Mozambique

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Mozambique - Still a benign example in Southern Africa

- In 2009, the Mozambican economy will continue to grow at a comfortable pace despite the overall global recessive picture. Currently, the discussion on 2009 growth level is centred on a range between 4% and 4.5% which is very positive amidst the backdrop of the adverse international context. However, growth risks are tilted downwards as some impact arising from the international financial crisis seems unavoidable. This crisis should be felt mainly through a narrowing of investment and exports, particularly aluminium, due to its still considerable weight in production and on the external balance.

- In contrast, supporting economic activity, international donors (Partner Support Program - Portuguese anachronism PAP) have committed themselves to maintain their donations until 2010. These grants represent approximately 14.5% of GDP, 50% of public revenue and help to finance public spending which has positive implications on private investment and activity. Furthermore, the Government has put in place strategies to mitigate the harmful effects of the global crisis - for example, by seeking alternative destinations for exports. In addition, we underline the continued effort to increase the formalization of economic activity in an effort to generate a more sustainable basis for expanding the public accounts.

- The fall in both oil and food prices in international markets along with good prospects for this year's harvest, have contributed to inflation slowdown. However, the exchange rate developments may weigh on inflation at the end of the year and damage the current deceleration.

- In this publication we present a note on our recent visit to Mozambique where we higligt our views on the country. While Mozambique cames across as an example of a sucessful post-conflit economy and is emerging as a potential crucial energy supplier in the region on the back of its hidric and gas resources, there are still many challenges lying ahead; namelly dependance on international aid; high HIV/AIDS prevalence rate; low savings rate along with difficult access to credit; and low labour force skills.

Mozambique - Mozambique Island

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1 - Macroeconomic Scenario

... Solid but Decelerating Growth

In the last three years, the Mozambican pace of economic growth has remained robust. GDP growth slowed from 8.7% in 2006 to 7.4% in 2007 and 6.8% in 2008. In 4Q08, compared to a year ago, growth fell by 2.6 percentage points to 6%, while in chain seasonally adjusted GDP dropped from 2.6% to 1.8%.

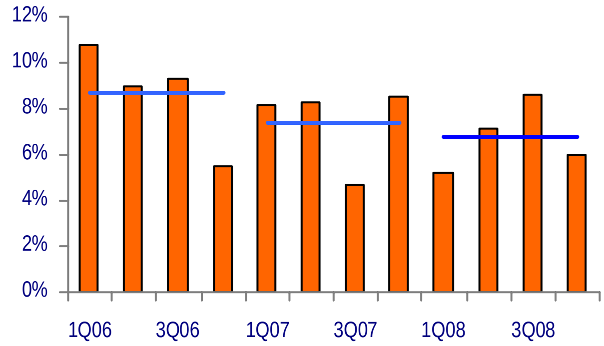
In 2008, the sectors that contributed most to GDP growth were:

- Agriculture, which accounted for 30% of GDP growth. The agricultural sector is posting strong increases led by Government strong impetus to develop small agricultural production units.
- Transport and Communication whose contribution constituted 25% of the total.
- Trade, with a contribution of 10.8%.
- Financial Services, 9.4%.

The improvement in the purchasing power of the population has been stimulating trade. Additionally, economic development has brought a greater degree of economic formalization which in turn, results in an increased legalization of small businesses and a greater connection both from the business sector and overall population to the banking sector.

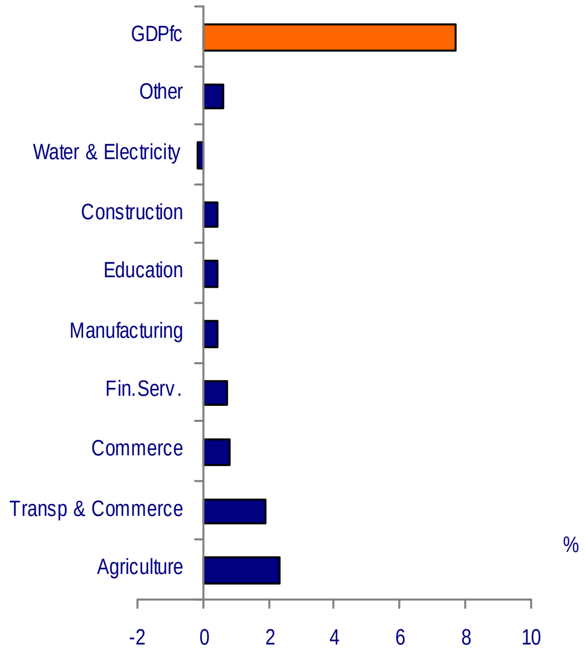
The sectorial breakdown of the Mozambican economy evidences some diversification. The agricultural sector has a weight of 26% in GDP which could be reinforced in the short /medium term benefiting from the efforts of the authorities and the country's huge development potential. Next in importance come manufacturing (14%), transport and communications (12%) and trade (12%). The weight of manufacturing is closely related to the Mozal plant so that in 2009, the demand contraction in aluminium international markets could lead to a loss in importance of this sector. Due to the contraction in exports, the transport and communications sector will also suffer as much of the activity is channelled abroad through seaports. The sectors of Electricity, Water and Financial Services account for a total of 6%. Construction of the new dam on the Zambezi River could provide a strong impetus to the electricity sector, while the financial sector could also benefit (although to a lesser extent) from the increased economic formalization. The development and commissioning of projects related to the mining industry, particularly the mining of coal in Moatize, will cause the weight of this sector to grow strongly (from only 1% now), primarily from 2010 onwards.

GDP real growth (yoy).



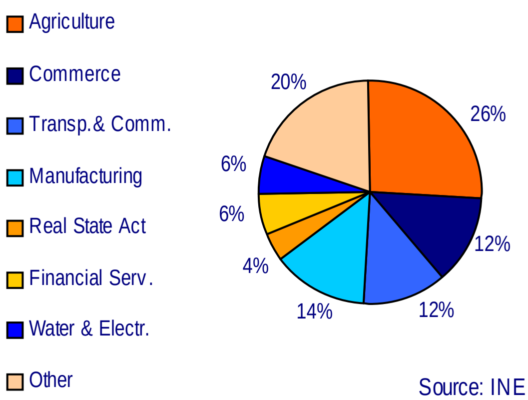
Source: INE

Contributions to 2008 GDP growth.



Source: INE

GDP sectorial breakdown in 2008 (% of total).



Source: INE

... Economic Climate

The main economic climate indicator has been declining since December. In April, it stood at 97.1, the lowest level since September 2005. As a qualitative indicator, this shows a growing pessimism among economic agents and a negative trend on economic activity. This downtrend reflects a full-fledged decline in confidence though primarily in Construction, Commerce and Transport. The current employment indicator fell between February and April, from 107 to 105.7 while the indicator of employment expectations, which had been in sharp fall since November, rebounded slightly from 96.9 to 98.5 in April.

...Positive perspectives despite the international crisis

Mozambique's economy will continue to grow at a steady pace this year, despite the overall recessive picture. Currently the discussion is centred on whether growth will remain between 4 and 4.5% (the International Monetary Fund forecasts that GDP will grow by 4.3% this year and 4% in 2010) or be closer to the level reached in 2008, of 6.8%. For 2009, international institutions are unanimous in considering the level of 4-4.5% as the most reasonable scenario. However, for 2010 opinions differ, with the EIU and OECD anticipating growth acceleration (a hypothesis that seems reasonable amidst a less restrictive international scenario) while the IMF predicts a slight deceleration.

Mozambique - Macroeconomic scenario

		GDP		Inflation		Budget balance (% GDP)		CA (%GDP)	
Institution	**Date**	**2009**	**2010**	**2009**	**2010**	**2009**	**2010**	**2009**	**2010**
IMF	April	4.3	4	5.4	5.2	-7.1	-6.2	-11.7	-10.9
OECD	May	4	5.2						
EIU	May	4.8	5.2	6.8	7.2	-6	-5.7	-8.4	-10.2

It is inevitable that the international financial crisis will have a negative impact on growth given the antecipated slowdown in both investment and exports, particularly of aluminium. On the public accounts side, the fall in Mozal's activity will also represent a revenue loss, through lower taxes (marginal effect is estimated at about 1% of public revenues in 2008) and dividends (because the state is a shareholder).

However, there are compensatory effects. Falling prices of raw materials (mainly oil) and food will have a positive impact on economic activity. The fact that international donations are secured is also essential for the Mozambican economy. These are equivalent to approximately 14.5% of GDP, equivalent to about 50% of public revenue and finance the state's expenses. This in turn has positive implications on economic activity as well as on private sector investment. Furthermore, the Government has actively sought to develop strategies to mitigate the harmful effects of the crisis, both for the private sector and for public accounts:

- Simplified Tax - In 2008 the Government implemented a simplified tax for small taxpayers (those with a turnover less than 2 million meticals) where they may opt for the payment of 75 thousand meticals per year or for the payment of 3% on sales receipts, which requires taxpayers to have organized accounts and commercial records. A huge adherence rate to this tax was registered and we expect this to be maintained. The small traders/entrepreneurs, without formal accounting are persuaded to pay through a moralization campaign, which calls for formalization of the relationship with the state, thereby improving activity.

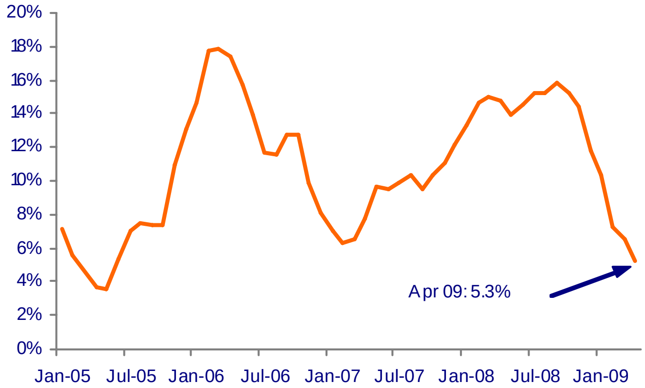
- Informality Reduction - in addition to the simplified tax, there was an increase presence of local tax structures and local government offices operate as instruments of tax liquidation.

- Alternative markets - the government has been actively seeking alternative export markets for the most affected products. For example, in the case of shrimp, the main destination markets have shifted from Europe to the U.S., where demand is higher.

...Inflation deceleration

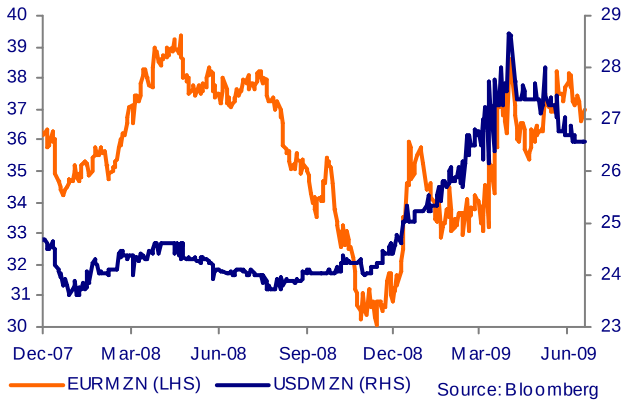
Inflation in Mozambique is heavily influenced by the evolution of food and energy prices due to their weight in the consumption basket. Thus, following a sharp increase in prices between early 2007 and September 2008, inflation has been decelerating and is currently significantly below the levels registered in early 2007, at 5.3%. The fall in oil and food prices in the international markets along with prospects of a good harvest have been behind this benign evolution which should be extended in the coming months, benefiting from favourable base effects.

Inflation (yoy).



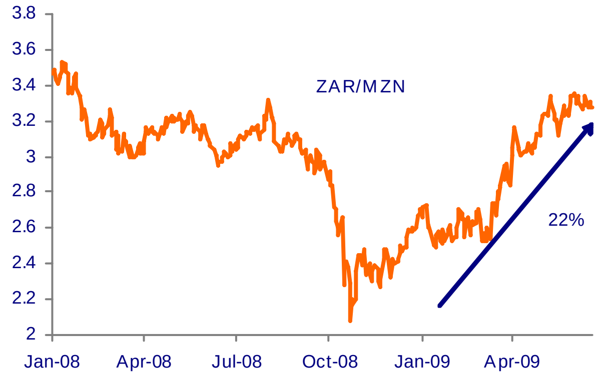
Source: INE

Metical has stabilized after a period of strong depreciation and high volatility.



Source: Bloomberg

Since the begining of 2009, the metical has been depreciating also against the rand but there are some signs of stabilization.



Source: Bloomberg

It is uncertain if inflation will finish the year close to the Central Bank's target of 6%, given the influence of exchange rate changes. Imports weigh significantly on economic activity (around 40% of GDP) so that the recent depreciation of the Metical against the dollar and especially against the South African rand (about 22% since January) will have an adverse effect on CPI (in 2008, 27% of imports came from South Africa). The influence of this movement in inflation may become more significant near the year-end, due to the typical demand peak at festive periods.

... External and government accounts reflect key economic constraints

The State Budget depends considerably on foreign aid. The Government aims to increase tax revenue (as a percentage of GDP) to 20%-25%, values commonly recorded in developing economies, though the current revenue to GDP ratio remains considerably below this level. To this end, the Government intends to increase tax revenue by at least 0.5% of GDP per year.

Public accounts (% of GDP).

	2008	2007		2008	2007
Total Revenue e Donations	28.70%	25.30%	Total expenditure and loans	33.10%	28.20%
Fiscal Revenues	14.40%	14.00%	Wages	8.20%	7.80%
Donations	11.90%	9.30%	Debt service	0.60%	0.60%
			Budget balance	-4.40%	-2.90%

Source: OECD.

Huge tax exemptions granted to early megaprojects contribute to perpetuate the dependence on external aid. Nevertheless, the authorities have recently changed tax incentives such that those projects approved in recent years or in the process of execution, are only partially exempt in the implementation and construction phases. Once in operation, they are subject to the normal tax regime.

In terms of financing, public expenditure should be maintained as planned and the priority is to strengthen fiscal revenue by preventing loss of revenue (reduction in grants). In the event of possible revenue shortage, the Government can issue new treasury bonds (Treasury Bills are not used as a tool for financing, but only as a liquidity management tool in the financial system).

External account - some indicators.

	2008	2007
Current Account		
% of GDP	-10.1	-9.7
USD millions	-975	-785
Excluding Mega projects (% GDP)	**-13**	**-14.9**
Excluding Grants (% GDP)	**-21.2**	**-15.9**
Balance on Goods and services		
% GDP	-12.4	-9.9
Excluding Mega projects (% PIB)	-22.9	-22.6
FDI - inflows		
% GDP	6.1	5.3
USD millions	587.1	427
Excluding Mega projects (% GDP)	**3**	**2.6**
Grants - total		
% GDP	10.7	9.6
USD millions	1031.8	778
Reserves		
USD millions	1,684	1504
Months of imports	3.6	5

Source: OECD, Bank of Mozambique, IMF.

The **current account** deficit remains considerably high, supported by current transfers (entry of donations) and financed by FDI inflows. Without grants, the current account deficit would have exceeded 21% of GDP (according to the IMF). As one would predict given the characteristics of the external accounts and adverse international context, the country has experienced some difficulties in terms of exchange rate pressure in the first months of the year. As many capital movements are still subject to approval, the situation was counteracted by central bank intervention to support the exchange rate. This intervention brought some stability to the exchange rate (namely against the USD). However, the endurance of the international crisis will bring a negative effect on the external accounts, particularly at the reserves level. Nonetheless, the availability of the IMF's External Shocks Facility should alleviate the problem and allow confidence to return. In addition, according to the Bank of Mozambique, the current level of reserves amounts to 5 months of imports, higher than the OECD had forecasted. Also according to Central Bank, reserves are held 60% in USD, 30% in EUR and 10% in other currencies.

The **balance of goods** and services shows a significant deficit of around 10% of GDP in 2008 even including major projects. Imports of capital goods and refined fuel (respectively 14% and 17% of imports of goods) weigh heavily on the external balance. Grain, cars, medical drugs, sugar and beer are the main consumer goods imports. However, in 2008 there were positive developments regarding exports which, excluding megaprojects, increased by 41%. We highlight exports of tobacco, almonds and cashew nuts and gas as well as sugar, which posted the highest growth rates. In terms of the weight on total exports, the emphasis goes to electricity, gas, tobacco and sugar.

Goods Exports (USD millions)

	2007	Weight	2008	Weight	Annual var.
Total	**2,412.10**	**100%**	**2,653.30**	**100%**	**10%**
General commodities	2,112.70	88%	2,196.50	83%	4%
Aluminium	1,480.20	61%	1,451.80	55%	-2%
Electric energy	239.7	10%	221.2	8%	-8%
Gas	120.7	5%	152	6%	26%
Tobacco	51.8	2%	132.1	5%	155%
Sugar	61.8	3%	71.3	3%	15%
Cotton	42	2%	48	2%	14%
Shrimp	62.1	3%	45	2%	-28%
Ilmenite	2.9	0%	26	1%	797%
Wood	31.9	1%	25.5	1%	-20%
Cashew apple	10.8	0%	12.5	0%	16%
Cashew nut	8.9	0%	10.9	0%	22%
Fuel acquired in ports by transport companies	20.9	1%	27.8	1%	33%
Reexports (Fuels)	28.7	1%	32.6	1%	14%
Others	249.8	10%	396.3	15%	59%
Mega projects exports	**1,843.50**	**76%**	**1851.1**	**70%**	**0%**
Exports excluding mega projects	**568.6**	**24%**	**802.2**	**30%**	**41%**

Source: Bank of Mozambique.

Note: Mega projects include Mozal, Sasol, Heavy sands from Moma (Kenmare), Heavy sands from Chibuto (Corridor Sands), Rio Doce Moçambique and Hidroeléctrica de Cahora-Bassa.

FDI entries increased by 37.4% in 2008, reaching USD 587 million. The contribution of major projects (including Mozal, Sazol, heavy sands in Moma (Kenmare), heavy sands in Chibuto (Corridor Sands), Rio Doce Mozambique and the Hydro-electric (Cahora-Bassa)) is being reduced, representing approximately 50% of total FDI.

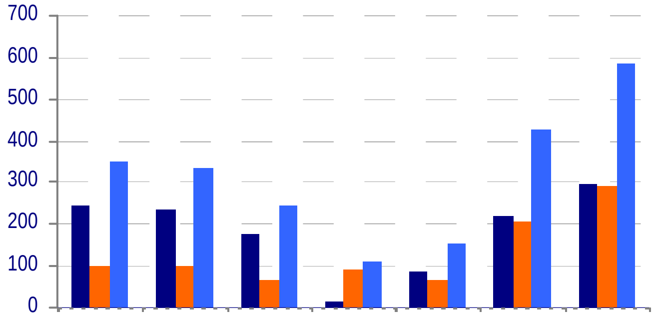
By sector, the breakdown is as follows:

FDI by sector, in 2008

Manufacturing industry	44%
Agriculture, Livestock, Hunting e Forestry	32%
Extractive industry	10%
Whole and retail trade and others	5%
Financial activities	4%
Hotels and restaurants	2%
Construction	2%
Others	1%

Source: Bank of Mozambique.

Foreign Direct Investment in Mozambique 2002-2008 (USD Million).

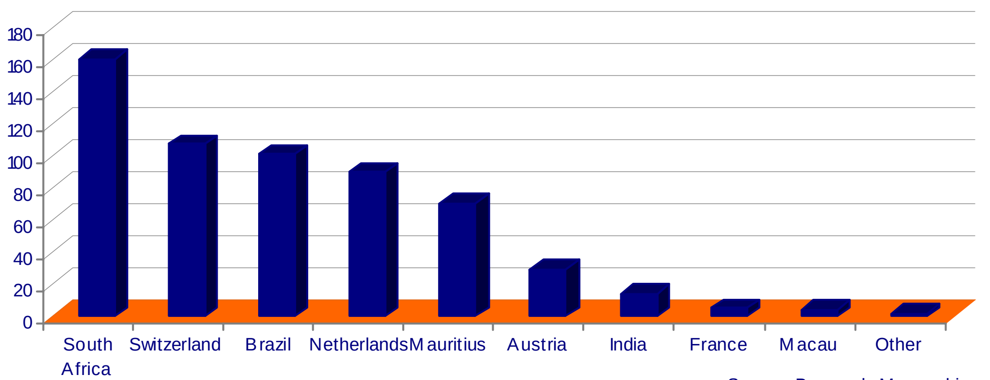


	2002	2003	2004	2005	2006	2007	2008
FDI big projects	245	234	178	15	86	220	295
FDI excl. big projects	103	103	67	93	67	207	292
FDI total	348	337	245	108	153	427	587

Source: Banco de Moçambique.

Main investors were South Africa (for the third consecutive year), Switzerland, Brazil, Netherlands, Mauritius, Austria and India.

Ten major investors in Mozambique, 2008 (USD Million).



Source: Banco de Moçambique

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2 - Visit to Mozambique - Our assessment

Period of visit: 3rd to 7th May
Entities contacted: CFM, Ports and Railways of Mozambique; AICEP; Ministry of Planning and Development; the Hydro-electric facility in Cahora Bassa; BCI; Socremo (financial institution- microcredit); CETA, construction sector; World Bank; IMF; Bank of Mozambique and Ministry of Finance.

2.1 - General View

Our previous visit to the country took place two years ago at the start of country's economic coverage. Mozambique will probably be one of the Southern African countries least affected by the international financial crisis. Grants are guaranteed until 2010 and the expectations of only a moderate production slowdown in the industrial complex of Mozal justify the relatively optimistic forecasts for the country: the worst-case scenario anticipates GDP growth of around 4% both for this year and 2010. However, some impact arising from the crisis is inevitable: a loss of activity was felt for example, in goods transport for export, particularly iron ore (-30% in the first months of the year), thanks to the slump in demand by Asian countries, including China and India; FDI should slightly retract despite the huge support given to some projects (in the energy sector, mainly); international grants are not at risk but could be reduced in 2010 in light of domestic difficulties experienced in some of the main donor countries (for instance, the United Kingdom), despite the general feeling that the majority of donors want to continue participating in the development project of Mozambique.

Our general opinion about the city of Maputo and the economic and social life of the areas we had the opportunity to visit was quite favourable. Since 2007, the year of our first visit, we observed a significant increase in the movement of people and cars; some renewal of the car fleet (probably signs of the increasing number of expatriates and growing tourism activity); more trade availability, reflected not only in quantity and types of street shops or gathered in commercial spaces, but also in the increased presence of some international brands. We also highlight the existence of at least two malls opened recently, the Polana Shopping Centre and another in downtown Maputo, the latter with a rather large and relatively diverse range of goods. The number of supermarkets has increased, with prices similar or slightly more expensive than those practiced in Portugal, showing the existence of pent-up demand.

Despite this overall positive assessment, there were other less favourable developments which are naturally related to the hurdles that are yet to be overcome in the development process: we highlight shortcomings in basic sanitation; some damage (which persists) in housing even in the key areas of Maputo; infrastructural bottlenecks, especially regarding roads (roads and pavements are in poor condition) and public transportation, etc. However, the positive aspects were clearly dominant. Also notable was the ease of pedestrian movement, evidence of low urban criminal ratings, something that clearly favours the business climate.

In macroeconomic terms, our assessment differs depending on the time horizon.

- **Short to medium term** - some uncertainties do exist and risks are still skewed to the negative side. International grants have some, though limited, risk; the Mozal project (which represents about 55% of goods exports) seems to have no risk regarding its continuity, although the fall in production will be reflected in GDP growth this year; other large investment projects have in some cases been cancelled or postponed (e.g. the corridor of heavy sands in Moatize) while others have reduced production (e.g. Mozal and some projects in Moma) an effect that can be balanced by increasing production in Sasol oil and natural gas pipelines that supply South Africa. Additionally, there is hefty activity in other projects (already approved or in the approval stage) that will only directly generate added value in 2010 or 2011, but which already have implications in infrastructure and by contributing to the emergence of specific services, etc. Strong activity is seen in the project to exploit the coal reserves in Tete: the railway line of the Seine (which connects Caia to the Beira Port) is being upgraded and the Beira Port is being restructured to allow the entry of bigger vessels; activities to exploit natural gas and oil in the Rovuma region remain active; and the project for the second dam on the River Zambeze (South of Cahora Bassa dam) could also start this year (still, some uncertainty remains). Given the dual and bipolarized economy that characterises Mozambique, there seems to be no major risks to growth because there is some insulation against international financial crisis. The crisis can only became more challenging to this economy through funding difficulties affecting international grants and FDI, or through a more significant production slowdown in the industrial complex of Mozal, factors that seem to be under control and to which we address relatively low probability. The prospect of access to an IMF funding line - the Exogenous Shocks Facility - to help the country face any anticipated fall in export earnings and an eventual downward pressure on the Metical, will contribute to enhance confidence and stabilize foreign reserves.

- **Medium to long term** - Despite the excellent performance of the country, an example in implementing stabilization policies in post-conflict environments, the long term development strategy carries some risks, which arise from the apparent absence of strong consensus as on the best way forward. The perception that it is necessary to reduce external dependence is clear - in particular, what concerns the reliance on international grants which represent about half the state budget. However the delevery strategy is diffuse. Which sectors should be actively nurtured? How best to promote conditions for the development of a robust private sector? How can one actively reduce economic informality (which may represent about 80% of economic activity)? These are some of the issues that arise in the long term. Ultimately - where does Mozambique want to go? Which sectors should the country stimulate? And which infrastructures to construct? etc..

In social terms, the main aims are centred on poverty alleviation and education improvements, moving towards the achievement of the Millennium Development Goals. However, it seems that a clear understanding on how to get there continues to prove elusive. Attention and efforts are excessively concentrated on capital-intensive sectors and in large investment projects (see attached table at the end of publication) with limited ability to stimulate other sectors of the economy. The authorities talk about tourism and agriculture development but there is no supporting infrastructure and no benefits set up. In the case of agriculture, lack of infrastructure makes it very costly to create economically viable production units with commercial purposes while there are also significant weaknesses in labour skills in the sector, resulting from the legacy of the belligerent period that triggered population displacement and the loss of traditional knowledge. However, it should be noted that improvements in this sector are evident, helping to reduce serious food shortages due to the gradual emergence of subsistence agriculture.

Despite the absence of a clearly defined strategy, particularly in the long term, it seems that there is some awareness among the ruling classes in this area. These drawbacks also relate to the complex country history: a history of war, production unit abandonment and human capital destruction and wastage. Firstly, the time distance from the end of the conflict is still short, from a historical perspective. Secondly, resources are very limited (according to the IMF, the Mozambican economy in 2008 amounted to approximately USD 9.7 billion, about 1% of GDP in sub-Saharan Africa and 2% of SADC countries) and immediate decisions should be taken to address the course of development, from which results will only be apparent in the long term. For example, a criticism often identified is the focus on quantitative indices of education. This concern is mirrored on the focus that is given to the construction of more schools and hiring of more teachers, while educational contents for instance, receive much less attention. However, this is perhaps the most reasonable option given the low starting level, both in infrastructures and level of schooling. In the medium term, by gradually focusing more on the contents and quality of the educational system, this may prove to have been the right strategy, contributing to the spread of schooling and literacy, the basic steps necessary to achieve economic development.

To sum up, we are generally optimistic on Mozambique even if the significant improvements observed in the main development indices now appear to be losing steam as the catching-up process is winding down. The political class and the Mozambican leaders are quite aware of the need to act urgently in a very pro-active manner to promote development and poverty alleviation. On the one hand, evidence from other countries shows that growth based only on natural resources exploitation is unsustainable. On the other hand, the widening gap between the formal economy, reflected in official figures, and informal activity is not a positive development, given the high likelihood of surging social unrest. Finally, we underline the political stability and perspectives that the elections scheduled for next October will pass off uneventfully. This also justifies some optimism for the country as there will be sufficient political strength to move forward with more reforms and structural measures that could give the development process a renewed momentum, contradicting some critics related to the loss of impetus on poverty alleviation.

2.2 - Risks / Weaknesses

HIV / AIDS - In addition to all the cyclical and structural risks already mentioned, we consider AIDS as the most serious and biggest challenge the country faces. According to the results from the last epidemiological round held in 2007 and whose findings were published in 2008 (with the sponsorship of the World Bank), the HIV prevalence rate in adults (15-49 years) stood at 14% in 2008, affecting 16% of pregnant women. The number of people living with HIV reached about 1.6 million people while every day about 440 new infections are recorded, more than 380 thousand people need antiretroviral treatment (including 45 thousand children), the number of deaths in 2008 was 92.1 thousand individuals and 463 thousand children became orphans. It should be noted that figures released by both the Joint United Nations Programme on HIV/AIDS (UNAIDS) and World Health Organization are similar, suggesting that the number of adults infected in 2007 was between 1.3 million and 1.7 million.

The estimated prevalence rate for Southern and Central regions is well above that of the Northern region: respectively 21% for the provinces of Maputo (city and province), Gaza and Inhambane (having the lowest of the four, 12%), 18% in the Central region, particularly Sofala and Zambezia with 23% and 19%, Tete with 13%, 9% in the North, including Niassa, Nampula and Cabo Delgado.

These are the official estimates which by themselves present a worrying picture, one of the worst cases in the region. However there have been some signs of stabilization, especially in the provinces of North and Central regions but the southern region seems to be still in an expanding phase of the contagium cycle. Moreover, the official estimates probably underestimate the problem, which is suspected to be more serious.

Demographical impact from HIV/AIDS, main indicators
(Mozambique, years 2008 a 2010).

	2008	2009	2010
Adult prevalence rate of HIV			
Population 15-49 years	14.00%	14.00%	14.00%
Pregnant women 15-49 years	16.00%	16.00%	16.00%
People living with HIV	1.6 millions	1.6 millions	1.7 millions
Number of daily new infections	440	440	445
Number of people that need anti-retroviral treatment			
Adults (15+)	385.2 k	425.1 k	465.9 k
Children (0-14)	44.7 k	47.0 k	49.2 k
Number of deaths due to AIDS	92.1 k	96.3 k	98.0 k
Number of orphans due to AIDS (0-17 years)	462.9 k	510.5 k	557.5 k

Source: "Ronda de vigilância epidemiológica", Set 2008; INE, Min. of Health, Min. Plan. e Development, et all.

Besides the loss of lives and foreseeable increase in number of orphaned children, the fact that the disease affects mainly young adults, in the period when they could provide a greater contribution to both the society and economy, poses challenges to the Mozambican society in general, individuals and businesses. Indeed, although the state provides free treatment, employers must also make a significant effort not only in prevention but also in treatment with the associated high costs for companies, especially those that generate less value added per worker.

In this context, the main challenges are (apart from prevention and treatment), to develop strategies to "take advantage" of people already infected which cannot / should not be considered a liability to be eliminated. On the other hand, more effective prevention measures are to be enacted because contamination does not only occur through the traditional ways. Transmission is also linked to the lack of health care and poor hygiene facilities available to the population as well as from old attitudes that derive from deeply rooted beliefs, such as the broad and widespread use of traditional healers.

Weak inter-regional integration - no railway link exists to connect the north to the south and the link road is very poor. The alternative more intensive use of maritime transport is unviable because it costs three times more than land-based freight transport, due to the taxation regime and the cost of maintaining the channels open, attributed to cabotage companies. What is certain is that there is no critical mass to justify the launch of more functional connecting routes. However, how can one develop other sectors of economic activity (namely tourism and agriculture) without adequate infrastructure?

Development of a strong and representative private sector - this is one of the biggest challenges that Mozambique faces in order to generate a dynamic self-sustainable domestic growth. In fact, the Mozambican economy is bipolarised. On the one hand, there is the formal economy (as reflected in the numbers that we analysed) while on the other hand, there is a huge population living informally - from small business transactions, one-off deals, the "odd jobs", etc... It is estimated that informality represents about 80% of total economic activity.

To develop a strong private sector it is essential to improve the business environment (the Doing Business index classification deteriorated in 2009, moving from position 139 to 141 out of 181) through: reducing bureaucracy and corruption; making labour legislation more flexible - in this field it would be necessary to implement a more flexible system for hiring expatriates (maximum 5% for companies with more than 100 employees - it is not by economic group but rather by production unit, i.e. the administration account for each individual company; implementing a national training plan to counteract the existing deficit in certain job skills in the country (which would be even more important than the number of workers per se). An example here would be the area of accounts certification to international standards.

Mozambique position in Doing Business ranking from World Bank.

	2007	2008	2009
General index	140º	139º	141º
Starting a business	157º	130º	144º
Dealing with construction permits	147º	147º	153º
Employing workers	162º	166º	161º
Registering property	124º	144º	149º
Getting credit	94º	126º	123º
Protecting investors	96º	33º	38º
Paying taxes	66º	77º	88º
Trading across borders	137º	145º	140º
Enforcing contracts	141º	142º	124º
Closing a business	130º	137º	133º

Source: Doing Business 2009.

Difficulties in obtaining credit are one of the factors usually mentioned as an obstacle to private sector development. This is not an easy problem to solve; hence it depends on the slow emergence of a more robust formal sector. Indeed, hardly any traditional bank provides credit without conducting a credible and consistent analysis of investment projects. Besides the necessary reliability of projects, there should be an evident management capacity. In this context, it could be argued that there is no capacity to develop such activities. Typically, businesses do not have organized accounting. Furthermore, projects themselves are sometimes of dubious nature (occasional deal, etc). In this field, **the gradual emergence of microcredit institutions with a certain capacity for intervention and expression may be crucial for Mozambique to reach a higher level of development**. Indeed, in the traditional banking sector, which only deals with the formal sector of the economy, there is a huge concentration of customers, closely reflecting a bipolarized society: roughly, the 100 largest borrowers account for more than half of credit granted by the system.

Political risk - No considerable political risk exists despite the proximity of elections (presidential, legislative and provincial), simultaneously scheduled for 28th October 2009.

- The Frente de Libertação de Moçambique (FRELIMO) continues to hold political leadership and parties that now form the opposition will not gather a significant proportion of votes in the next elections.
- This follows, on the one hand, some erosion that has affected the largest opposition party, Resistência Nacional de Moçambique (RENAMO), in particular its leader Afonso Dhlakama. Recently a new party has emerged, Movimento Democrático de Moçambique (MDM) whose leader is Daviz Simango, a former independent who won the elections in the city of Beira last November. It is unlikely that this new party will have a visible expression in the forthcoming elections, thereby not threatening the hegemony of Frelimo.
- In the medium term however, the MDM can help consolidate the opposition, which also strengthens democracy.
- The incumbent President, Armando Guebuza, will comfortably win the next election, in what is his second and final term (according to the Constitution).
- **The absence of risk surrounding the staging of the next elections does not imply that there is no political risk in Mozambique.** Indeed, the apparent slowdown in reforms momentum together with the perception that the process of reducing poverty and improving living standards in the general population are slowing significantly, has created some discomfort and social unrest.

This became evident in 2008 when higher fuel and food prices led to popular riots, which apparently arose spontaneously suggesting an even greater cause for concern. In this context, it is necessary to accelerate the development process, reduce poverty, invest more in education and foster a strong and diversified private sector which generates employment, in order to limit the emergence of social tension, potentially disrupting the success already achieved.

2.3 - Opportunities / Strengths

The geographical location of Mozambique, its extensive coastal line and the fact that it shares borders with countries holding significant economic dimensions in the context of southern Africa, are some of the economy's strengths. It could be argued that these have not been fully exploited. The ability of Mozambique to function as a logistical and commercial trade platform for landlocked countries such as Zambia, Zimbabwe or Botswana and the intensification of economic links with South Africa, the region's largest economy, is an opportunity still underexplored. For this, it is essential to improve railways, proceed with structural changes in major ports to enable their use by larger vessels, improve the railways and create logistical terminals, among others. We recall that the freight transport system in Mozambique is based on 3 rail-port systems, with the following estimated transaction volumes:

- Southern line, with reference to the Port of Maputo, to connect with Ressano Garcia (border with South Africa, the most important), Swaziland and Zimbabwe, with a transactions volume of around 8 million tonnes /year.
- The Beira corridor, affected by the crisis in Zimbabwe but which is again rebounding thanks to new projects in coal extraction in Tete province. Ongoing rehabilitation work is continuing in the Line of Sena which connects Moatize to the Port of Beira (where a dedicated coal terminal is being built). This corridor carries about 2 million tons /year.
- Northern line, which serves the Port of Nacala, carrying less than 1 million tonnes /year.

Comparative economic dimension in 2008.

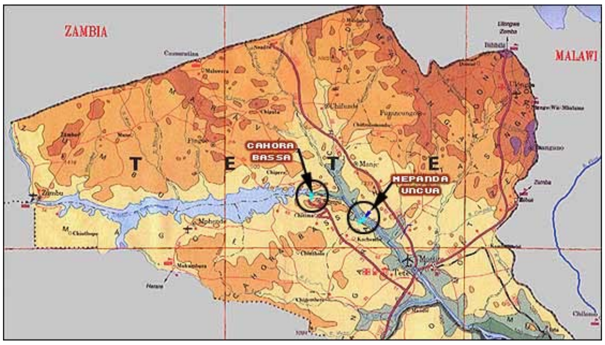
	GDP current prices, USD billions	In % of GDP from Sub-Saharan
Sub-Saharan Africa	991.5	-
Southern Africa countries	478.3	48.20%
South Africa	277.2	28.00%
Angola	83.4	8.40%
Zambia	14.3	1.40%
Botswana	13.5	1.40%
Zimbabwe (1)	12	1.20%
Mozambique	9.7	1.00%
Madagascar	9.3	0.90%
Mauritius	8.7	0.90%
Namibia	8.5	0.90%
Malawi	4.3	0.40%
Swaziland	2.8	0.30%
Lesotho	1.6	0.20%
Remaining SADC countries		
Tanzania	20.7	2.10%
RD Congo	11.6	1.20%
Seychelles	0.8	0.10%

Source: IMF, BBPI.
Note: (1) - 2007 data.

Clearly the Northern line appears underused while the Beira Corridor should develop significantly in the coming years. In addition, there are medium term growth prospects in the Northern line, which can connect Angola and Congo to Mozambique through Zambia and Malawi. Apparently this connection is dependent on the conclusion of about 2 km of line between Zambia and Malawi.

Other constraints exist in the transport system: only the port of Maputo can handle larger sized, international cargo ships while the northern and central ports of the country are mainly devoted to cabotage (although the possibility of a deep-water port in Beira is currently being discussed). There is an old project involving the construction of another deep-water port in Matutuine in Maputo province, which apparently could get the green light. This port would have the purpose of drawing coal from South Africa and Botswana for export while also allowing transport of refined crude oil from a refinery unit to be built in the same area. Its construction is justified given the inability of the Maputo and Matola terminals to fulfil this function.

Natural resources, especially coal and natural gas together with serving as a potential platform for electricity supply to regional countries, taking advantage of the abundant water resources and electricity generation through coal. The potential to export coal to regional countries is clearly booming in the Mozambican economy, which seems in fact to be fulfilling its potential, particularly the Mozambique central region (Tete provence). Recently, some very large coal reserves were confirmed and several projects are being implemented around Moatize, with the participation of several international companies. These include Riversdale, the Australian mining company, Vale do Rio Doce, the largest Brazilian mining company, Tata Steel, the Indian company in the area of steel; Sazol, a South African oil company which also acts in the chemical industry, mineral exploitation, fertilizers, etc. and Eskom, the electrical company responsible for generation, processing and distribution of electricity in South Africa etc. Additionally, in the basin of the Rovuma river, oil and natural gas prospection continues. Project preparations to build a thermal power plant for energy production through coal, similar to that which already exists in South Africa, are still in place.



In relation to water resources, several investment projects are being examined. **The OECD in its latest report on the African region, refers to 7 projects, which should increase the capacity to generate energy from the current 2 thousand MW (megawats) to 6 442 MW**. Apart from the Cahora Bassa dam (HCB), there is the possibility of building two new dams, one north of Cahora Bassa; expanding the existing HCB to 2.9 MW; constructing the Mepanda Uncua dam between the current HCB and Tete, with a capacity of 2 400 MW; rehabilitating the hydroelectric stations of Chicamba (45 MW) and Mavuzi river and constructing a thermal station in the province of Tete. Apparently the advance of Mepanda Uncua could be announced soon, although doubts remain as to how to secure funding. It is true that there is sufficient demand (current and potential), to justify the increase in electricity supply arising from the construction of new dams. As far as supply for export is concerned, at least South Africa has low self-sufficiency at this level and domestically there is a high and growing potential demand, given the gradual electrification of the territory: currently only 86 districts are connected to the national electricity grid - it is expected that a further 9 will be connected by the end of the year and 34 districts will remain non-electrified in 2010. Furthermore Eskom, the South African electric company, is about to complete the first wind power system in the province of Inhambane with the aim to subsequent connection to the national grid.

Agricultural sector - this has a significant weight in GDP of about 20% and is responsible for about 80% of employment. However, its contribution to growth has been volatile, greatly depending on the weather. This is a sector where there is a full duality: on the one hand there is a significant number of households whose income directly stems from agricultural activities and which are mainly subsistence in nature (it is estimated Mozambique has around 3.2 million small farmers). In contrast, there are large scale producers (about 400 commercial farmers) which produce mainly for foreign markets and are typically related to foreign direct investment - namely large-scale production of sugar cane, tobacco, cotton, tea, etc. .
Given the strong climatic variations, particularlly affecting production in the most fertile areas such as the valley of the Zambezi River, and following the industry trend in recent years, the authorities have sought to promote agro-livestock production (Action Plan for the Production of Food), especially for small and medium farmers. This has been aimed at becoming self-sufficient in some basic food products: corn, wheat, chicken, beans, rice ... In parallel, several projects have been emerging and are under evaluation for the production of bio-fuels - for example the Massingir project, dedicated to the production of sugar cane for alcohol production.

This is a sector of great investment opportunities as there are several needs ranging from the degree of mechanisation, irrigation systems and training for small and medium-sized farmers. However, although the authorities provide some raw materials, including seeds and have established silos for storage in some locations, there are still many barriers to full development of this activity. As an example, there is no concern about the production distribution, transport system to silos or markets. Additionally, there are significant training needs to be addressed in the sector. For example, the know-how to use machinery and techniques to improve production, whose implementation should be taken by the authorities because of the low critical mass for private initiatives to emerge in this area. Despite the deficiencies and the fact that there remains much to be done in agriculture, it can be said that very gradually, we are witnessing the rebirth of subsistence agriculture, which is a positive step towards relearning ancient techniques that had been lost in years of armed conflict. It is also a major step towards reducing poverty levels and improving the standards of living in the population (mainly rural).

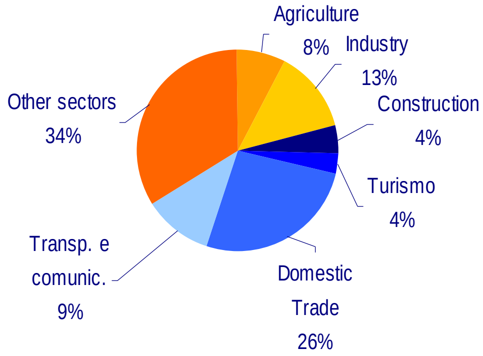
Other sectors with investment opportunities

- **Tourism** - given the geographical conditions and natural beauty of the country. However, the full development of this sector faces significant barriers, including deficiencies at the level of transport infrastructure, health-system, water networks, etc., besides high travel costs. This makes the country less accessible to the attractive markets of the North-America and Europe.
- **Agro-industry** - it is not sufficient to have agricultural production and at the same time export grains. It would be preferable to process products for export. With a guaranteed market outlet, the need to invest in higher productivity would be more evident.
- **Agriculture equipment, techniques, etc.** - some incentives, exemptions, lower rates, etc...
- **Construction** - strong activity in the recovery and building of roads, schools, dams and thermal power plants. The port of Beira will undergo improvements (draging activities). Growth in private construction has been registered.

2.4 - Financial System

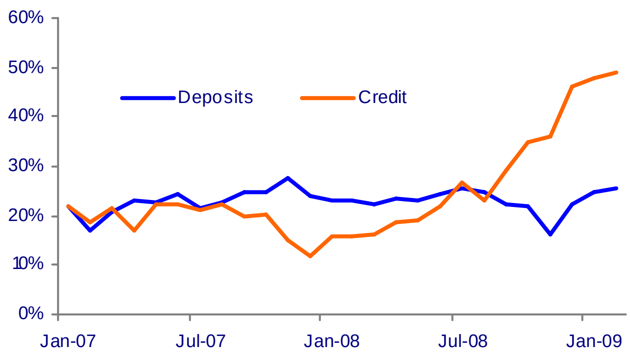
- The financial system is composed of 14 banks but there is a large concentration in the four largest, which in December 2008 accounted for 89% of the total credit and 91% of deposits.
- The progressive expansion of the banking system through the territory remains. In particular, the largest banks are expanding their branch network outside large urban centres, with some Government help, for example, through the captation of civil servants' accounts. Examples of these locations include Magude or Caia, where the bridge over the Zambezi River will be constructed. Other incentives include a reduction of: capital requirements for financial institutions that open in more remote areas; taxes of imported equipment and; required reserves.
- The domestic financial system has been relatively shielded from the international financial crisis because the banks had no direct exposure to the most troubled assets and indirectly, through the shareholder structure there has not been any major impact either. In any case, the central bank regularly carries out prudential reviews in order to measure the impact of the crisis. Supervision based on risk analysis is being initiated and the central bank is receiving consultations on Basel II (which is currently being implemented in the banking system), corporate governance, money laundering, microcredit, etc..
- Regarding prudential elements, solvability indeces, profitability, credit risk and liquidity are considered satisfactory by the central bank. The large banks have solvency ratios comfortably above 8% while the levels of default are at around 1% (and write-offs are non-representative, according to BoM).
- Credit to the economy accelerated in 2008 (from 11.6% y / y in December 2007 to 49% in February 2009) and excluding the large projects, a greater use of private foreign debt was seen. Credit in foreign currency has been growing at a faster pace than credit in national currency and its proportion increased from 1/4 of the total at the end of 2007 to 1/3 of the total by February 2009.
- The sectors with the greatest weight in credit granted are trade (26%), industry (13%), transport and communication (9%) and agriculture (8%). Approximately 34% of the credit is spread over several economic sectors which could be considered a positive factor towards diversified growth. Aditionally, greater allocation of credit to agricultural and industrial sectors can be viewed as beneficial. Increased agricultural production allows not only the development of rural areas and the decrease in extreme poverty but also the reduction of the country's dependence on foreign food. Similarly, industrial sector development allows for a reduction in dependence on consumer goods which currently need to be almost entirely imported.

Credit by sector (Dec-08).



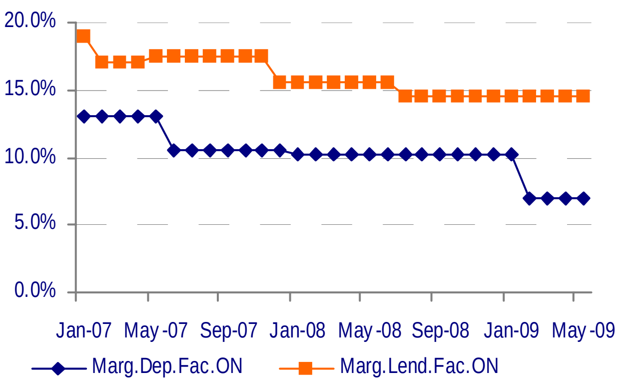
Source: Banco de Moçambique

Credit and deposits (yoy).



Source: Banco de Moçambique, BBPI

Main reference interest rates stable since February.



Source: Banco de Moçambique

- The growth rate of deposits has remained high. In 2008, deposits grew by 22%, 2 pp less than in 2007. In February, annual growth of deposits stood at 25%. Deposits in national currency grew at a higher rate than deposits in foreign currency and accounted for 61% of the total in December, an increase of 7 pp against the previous year.
- The differential between credit and deposit interest rate remains high. Interest rates for 180 days'deposit operations remained between 10% and 11% while interest rates for 180 days'credit operations were between 21% and 22%. This high differential is justified first, by the higher rate offered by TBills for the same period (around 14%) who have no risk and secondly, the high risk that still exists in granting credit to private entities through the lack of collateral and the frequent absence of a business plan to support the economic viability of the projects.

The Microcredit Example

- Several microcredit institutions operate in Mozambique. Despite having little expression in terms of assets and liabilities, given the high turnover of its portfolio and the small amounts usually involved, microcredit assumes an essential role in the economy, given the significant weight of informality.
- There are two types of players in this market segment: those who act on the scope of non-governmental organizations (NGOs) and those with a base of private capital, which of course weighs on their business model.
- For the second type of institution, the average loan period is 1 year, the average amount financed is 1000 USD; about half of the portfolio has an average outstanding amount up to 10 thousand meticals.
- This is a highly specific business because the portfolio is very rotative. Almost all customers derive from the informal sector, so each credit analysis, conducted (and completed) within a period between 3 and 5 days, is very labour intensive. Document analysis is replaced by the direct relationship between staff and customers, suppliers, even with the family of the potential customer. In the case of new loans to the same individual (a very typical situation) a further intensive credit analysis is unnecessary, thereby reducing the marginal cost of reloans.
- Examples of businesses usually financed - bakeries; scrap industries, one-off deals, odd jobs, etc.. By contrast, some microcredit institutions do not usually engage in consumer credit.
- The advantages of this type of institution are more related with the diverse base of clients. The collateral is not traditional but usually has a psychological value to the customer (bicycle, television, etc.) and so typically, the weight of outstanding loans in default or delay is very low. These low default value levels are only possible due to the pressure for immediate payment in the event of delay, coupled with the moral obligation that exists. Moreover, the existence of collateral with a mere psychological value poses a risk because of their characteristics as they have no commercial value and the slow functioning of the courts makes recovery slow, if not impossible.
- Compared to traditional banking, there is currently some competition and aggressiveness on the part of the microcredit institutions which offer better deposit rates. Although they have a low expression in resources capture, they end up influencing the costs of deposits upwardly. Regarding the credit conceded, the cannibalization question does not arise from the microfinance institutions as the loans they make relate to the informal sector, targeting different market segments in relation to the traditional banks.

Annex - Major Projects

Investment	Amount	Current situation	Investors	conclusion scheduled for	Description	Source
Mining of coal in Moatize	USD 1.3 bln	Under construction	Vale Rio Doce	Dec10	Proven reserves around 833 million metric tones, prodution capacity of 11 million metric tones and a coal washing plant with 26 million nmetric tones capacity.	http://www.vale.com
Mining of coal in Benga	Direct capital investment during the development stage: more than USD 800 M	under construction	Riversdale (65%) and Tata (35%)	4Q10	Reserves of 273 million metric tones, initial prodution of 5.3 million metric tones a year and rising till 20 Mtpy depending on disclosure capacity.	Site Riversdale e Reuters
Upgrade of the railway line Moatize-Beira	USD 200 M	under construction	CFM (49%) and Rites (51% Índia)	Jan10	USD 104.5 M financing from the World Bank secured and more USD 45 M in negociation.The remaining financing cames from CFM and RITES. EIB loan of EUR 42 M in 30/04/09	Reuters, BEI
Upgrade of Beira port	USD 40 M	under construction	CFM		EUR 23 M financing from the EIB.	BEI
Thermoelectric coal station	USD 3.1 bln		Riversdale			Reuters
activities to exploit natural gaz in Buzi (Sofala region)	USD 30 M		ENH (25%) and PT Kalila (75%)		Estimated reserves around 10 e 17 bln cubic feet	Reuters
Heavy sands project in Chibuto, south of Gaza	USD 800 M	In development	BHP-Billiton		Postponed according to A. Nucifora and S. Fischer	Reuters
Activities to exploit natural gaz and oil in the Rovuma bay	USD 1.4 bln		Several	2011	USD 467.3 M invested in 2008 and USD 560 M forecasted in 2009.	Reuters
Gas pipeline from Pande and Temane to SA	USD 1.2 bln		Sasol			Reuters
Cahora Bassa north station	USD 1 bln	lack of financing			Increasing prodution capacity by 50%.	HCB
Mependa Uncua dam	USD 1.65 bln	Securing financing			Dobble the prodution capacity of Cahora Bassa. High uncertainty surronding financing. May start in 2009.	CPI, HCB
Refinery in Matutuine	EUR 5.3 bln	feasibility study	OilMoz and Shell		Refining capacity of 350 thousand b/d. If implemented, contruction should be launched in 2010. The country needs around 16 thousand b/d.	EIU (Jan), http://www.power.inf.br/pt/?p=2697
Electric Transmision line between Cahora Bassa and Maputo	USD 2.5 bln	Securing financing				CPI
Road connecting Montepuez to Lichinga	USD 105.93 M			until 2014	Securing USD 44.2 financing from the ADB. Japan, Sweden and Denmark Japão, Suécia e Dinamarca have also financed	CPI
Gaz combined cycle station in Moamba	USD 1.3 bln				Only and hypotesis. Prodution Capacity around 650 MW	KPMG, EIU(Jan)
Gaz combined cycle station in Inhambane					low probability	KPMG
silos for cereal storage in Nacala	USD 100 M	Under construction	Bakhresa Grain Milling		Silos with 60 thousand tones capacity, USD 15 M World Bank financing.	CETA, http://ulkmaterialsinternational.com/htm/w20090109.560286.htm
Heavy sands in Moma		In implementation			S. Fischer	FMI

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