Zambia Viewpoint

Macro woes take shine off medium-term copper boom

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Bright copper prospects with huge investment, but…

Zambia is set for a medium-term mining boom. The investment pipeline stands at $7 billion, or >20% of GDP from major players like Barrick, FQM, Vedanta, UAE and China. What's more, copper is green and demand-resilient. We are bullish copper prices, at above US$10k/ton in 2025. This should support 5% real GDP growth and a 10% current account surplus next year. Exciting stuff but marred by near-term macro pain.

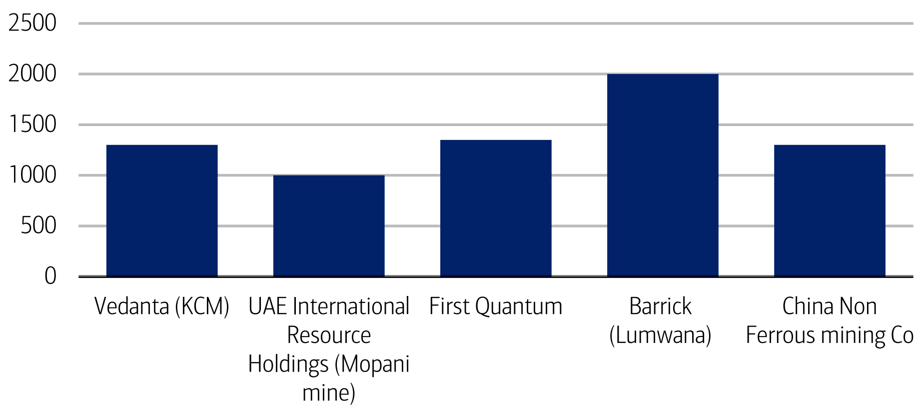
Near-term strain: drought, weak kwacha and rising CPI

Still-weak copper production is causing lower export receipts and FX shortages, in turn leading to kwacha depreciation and higher inflation. On top of this comes the drought (adding to risks CPI exceeds 15% in 2Q) and further delays to debt restructuring. The central bank is tightening monetary policy but is unlikely to eliminate negative real rates in the next two quarters. We estimate real GDP growth slows to 3.4% in 2024 while the current account could return to a 2% of GDP surplus from a 1% deficit last year.

Debt talks could finally be concluded by 2Q 24

Debt delays have hurt sentiment. Expectations were raised with the official creditors deal on Oct 11 and Eurobond holders on Oct 26, see Zambia Viewpoint: Debt deal done – IMF upgrade next? 31 October 2023. But the creditors rejected the Eurobond offer on 'comparability of treatment' concerns, despite it meeting government and IMF program requirements. There are arguments over what 'comparable treatment' is. We expect some agreement in 2Q, allowing Zambia to refocus on macro. The post-default rating is likely to start at CCC+, at best B-. A mining boom could see scope for upgrade to B but not the B+ of 2012 when Zambia issued its first Eurobond at a less expensive price than Spain.

Exhibit 1: Zambia mining investment pipeline (USD millions)
Despite a dip in current production, medium-term investment presents upside potential to volumes



Source: BofA Global Research

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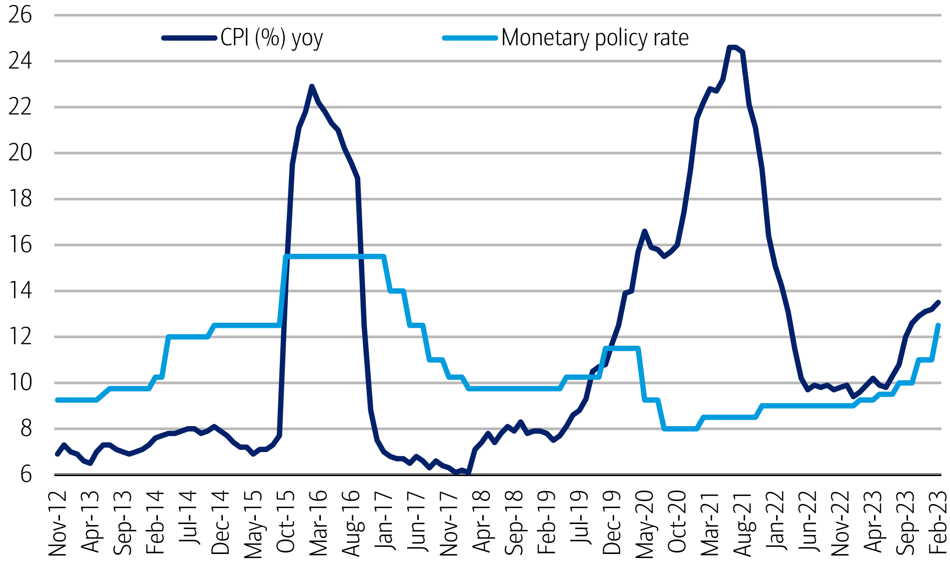
Positive FDI medium-term outlook

Inflation and monetary policy outlook

Exhibit 2: Inflation and Monetary Policy rate
Inflation spikes in 2015/16 and 2021 have not necessarily been followed by aggressive hikes.



Source: Haver, BofA Global Research

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Further CPI upside risks on the horizon

Inflation is on an upward trend thanks to a multitude of factors. The recent bout of rising inflation was primarily driven by currency depreciation due to lower copper export receipts following a large drop in production volumes. The local FX market is heavily reliant on copper export receipts flowing into the local market through the central bank. FX shortages have put pressure on the currency which had been moderately depreciating until these issues emerged in 2H 23. Electricity tariffs are also look set to increase in 2Q, by 9% in 2Q 2024, 15% in 2Q 2025 adding to upward pressure on inflation.

Drought double blow: food and electricity shortages

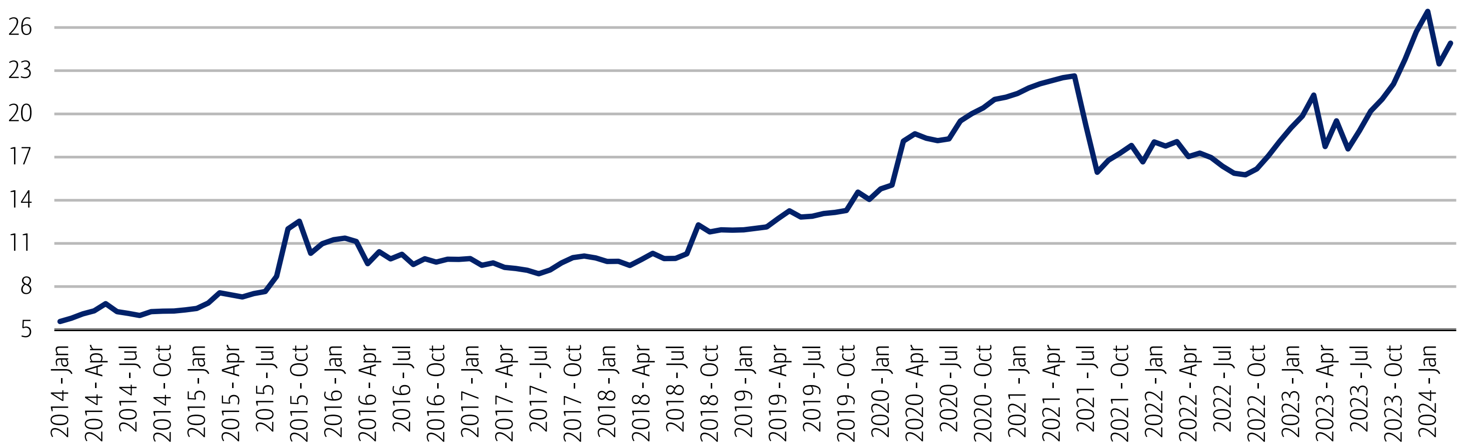
A second wave likely to hit 2Q inflation prints is the impact of drought on agriculture output. Almost half the maize crop is damaged: about 1 million of 2.2 million hectares. President Hakainde Hichilema declared the drought was caused by El-Nino weather conditions, namely extended dry periods. The rainy season is usually October to March. Food inflation is already high, close to 14% and likely to reach 15-20% over the next three months. The drought also means low water levels at the Kariba dam. The dam is the main supplier of the country's hydropower (which accounts for 80% of power supply). We think inflation is likely to peak at slightly above 15% before declining in 2H 24, benefitting from base effects.

Policy tightening and USD inflows = stronger kwacha

On 14 Feb the Bank of Zambia (BoZ) raised the policy rate by 150bp to 12.5%, a follow-up hike after 100bp in November 2023. The monetary policy response was largely welcomed by the market – the hike reduced negative real rates. The BoZ hike and increase in FX supply helped the kwacha to appreciate in February post the MPC. However, the weakening trend has since returned, and is likely to persist until the supply side improves or debt restructuring is concluded by the end of 2Q. Based on our positive view of the mining sector over the medium term + dollar inflows, we foresee kwacha appreciation. We forecast 24 per USD by year-end 2024, and 22 per USD by year-end 2025.

Exhibit 3: Monthly USD-kwacha movements

Recent appreciation was short-lived due to still limited FX inflows. We see upside to FX inflows over the medium-term supporting kwacha appreciation to 24 per USD by end of 2024, and 22 per USD by end of 2025.



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Negative real rates as CPI outpaces rate hikes

We believe inflation is likely to remain outside the 6-8% target band in 2024 while real rates could be neutral to positive by year-end. The central bank does not appear to be planning aggressive near-term rate rises. It could be cautious on price rises emanating from the effects of the drought. Instead, it perceives tightening to be reflected largely in the overnight lending facility rate around 29%.

Domestic credit conditions becoming tighter

Local banks have faced a double blow. First, a law requiring government departments to shift their banking from commercial banks to central banks, sapping liquidity from deposit-taking institutions. This is part of public finance management reforms so the central bank can perform its role as banker to the government. Second, the cash reserve ratio is increasing, which also saps liquidity from deposit-taking institutions.

Lower mining receipts at heart of FX issues

The FX shortages largely started in 2H 23 as mining sector tax receipts declined, leading to lower FX supply and a weakening Zambian kwacha. Mining taxes fell sharply. Since these are paid in dollars directly to the government, the central bank benefits by being a supplier of FX to the market rather than the banks. The policy change to pay mining taxes in USD since 2020 has led to a decline in net FX supply, weakening the interbank FX market. Local participants view activity levels as low and largely dependent on FX supply from the central bank. 70% of FX supply comes from the mining sector.

Easing FX issues require a supply-side improvement, largely increased copper production. In the short term (2Q) copper production is likely to be constrained, though it should improve in 2H and over the medium term. Consequently, the kwacha should remain under pressure in 2Q.

In 2024, production improvements are likely to be small, largely in 2H 24 rather than 2Q 24. We expect production to increase to 750k tons per year, from below 700k in 2023. The issues facing two mines that are largely responsible for the fall in production – KCM and Mopani – are now being resolved thanks to funding from new equity partners. The KCM mine was returned to Vedanta in 2023. While Vedanta is facing financial difficulties at the parent level, we understand the investment in KCM will be separated from group-level financial issues, allowing Vedanta to raise about $1.3 billion to pump into KCM. On the other hand, the Mopani mine is now owned by UAE company International Resource Holdings, which is looking to invest about $1.1 billion.

Exhibit 4: Annual Copper production
In 2023 annual copper production declined to 700k tons from 760k in 2022.

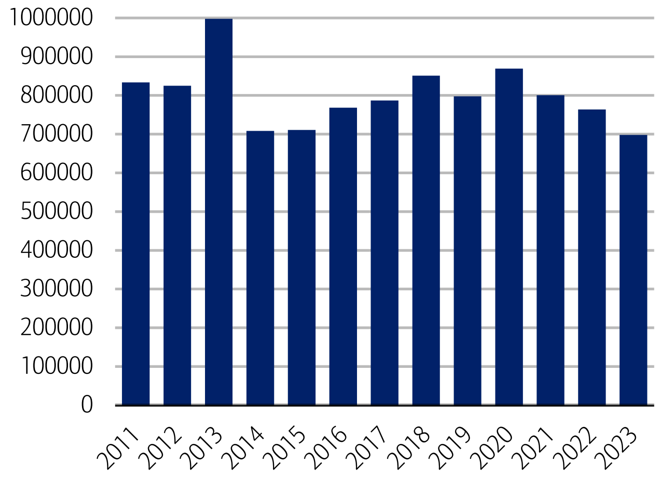

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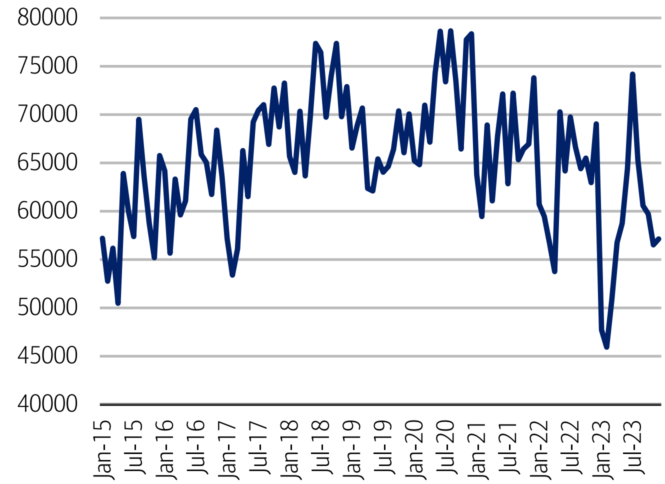
Exhibit 5: Monthly Copper production
Fell sharply since July 2023, and is still to recover



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Mining sector: large FDI flows ahead, 25% of GDP

Mining sector: near-term marginal gains from weak 2023 levels

Mining production is a long game: the volume dip in 2023 has been attributed to a lack of commitment to investment as far back as 2018 under the previous government. The challenges involved disputes over the expropriation and eventual exit of Glencore. Since the new government came to power in August 2021, mining sector stability has been achieved through a predictable fiscal regime and efforts to resolve past disputes. This stability has helped shape the investment commitments now being announced.

The copper production outlook over the medium term is much brighter than suggested by 2023 data. Mining sector companies are now largely positive. They are planning to invest in exploration (at least $200 million per annum) and investment activity to the tune of $7 billion, that is around 25% of GDP in the pipeline. Copper reserves have reached 30 million tons, while the government has ambitious plans to reach annual production of 3 million tons. Over the medium term, we think 1 million tons of production is possible, should some projected investments materialize.

Already existing firms are ramping up investment, e.g. the $1.35 billion expansion of **FQM's Kansanshi** mining operations and nickel production at the Kalumbila mine. **Barrick** is investing $2 billion in expanding its **Lumwana Mine**. Lumwana produces about 50 thousand tons per year and this could be increased to 240 thousand (currently in the feasibility phase until the end of 2024). Separately, the **China Non-Ferrous Metals Mining Corporation**, including the Fishtie copper project, has committed to investing $1.3 billion. Other investment relates to cobalt and nickel mine production.

Hurdles to all this investment include the request for free carry. The government, through its state-owned company ZCCM, is asking for free carry for all new exploration activities. This is similar to South Africa's local ownership calls for free to empowerment. This could be negative for new investment and weigh on an otherwise positive outlook for the mining sector. Lastly, the government could consider gradually implementing its pledge to reduce the effective tax rate for mining companies. At present it stands at over 50%, when peer countries offer 40-45% depending on whether it's open cast or deep underground mining.

Copper price outlook remains bullish

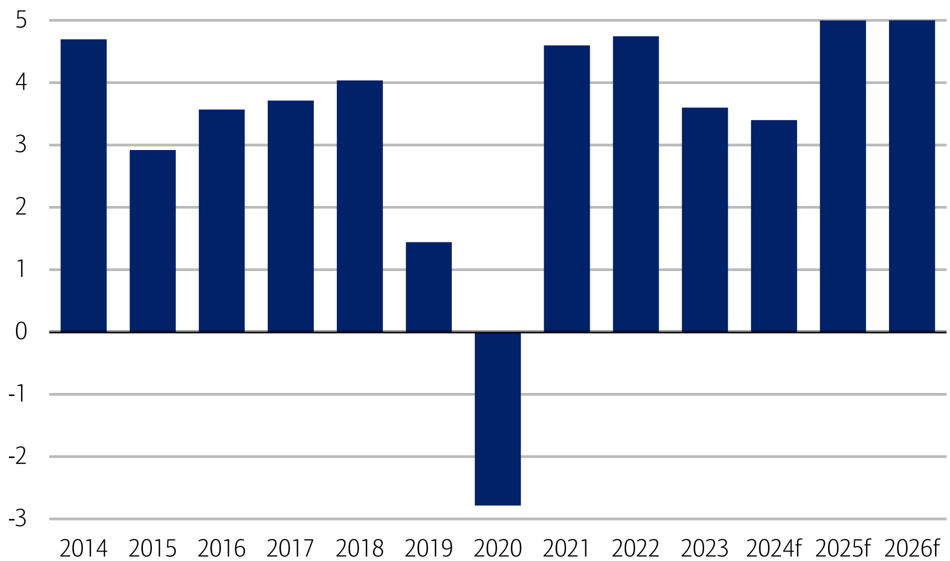
China demand continues to support copper prices over the medium term, both for investment and green spending. In the near term, however, China demand is weak due to stresses in the credit and housing markets. Overall, the dip in Chinese economic performance has been offset by demand for copper in green energy, which has kept copper prices resilient. Investment in renewables and electric vehicle production has been strong, while grid spending has offset some weakness from the housing market. Government stimulus could help improve sentiment and ease credit strains.

In the meantime, copper prices could exhibit seasonality due to rising inventories in spring/summer, which could keep prices below our medium-term view. We expect copper prices to average $8,625/t in 2024, similar to central bank assumptions for the year. However, we are more bullish for 2025. We remain constructive on copper into 2H24 and expect prices to average $10,500/t ($4.76/lb) in 2025. The local mining sector is comfortable with prices of at least $8,100. During tough times, copper prices have fallen as low as $6,000.

We expect the current account to switch back into a surplus of 2.3% of GDP in 2024, relative to a deficit of -1.1% of GDP in 2023. Our 2024 current account estimate is below the central bank estimate of 3.9% of GDP. We are more bullish in 2025 when both increased volumes and high prices could result in a current account surplus of 10% of GDP.

Exhibit 6: Real GDP growth trend and forecast (%)

We forecast better growth performance from 2025 as copper volumes and prices increase



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GDP growth downside risks, estimate 3.4% in 2024

We think near-term prospects are likely to be weighed down by power outages and the impact of drought on the agriculture sector. We estimate 2024 GDP growth of around 3.4% (Bank of Zambia 3.9% and IMF 4.7%). Given the positive outlook for the mining sector, medium-term growth could even reach around 5%. The IMF projects around 4.8% in 2025 and 2026.

Exhibit 7: Debt service distribution (KES millions)
Domestic interest payments have escalated since 2021 due to increased domestic borrowing, outweighing the external interest moratorium.

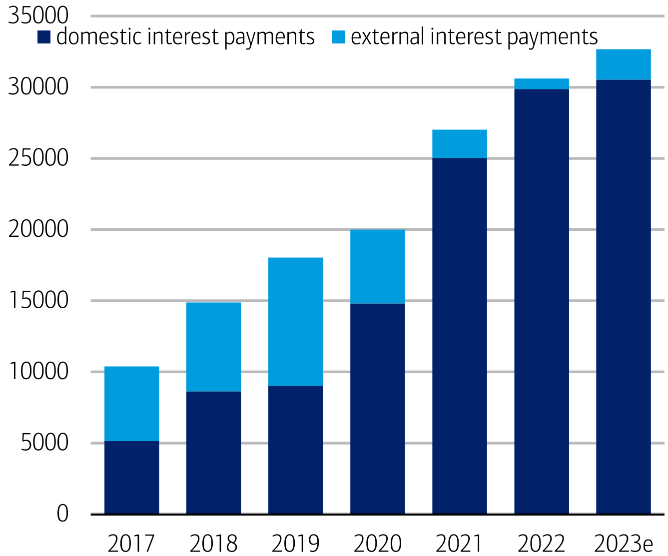

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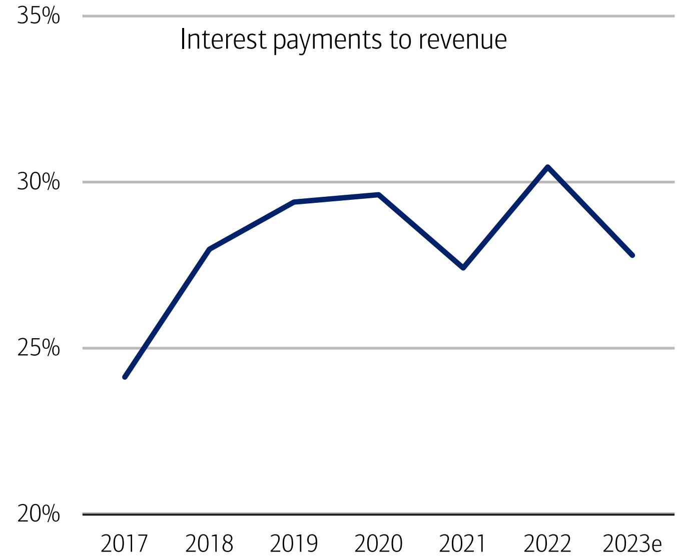
Exhibit 8: Debt service to revenue
Still remains relatively high, close to 30% despite external debt service moratorium.



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Fiscal progress with some pain points

Fiscal consolidation is largely on track. On a cash basis the government has managed to bring down the headline deficit close to -5.4% in 2023, relative to -7.7% in 2022 and -8.2% in 2021. Primary balances have turned positive since 2023, which is likely to result in large primary surpluses averaging 1-2% of GDP over the medium term.

Pain point 1: spending arrears

When we include spending arrears, though, the deficit on a commitment basis becomes larger that suggested by the cash deficit. That is -7.5% in 2023, from -9.5% in 2022, and -11.7% in 2021.

Pain point 2: lack of interest savings on external debt default

Interest savings from external debt default are not evident. That is interest cost savings on external debt service seem to be outweighed by a tripling of domestic debt service since 2021. The interest to revenue ratio remains around 30%, similar to pre-default levels. The rise in domestic debt service costs is due to increased borrowing in government securities in the local market. We think external interest cost is likely to increase once restructuring is concluded.

Pain point 3: fiscal slippage owing to drought

Spending on drought-related risks could result in fiscal slippage in the near term. A supplementary budget is likely in coming weeks, once the government has costed the additional financial support required. Suggestions from the Presidency include cutting goods and services spending to mitigate the overspend and stick to the originally outlined fiscal targets.

The authorities are proposing a faster fiscal consolidation path: -4.8% of GDP in 2024, -2.8% in 2025 and a -2.2% overall deficit in 2026. We think these are ambitious targets, particularly in the last two outer years. We estimate headline deficits of -5% in 2024, -3.7% in 2025 and about -3% in 2026.

New tax measures are limited. We see revenue to GDP as already high, around 22.5% of GDP, and less likely to improve substantially each year due to improvements in tax administration. The government expects expenditure to GDP to reduce to 25.7% in 2026 from 27.8% in 2024 driven by lower spending on interest payments after external debt restructuring.

Getting closer to a debt deal

In November 2023, the official creditors committee rejected a second debt relief proposal offered by the Eurobond holders committee even though it had been accepted by the International Monetary Fund (IMF). The Official creditors committee (OCC)'s rejection was premised on presumed non-compliance with the Comparability of Treatment (COT) in the Base Case scenario due to a shorter extension of maturities. Eurobond holders were providing nominal face value haircuts while the OCC only kicks out maturities to longer repayment timelines. The nominal haircuts were not considered sufficient under the G-20 Common Framework criteria to assess Comparability of Treatment. Even then, it appeared there was no common understanding among OCC members of what level or size of reductions would be deemed comparable to comply with the COT principles.

We think there is enough push from the government, the IMF and the OCC to find a common position on agreements. In 1Q President Hichilema visited China and came back positive on the country's cooperation in the three debt talks. The IMF spring meetings are upcoming in April, where Zambia could be unveiled as a successful case of debt restructuring under the G20 common framework. So, we think that a deal is likely between April and June.

Exhibit 9: Zambia timeline

Last step on negotiating comparability of treatment likely to be reached by end of 2Q 24.

Event	Activity
Oct-20	Decides to stop external debt repayments
Nov-20	Misses Eurobond coupon payment due November 2020
Aug-21	Opposition party wins elections, forms new government
Dec-21	IMF staff level agreement with authorities
Apr-22	Official creditor committee formed – China agrees to join and co-chair with France.
July, 2022	Official creditors provide financing assurances in a joint statement
Aug-22	IMF board approves a 3-year US$1.3 billion program
September, 2022	IMF publishes the full Debt Sustainability analysis
Jun-23	Government reaches a debt restructuring agreement with official creditors
Jul-23	IMF Board approves 1st review of 3year funded program
Oct-23	Official creditors and bondholders provide debt relief offers to government- debt deal done?
Nov-23	Official creditors reject Eurobond offer on lack of comparability of treatment grounds
Jun-24	We expect some agreements by end of 2Q as government push for deal.

Source: BofA Global Research

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