In developed economies, Central Banks control the growth of money by issuing bonds, which take liquidity out of the market, and by adjusting key interests rates. In Mozambique, the Central Bank has been relying on adjusting key interest rates.
Needless to say, with domestic credit growing by 44%, the Central Bank has not been terribly successful in anchoring its monetary policy. And there is one important reason why that may be so: as the Central Bank raises its benchmark interest rate, the interest rates on all other loans, also rise. Importantly, higher interest rates affect productive activities, and when companies that need loans to be able to produce more have to pay more interest, it affects their profit calculations. This may lead companies to not borrow, affecting domestic production and the GDP growth rate.

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The Bank of Mozambique raised its benchmark interest rate twice in recent months. But since money still grew by 44%, it means that the increases were not sufficient to maintain a stable macroeconomic environment. This highlights the dilemma between fiscal and monetary policy: if the Government assumes a lax fiscal policy, as evidenced by its large share in creating new money for Mozambique's economy, then the Central Bank is limited in its use of monetary policy: it can raise interest rates only so much before the real sector, i.e. productive activities, is affected in a major way that can cause massive unemployment.
Contrary to intuition, the money created is overwhelmingly in the form of deposits in bank accounts, not banknotes and coins. At end-April 2016, only 7.8% of "total" money ("money and quasi-money," the latter being time deposits) was in the form of banknotes and coins.
The need for money in day-to-day transactions (as opposed to deposits) is referred as the "transactions" demand for money. To the extent that people use more and more ATM and credit cards, as well as checks, tangible money that you can touch has been decreasing world-wide. In fact, in the United Kingdom, tangible money represents only 3% of total money.
As to the effect on demand for foreign exchange or for goods, it makes no difference what form money takes (tangible or bank deposits), since the payment mechanisms work smoothly no matter what the medium is.
There is, however, one situation where the form of money makes a noticeable difference: the case of hyperinflation. Banknotes and coins have to procured or produced by the Central Bank, and that costs money. A textbook case of the cost of printing money is Bolivia in the 1980s, which entered into hyperinflation with rates of 20,000% per year (Box 1).

[3] It is true that exchanging foreign currency for Meticais also results in the issue of money. However, such a transaction does not usually have inflationary consequences (although it may do so in the context of megaprojects), and this Note does not cover that aspect.

Box 1. The cost of banknotes in Bolivia

When Bolivia's inflation rates exceeded 1,000% per year in 1983 (peaking at 20,000% per year), the Government realized too late that the economy would implode into barter trade unless higher denomination notes could be introduced. Transaction demand was still relatively high in those days, and the existing currency notes were quickly losing their face value; at one point, the highest denomination banknote (100 pesos) was worth 5 Meticais. To go shopping, the notes were packed into "bricks" of 100 notes. At that point one would only count the bricks, but no longer the notes themselves, and often the shopping was less voluminous than the notes needed to pay for it!

To prevent a collapse of monetary transactions, the Central Bank had to enter into emergency contracts with companies to quickly bring large denomination notes into the country (the largest note printed was 10 million pesos, in the end worth 100 Meticais).

Most central banks in developing countries purchase their banknotes from specialized companies in developed countries that provide key safety features to help prevent banknote forgery. Contracts are normally placed well in advance, since it takes time to produce forgery-proof notes. Therefore, the Bolivian Government had to pay dearly to obtain banknotes for their emergency. In the final year of hyperinflation, the cost of printing banknotes earned a separate entry into the balance of payments.

The (simplified) steps for issuing banknotes (as well as coins) are:

- The Central Bank places an order with a specialized company that produces bank notes (such as Thomas de la Rue, used by Mozambique's Central Bank for banknotes)
- Following the design instructions, the producing company prepares dozens of samples of the banknotes (called Specimen banknotes) to be reviewed by the Central Bank for their final approval
- Banknotes are printed in the quantities requested by the Central Bank, paid for, and shipped via special cargo plane to Maputo. Central Bank armored trucks pick up the crates and deposit them in the vault. *Up to that point, no new banknotes have actually been issued, and the nominal value of the shipment is not part total money.*
- Based on their operational needs, commercial banks request banknotes from the Central Bank, which debits the commercial banks' accounts. *While new banknotes have been issued, the total amount of money has still remained unchanged (banknotes increased, but banks' deposits decreased).*
- In their day to day operations, banks fill their customer's needs for cash by (1) exchanging local currency deposits of customers for banknotes (without any new money actually being issued, since customers reduce their deposits in order to receive banknotes); and (2) paying out a new loan as cash. *It is only during this latter operation that the issue of banknotes results in an increase in total money.*

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Editorial Information

Director: Adriano Nuvunga
Technical team of CIP: Anastácio Bibiane, Baltazar Fael, Borges Nhamire, Celeste Filipe, Edson Cortez, Egídio Rego, Fátima Mimbire, Jorge Matine, Stélio Bila.
Program Assistent: Nélia Nhacume
Ownership: Centro de Integridade Pública

Design and Layout: suaimagem

Contact:
Center for Public Integrity (Centro de Integridade Pública, CIP)
Bairro da Coop, Rua B, Número 79
Maputo - Moçambique
Tel.: +258 21 41 66 25
Cell: +258 82 301 6391
Fax: +258 21 41 66 16
E-mail: cip@cip.org.mz
Website: www.cip.org.mz