

# **MACRO-BRIEF: ANGOLA**

*August 2009*

## **I. Angola's Economy: A Mid-Year Review**

The global financial-economic crisis hit hard the economy of Angola as price of oil started a free fall trend in the second half of 2008. It has been a rough economic ride in the first half of 2009, as high levels of uncertainties, nervousness of economy agents and rumors on the direction of macro policies resulted in large imbalances in some markets especially the foreign exchange and government securities markets.

There are indications of some light at the end of the tunnel. However, the tunnel seems to be long and there are still many difficulties ahead. Nevertheless, this crisis created opportunities and indicated paths for a more sustainable economic growth in the future and the government has shown clear signs of understanding these challenges and taking some appropriated steps in that general direction.

## **II. Revising Estimation of Real Economic Growth**

A real contraction was forecasted for Angola's GDP in 2009 in the January Macro-Brief since it was expected that the country would implement the production cuts (244 thousand barrels per day) agreed within the OPEC, a 13% cut compared to 2008 production levels.<sup>1</sup> A 13% decrease in oil production would result in a negative contribution to GDP growth of around 7% as oil represented around 55% of GDP in 2008. To compensate the -7% contribution of oil, the non-oil sector would have to experience a positive real growth rate of close to 16% for a flat overall GDP growth. In other words, to have a flat rate of overall growth, the non-oil sector would be required to grow around the same 15% rate of 2008, but in a year completely different in terms of economic conditions.<sup>2</sup> Taking into account the tight fiscal and monetary policies for 2009, the January macro-brief pointed to a real contraction of the economy. At that point in time, under those specific conditions, an expected solid real growth rate around 10% for the non-oil sector would result in an overall contraction of around 3% in 2009. At that moment, there were divergences among institutions and analysts on both the sign and magnitude of real GDP growth rate for 2009. Some were forecasting solid positive growth while most expected a real contraction. However, all agreed that nominal GDP, in dollar terms, would contract due to the striking drop in oil prices. The nominal contraction means lower export revenues to finance needed imports and the signs were for a very difficult year ahead. Since the January macro-brief, some assumptions have changed; the most important, the magnitude of the cuts in oil production for 2009. Instead of the expected 13% cut in production as agreed within OPEC, the adjusted budget submitted by the government to the National Assembly pointed for a cut around

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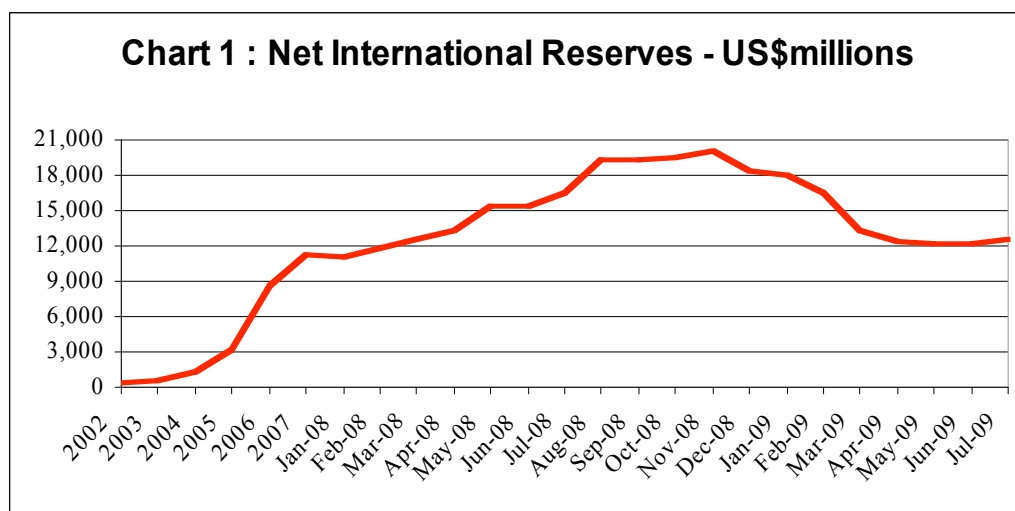
<sup>1</sup> The full implementation was expected as Angola assumed the presidency of OPEC in 2009.

<sup>2</sup> Most of 2008 was marked by extremely high oil prices, substantial increase in government revenues, expansionary fiscal policy with sizeable increase in capital expenditures, and expansionary monetary policy allowing for a considerable expansion of credit to the economy.

6%, which would continue to negatively impacting the real GDP growth in 2009 but at a much lower rate of around -3%. The overall real rate of GDP growth would then depend on the magnitude of growth in the non-oil sector. As will be discussed below, the response of the government to the crisis was to tighten both fiscal and monetary policies. On that base, it is likely that the non-oil sector would grow at a slower rate than previously expected, of around 7.5% with large gains coming from agriculture, manufacturing, and services. **In summary, given these assumptions, there is a revision of real growth in 2009 from -3% to around 0%.** It is important to notice that nominal contraction of GDP is likely to be lower than previously expected as oil prices recuperated from the extremely low levels of December 2008 and January 2009, improving the perspectives for the country as a whole. If average price of oil for 2009 ends up between US\$55 and 60, and production decreases by around 6% and non-oil sector has a real growth rate of around 7.5% and inflation around 14%; nominal GDP, measure in Kwanzas, will contract between 12% to 15% compared to 2008. This is less than the over 20% estimated in the January macro-brief and the 20% estimated in the new budget proposal submitted to the National Assembly.

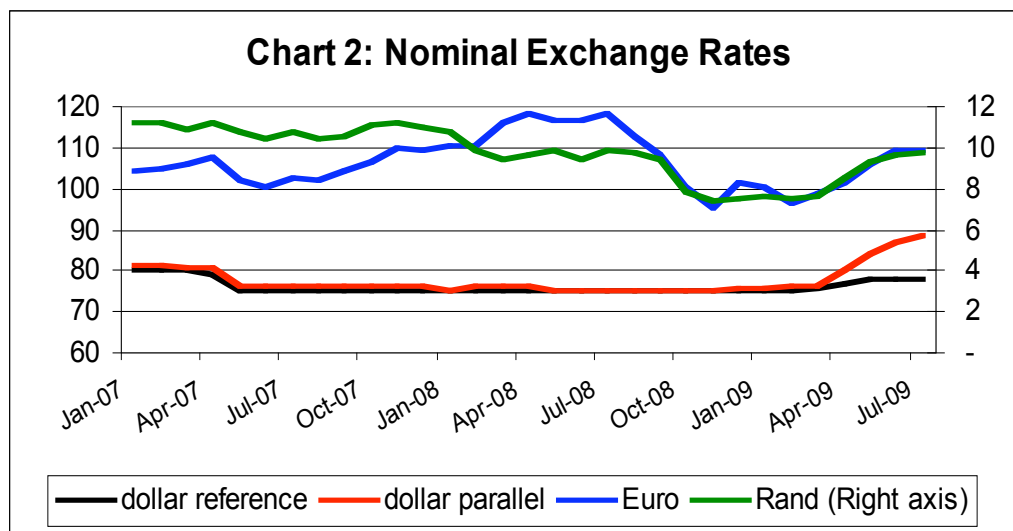
### III. Monetary and Exchange Rate policies

The impact of the global crisis was felt immediately in the Trade Balance as export revenues dropped dramatically and imports, much less elastic in the short run as Angola's consumption has a large share of imports, remained at high levels. Additionally, the historically negative service account contributed to the deficit in the Current Account, which, in the absence of higher inflows in the capital account, would be financed by international reserves. The decline in the international reserves, associated with the general apprehension with further decline of oil prices, generated certain degree of uncertainty in the markets which, looking for protection, resulted in a strong demand for dollars. The Central Bank (BNA – Banco Nacional de Angola), worried with the inflationary impact of a nominal devaluation of the Kwanza, sold large quantities of dollars, further depleting the international reserves (from around 20 billion dollars in November 2008 to 12.5 billions in April 2009 – Chart 1).



A decision was made to keep international reserves at a level compatible to six months of imports of goods and services. To do that, the BNA reduced the volume of foreign currency sold to Banks triggering a nominal devaluation of the Kwanza, which would impact inflation. Faced with the dilemma between selling less foreign exchange to stop the depletion of internal reserves and avoiding further depreciation of the Kwanza with its impact on inflation, the BNA adopted a new set of policies.

To keep the reference exchange rate stable, the BNA stopped foreign exchange auctions and started selling the limited amount of dollars at a fixed rate.<sup>3</sup> Simultaneously, the BNA enforced existing legislation related to foreign exchange outflows. The relative scarcity of foreign exchange resulted in larger depreciations of the Kwanza both in the secondary and parallel markets. Chart 2 shows the increasing gap between the reference and informal exchange rates as well as the exchange rates for the Euro and the Rand.



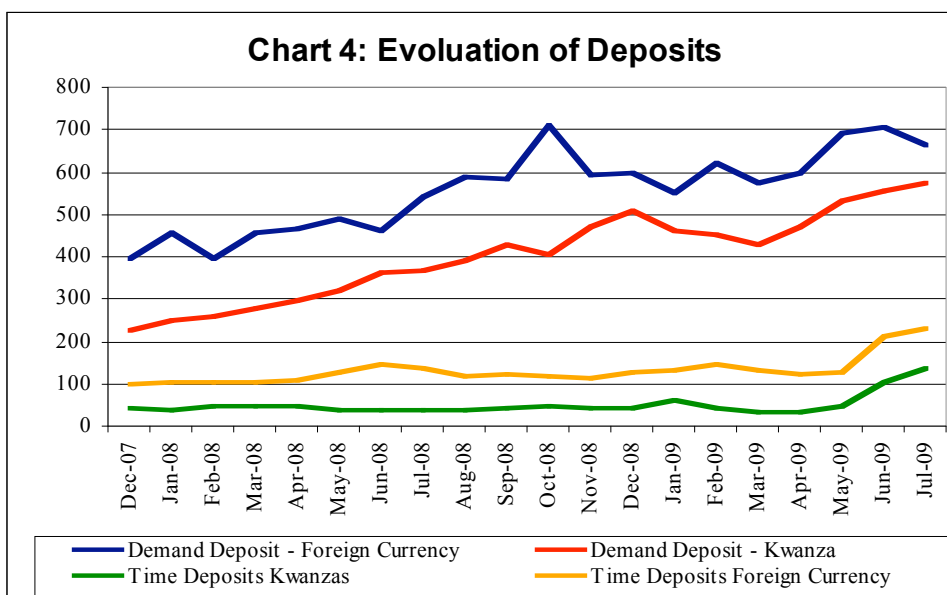
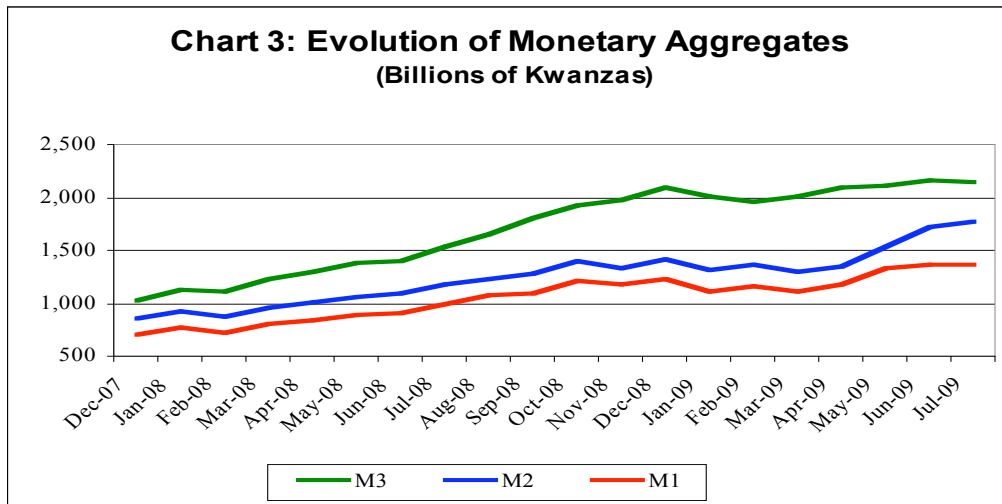
Simultaneously, the BNA adopted a more aggressive policy of reducing the supply of Kwanzas (thus, reducing pressure in the foreign exchange markets), raising the legal reserve requirements from 15% of Bank deposits to 20% in March and increasing it once more to 30% starting in May.<sup>4</sup> Chart 3 shows the evolution of monetary aggregates and Chart 4 shows the evolution of deposits.<sup>5</sup> Additionally the government has started an

<sup>3</sup> The reference rate is the rate resulted from foreign exchange auctions promoted by BNA with the participation of the banks (primary market). Interbank and banks-clients negotiations are known as the secondary market and transactions outside banks are known as parallel or informal markets.

<sup>4</sup> Later, the BNA softened the policy allowing Banks to use government bonds to partially fulfill the reserves obligations (both for domestic and foreign currency deposits). This change improves banks' situation in two ways: part of the reserves would be remunerated (bonds) and as banks had bonds already in the portfolio, substituting the cash reserves for bonds will improve liquidity and allowed banks to increase credit to the economy.

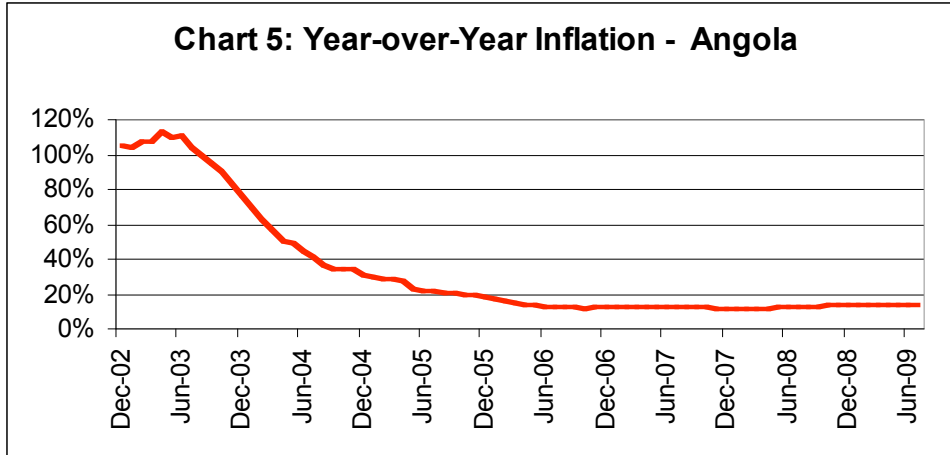
<sup>5</sup> M1 is the sum of currency outside banks plus demand deposits. M2 is the sum of M1 plus time deposits and other liabilities (in general resources associated with imports of goods). M3 is the sum of M2 plus other less liquid instruments.

effort to sell US\$9 billions worth of bonds in 2009, although the demand for such securities has been weak.

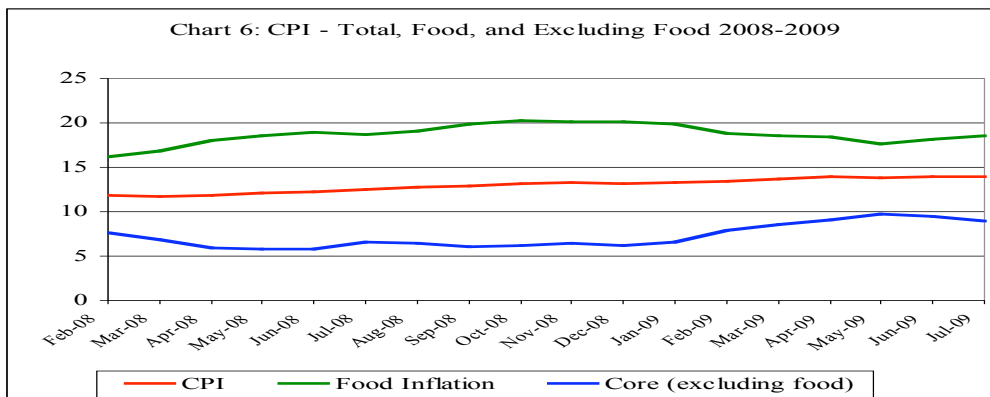


#### IV. Inflation

In the last years, Angola's overall inflation, measured by the Consumer Price Index (CPI) has declined dramatically, from 270% in 2000 to slightly below 12% at the end of 2007, as the government first began financing its deficits with oil-backed loans and achieving budget surpluses in the last three years. However, as shown in Chart 5, the declining trend reversed in the last one and a half years.



The increase in inflation in the last 18 months can be divided into three phases according to main inflationary sources. The first phase, from January to October 2009, reflected substantially the increasing international prices of imported food as well as the nominal devaluation of the Kwanza vis-à-vis the Euro as a large share of Angola’s imports come from the Euro area. The second phase, the immediate period after the October meltdown of the global financial markets, the pressure from food prices declined, likely the result of declining prices for food items in international markets and the nominal appreciation of the Kwanza vis-à-vis the Euro and the Rand; while supply constraints remained pressuring prices of other components of CPI. The third phase, starting in the second quarter of 2009 reflects the nominal devaluation of the Kwanza, especially in the secondary and parallel markets as discussed above.<sup>6</sup> The economic slowdown so far this year has likely impact the other components of CPI as demand reclines and supply constraints, such as port capacity, improves with lower flows of imports. Nonetheless, inflation is likely to remain at current or even slightly higher levels as long as imbalances in the foreign exchange markets remain with resulting further devaluation of the Kwanza in the secondary and parallel markets.



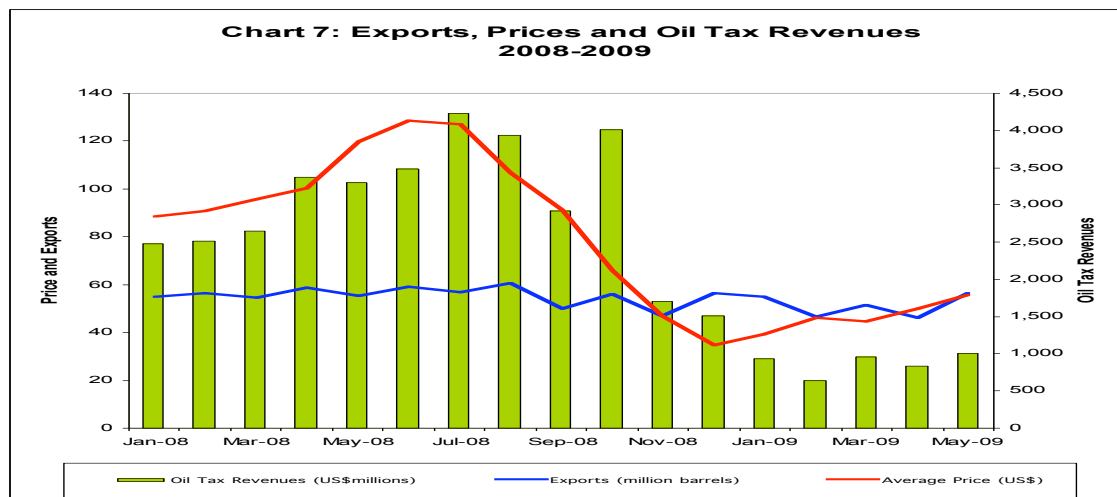
<sup>6</sup> In this brief “core inflation” is the CPI index after excluding the “food and non-alcoholic beverages” component from the consumer basket, which represents 46.09% of total consumption. The core-inflation was calculated by creating a series of all the other components, recalibrating their respective shares of the consumption basket to sum 100%, and creating the new “core-inflation” index.

## V. Fiscal Policy

The impact on trade balance reflected immediately on the fiscal accounts as oil taxes represent over 80% of total government revenues. Faced with declining revenues, the government first adjusted its financial programming for the first quarter of 2009 basing it on an average oil price of US\$35.<sup>7</sup>

### Revenues

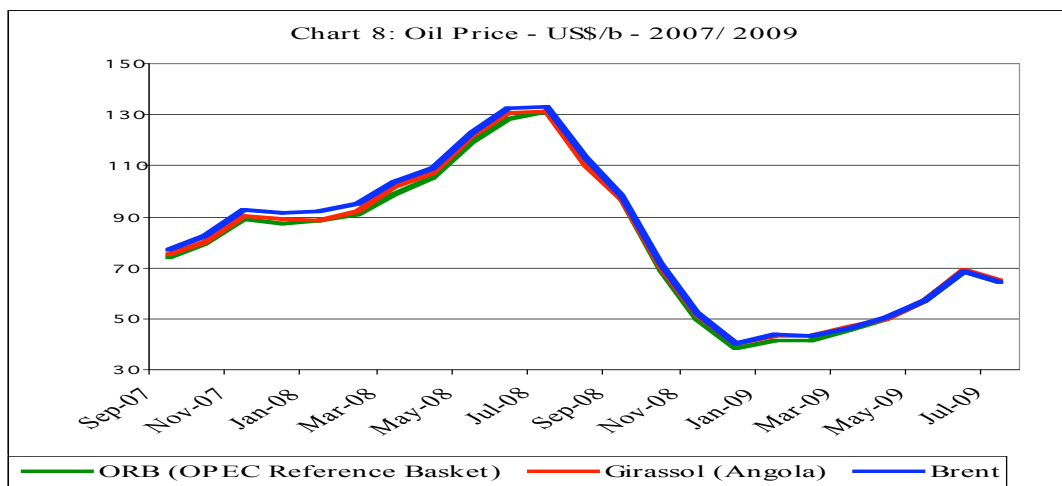
Recent data from the Ministry of Finance, Chart 7, shows the dramatic decline in oil tax revenues since October 2008. Small increases since March represent the beginning of recuperation from the dreadful levels registered in January and February.<sup>8</sup>



Despite the small gains since March, oil tax revenues for the first five months of 2009 represents only around 30% of taxes collected in the same period in 2008. It is expected that oil revenue will improve further in the coming months. There are two reasons for optimism: higher production and higher prices compared to previous months. As tax is reported one month after shipments, the low levels of oil taxes in the first five months of 2009 reflect the very low price levels of December/08 to February/09 (Chart 8).

<sup>7</sup> After the annual budget is approved, its execution is done through the quarterly financial programming, approved by the Council of Ministers, and based on the estimation of revenues and other parameters. Thus, even before the adjustment of the budget, the government started limiting expenditures below budgeted levels. However, as government suppliers continued providing goods and services, the financing program resulted in accumulated arrears with suppliers, around US\$2.5 billion so far.

<sup>8</sup> One should be careful with the interpretation of the data. Oil companies are requested to pay taxes one month after oil shipments. The concessionary income does not follow the same pattern. Thus, the months with large variation on tax revenues and small variations on volume and price are likely to represent those months when Sonongol, the concessionary, makes the income payments to the Treasury.



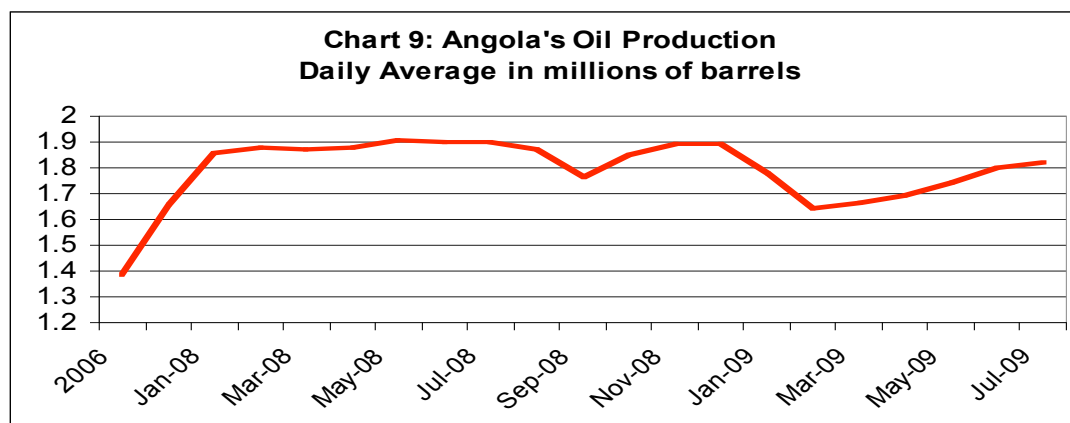
To be sure, average production and price reported from January to May, 2009 were 9% and 52%, respectively, below levels for the same period in 2008. However, in 2009, average price for the second quarter was 37% above the average price in the first quarter (US\$59 against US\$43) and average daily production in May was more than 6% above production in February (lowest month). Nonetheless, oil revenues in 2009 will be dramatically lower compared to 2008.<sup>9</sup> Chart 9 shows the recent increase in oil production in Angola.

The new proposed budget estimates revenues in 2009 to be half of levels registered in 2008. Most likely this is a very conservative estimate as it is based on an average price for oil of US\$37 per barrel, resulting in a decline in oil revenue close to 60% ( a decline of 45% compared to the first budget proposal). Non-oil revenues are forecasted to grow around 17%, consistent with the rate of 14.6% real growth for the non-oil sector in the new budget proposal), representing 8.5% increase compared with the first budget proposal despite the fact that the real rate of growth of the non-oil sector in the new proposal is lower than in the original one. That is due to the increased levels of revenues from taxes on “goods and services” and “transactions and international trade”, implying that government expects a higher level of tax collection efficiency.

It is likely that oil revenues will be higher than forecasted in the new budget proposal. Using an average oil price in 2009 between 55 and 60 dollars per barrel (prices staying

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between 60 and 70 dollars from August to December), production of around 1.79 million barrels per day for the whole year, and a very conservative assumption of non-oil tax revenues 10% higher in nominal terms compared to 2008, total fiscal revenues would be around 2 trillion Kwanzas, likely slightly higher than that. In that case, revenues would be between 45 and 55% above government estimates.



## Expenses

The new budget proposal estimated total expenditures to be around 2.37 trillion Kwanzas, a cut of 16.6% from the original budget proposal (including a 9.6% decline in current expenditures and 27% cut in capital expenditures). Compared to 2008, the new proposed budget results in a 5% decline for total expenditures, including declines for around 3% and 8% for current and capital expenditures, respectively. Payment of interests increased 86% in the new proposal compared to the original one and close to 600% compared to 2008 given the level of domestic debt at the end of 2008 and the need for financing the deficit in 2009.

Assuming an inflation rate around 14%, total expenditures would be close to 20% lower in real terms compared to implemented budget in 2008 and even higher for capital expenditures. Thus, a very high rate of execution should be expected for 2009, including the probability of an execution rate above 100% for current expenditures. However, as government delay payments to suppliers, they could slowdown implementation in the second half of the year.

## Financing the Deficit

The new budget proposal forecasts a budget deficit (compromise base) of 756.3 billion Kwanzas, 68.5% higher than in the previous proposal, due especially to the very conservative price of oil resulting in a sharp decline in oil revenues. The composition of the financing changed dramatically. Originally, the government projected the deficit financed 27% domestically and 73% from external sources while the new proposal expects 67.5% coming from domestic sources (bonds) and 32.5% from external sources



(credit lines). Comparing the two budget proposals, the last one forecast a 17.6% decline in resources coming from credit lines.

There are two points to consider here: how big will be the deficit and ways to finance it. The first issue, size of the deficit, is likely to be lower than forecasted in the new budget proposal for the reasons already discussed; i.e., estimated nominal GDP and fiscal revenues above government's forecasts in the adjusted budget. Assuming a execution rate of 100% for expenditures in the new adjusted budget, total fiscal revenues around 2 trillion Kwanzas, and a contraction between 12 and 15% for nominal GDP, the overall nominal budget deficit would be in the range of 5 to 7.5% of GDP, way lower than the 14.7% in the new budget proposal.

The financing needed is likely to be much less than forecasted in the new budget proposal. Assuming that the credit line financing is achieved, the need for net domestic financing would be diminished substantially. That would be welcomed news as demand the government bonds has been low and, so far this year, the net result for government operations has been negative (inflows from selling bonds lower than outflows of paying for bonds coming to maturity). However, in June and July, markets have shown a much larger appetite for government bonds.

## **VI. Perspectives for the Second Half of 2009: Light at the End of the Tunnel**

There are good indications that the financial-economic global crisis may have hit bottom and the global economic contraction is slowing down or even reversing to a slow positive growth by the end of the year. Picking up in aggregate global demand would include improvements in global demand for oil and prices are likely to stabilize or even increase slightly in coming months.

The government recently invited the International Monetary Fund (IMF) to visit Angola, which took place from August 3 to 7. The mission focused on economic diagnosis. A second mission is expected in September, 2009, when a program is likely to be agreed upon. Most of important than any balance of payment support by the IMF, the government initiative to invite the Fund to a dialogue on economic policy shows a commitment to find the best possible set of macro policies to deal with the short economic problems and mid-term economic perspectives. A program with the IMF will represent a strong positive credibility shock, which will improve the chances of the country getting additional financing from international markets.

All in all, these are excellent news for Angola in many fronts:

**International Reserves** – Higher oil prices and increased production has helped the Balance of Payments and net international reserves increased in July for the first time since November 2008. Granted that it was 3.5% increase compared to June, but any positive growth is great gain compared to large losses from December to April. Besides the improvements on the export side, imports are likely to decrease as it responds, with a lag, to the domestic economic slowdown. Improved Current Account will allow the BNA to maintain net international reserves at its current level and increase the supply of foreign exchange to banks. Higher foreign exchange sales by BNA, even at a fixed rate

initially, will reduce the repressed demand for dollars and help to reduce imbalances in the secondary and parallel markets and, eventually, will allow the Central Bank to return to price and quantity auctions of foreign exchange, the appropriate step towards the elimination of imbalances in those markets and allowing the exchange rate to fluctuate more freely. The growing gap between the different exchange rates is likely to slow down as devaluation in the secondary and parallel markets slows or even stabilizes, depending on volume of foreign currency offered by BNA.

**Reduction of Arrears** – Higher oil tax revenues will allow the Ministry of Finance to reduce the amount accumulated in late payment to suppliers. That will allow the government to keep tight fiscal policy via implementation of the budget and not by accumulation of late payment to suppliers. As those payments make their round in the economy, liquidity will increase and demand for government bonds should improve, again improving overall cash flow and most likely reducing imbalances in the security markets.

**Inflation** – As exchange rate stabilizes, its impact on inflation will be more neutral. Price pressures are likely to also be reduced due to slowing aggregate demand (general economic slowdown) and fewer supply side constraints due to logistics as delayed reductions of demand for imports materialize resulting in less congestion of ports and transportation in general. Inflation rate is likely to remain around 14% in 2009 but declining slightly after the end-of-the-year holidays.

## **VII. Future Sustainable Development: Some points to be studied and discussed.**

The strong impact of the global financial-economic crisis in Angola reinforced the concerns associated to the country's high dependency on oil and the need to create conditions for the diversification of the economy. This is not the unique case of Angola as many countries experience the same circumstances. However, what makes Angola a unique case is that only seven years ago the country ended long period of armed conflict.<sup>10</sup> Thus, Angola is a post armed conflict country with a high dependency in oil.

In the last years as oil prices exploded and production more than doubled, Angola achieved high rates of growth with the public sector leading the process. The government attempt to rebuild the country as fast as possible to create the necessary, but not sufficient, conditions to diversify the economy into other sector. The limited absorption capacity of the economy associated with limited institutional capacity to deal

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<sup>10</sup> Angola experienced over 40 years of armed conflicts starting with the independence war (1961 to 1975) followed by the civil war (1975-2002). The consequences of such long period of war were devastating: it has been estimated that more than one million people dies, an astonishing number of dislocated people (three million moved to the cities and 400 thousand left to neighboring countries) resulting in overpopulated cities, vast destruction of infrastructure, abysmal social indicators with extremely low standards of living and widespread poverty, lack of public services such as access to safe water and sanitation, very low school enrollment, high levels of illiteracy, all contributing to high infant mortality rates and very low life expectancy. On the economic side the country faced low growth rates, high inflation, high fiscal deficits, The public administration was more adapted to war efforts than to provide public services with low institutional capacity, lack of skilled labor, procedures and systems resulting in low efficiency of the public sector and poor delivery of services.

with the enormous effort of reconstruction, based on growing oil tax revenues, created several imbalances in the economy. For example, the lack of a skilled labor force resulted in large number of foreign workers coming to Angola, at a relatively high price, increasing demand for housing in a market with very limited supply resulting in a rent and sales price bubble. Increased demand for other goods and services for consumption and investment not satisfied by the extreme limited domestic production resulted in increased demand for imports. Logistic problems such as limited port and general transportation capacity resulted in increased production costs, making reconstruction more costly than under less strained circumstances.

The magnitude of the increases in public revenues and expenditures experienced by Angola in the last years would represent an amazing challenge for any administration including those which had not experienced wars and even among the most structured public sectors in the world. For a country such as Angola, starting from a very disadvantage position in terms of structure and capacity of its public sector, the challenges were astronomical. The risks associated with such growth of expenditures are many. Notwithstanding the long-term fiscal and debt sustainability, a major risk is related to the capacity of the government to manage these gigantic increases in expenditures with a multitude of investment projects and increasing demands for traditional public services. Given the much larger levels of efforts needed to execute ever increasing budgets there is the probability of lower levels of efficiency for the public sector unless institutional capacity increases at similar rates of the expenditures.

Some important questions are: Is the government current size, level of training and skills of the public servants, the structure and installed capacity in terms of systems of implementation, monitoring and evaluation of projects adequate to execute the growing public expenditures without losing efficiency? How to conciliate short term needs and demands with medium and long terms fiscal sustainability? How to increase the probabilities that the best projects are financed? How to avoid investing in projects with low levels of (economic and social) returns when there are so many social needs and most projects seemed to be important? In other words, how to prioritize and increase efficiency of public investments? Are the resulting recurrent future costs of present investments taken into consideration in the process of financing them? Are the overall capital expenditures avoiding duplication of efforts, taking advantage of potential synergies and maximizing social and economic impacts? Are the policy decisions on investment allocation pursuing social equity, reduction of regional and personal income and level of living disparities? These are challenges that any administration experiencing the levels of public expenditure growth observed for Angola would face.

The government of Angola has made remarkable advances in improving policy design, budget preparation, coordination between current and capital expenditures, and public financial management. However, the size of the changes in the economy and the growth of demands on the public sector require constant improvements and increased capacity of the government. There are many challenges ahead and the sustainable economic development of the country will depend heavily on how the public sector addresses them.