

Mozambique

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key figures

• Land area, thousands of km ²	802
• Population, thousands (2006)	20 158
• GDP per capita, \$ PPP valuation (2006)	1 957
• Life expectancy (2006)	41.8
• Illiteracy rate (2006)	48.3

Mozambique



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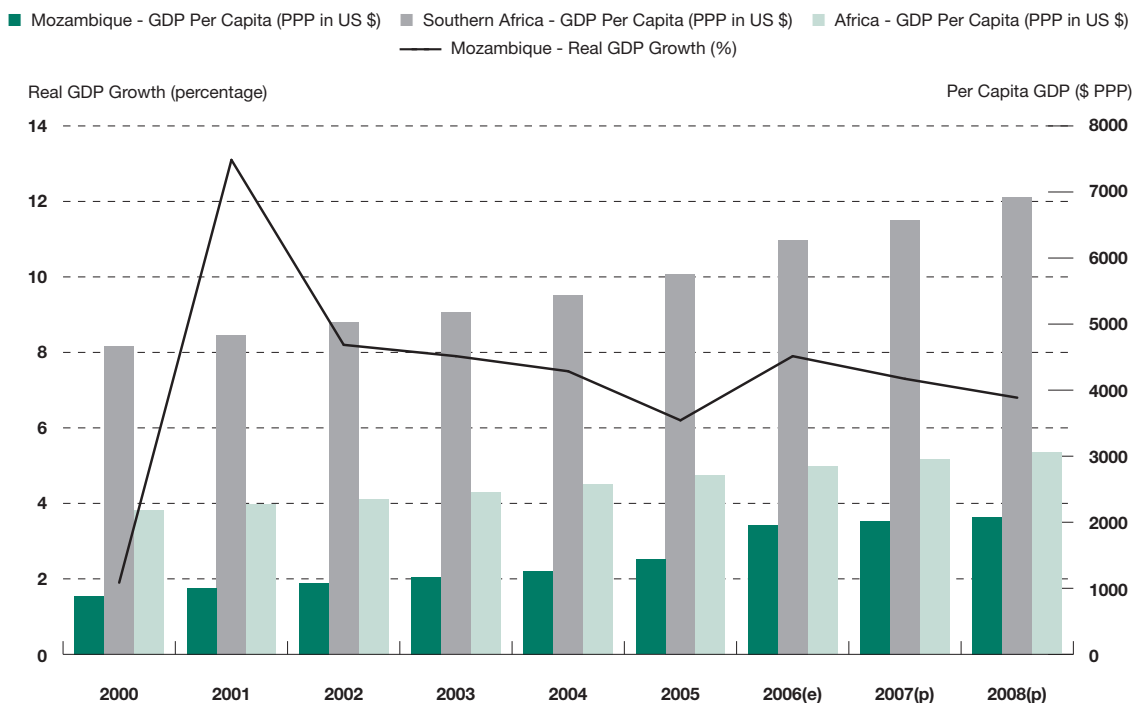
MOZAMBIQUE HAS ACHIEVED IMPRESSIVE economic expansion since the end of the civil war. Over the past five years, growth averaged 8.9 per cent, spurred by foreign-financed “mega-projects” and large aid inflows. The economy is estimated to have expanded by 7.9 per cent in 2006, supported by investments in the extractive industry, favourable harvests, and continuing infrastructure rehabilitation projects.

On the basis of continued expansion in construction and the coming on stream of investment projects, including Moma Titanium Minerals, growth is expected to reach 7.3 per cent in 2007 and 6.8 per cent in 2008. Further improvements in transport, especially railways and ports, and in energy provision are essential for the successful implementation of pending mega-projects in the extractive industry.

Since mega-projects generate limited spillover effects on the rest of the economy and contribute relatively little to job creation and tax revenue, broad-based growth remains a major challenge. Although the 2006 bumper agricultural production and the favourable prospects for the next harvest season can be expected to improve rural incomes and maize stocks, agricultural performance remains erratic and vulnerable to climatic shocks. Securing sustainable agricultural development requires a clearer sectoral strategy and complementary policies. Similarly, the lack of a coherent strategy to promote industry inhibits the country’s potential in agro-processing, light manufacturing, and tourism.

Continued expansion in construction and the coming on stream of Mega projects is boosting growth in Mozambique while a second wave of reforms is aimed at reducing poverty.

Figure 1 - Real GDP Growth and Per Capita GDP
(\$ PPP at current prices)



Source: IMF and National Institute of Statistics data; estimates (e) and projections (p) based on authors’ calculations.

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The country's development strategy is framed in the *Plano de Acção para Redução da Pobreza Absoluta II* (Action Plan for the Reduction of Absolute Poverty II – PARPA II) for 2006-09, which aims at reducing the incidence of poverty from the current 54 per cent to 45 per cent in 2009. To achieve this target, the government is consolidating macroeconomic stability and undertaking a second wave of structural reforms, encompassing the public sector, fiscal policy, governance, and the business climate. The implementation of a computerised integrated budget and treasury management system (e-SISTAFE) has contributed to improved public expenditure management. Revenue collection has increased moderately too. To boost revenue further, it will be necessary to broaden the tax base, especially in the extractive and informal sectors, and to strengthen tax administration. The government is committed to improving the transparency of special tax regimes for mega-projects and to reducing fiscal exemptions for new ones. In line with the PARPA target, the government is increasing spending in priority areas (to 65 per cent of total expenditure) and undertaking huge infrastructure rehabilitation projects. This increase in spending will be comfortably financed by rising aid inflows and, to a lesser extent, by resources freed up by the Multilateral Debt Relief Initiative (MDRI).

Nevertheless, progress in other structural reforms has been slow. Despite the large reduction in the number of days needed to register a new company, deep-seated constraints to private-sector development remain, notably the weak judicial system. In addition, institutional and capacity bottlenecks lead to very poor

performances in basic health services (HIV/AIDS antiretroviral therapy [ART] coverage), and in water (rural water supply and sanitation).

Better human resource management, more predictability of funds from the central government, and greater clarity in the processes of decentralised planning and budgeting should be key priorities in order to ensure the successful implementation of the PARPA.

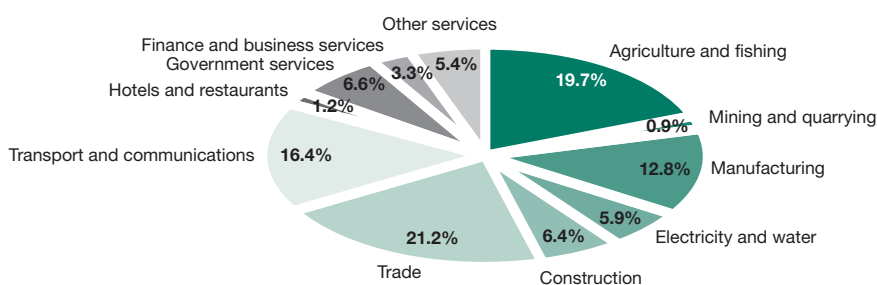
Recent Economic Developments

Mozambique has been one of the world's most rapidly growing economies over the past five years, with much of the impetus coming from reconstruction efforts and extensive foreign investment in projects based on natural resources.

In 2005, GDP increased by 6.2 per cent in real terms. This increase was led by industry, which expanded 7.8 per cent, mainly due to mining and electricity. The service sector followed, also growing strongly at 7.6 per cent. Agriculture and fishing registered a modest growth rate of 1.6 per cent. Real GDP is estimated to have risen by 7.9 per cent in 2006, with 10.9 per cent growth in agriculture and strong performance (15 per cent) in the extractive industry.

In 2005, agriculture and fishing accounted for 20 per cent of GDP, but 78.5 per cent of total employment. While fishing benefited from a strong rebound, agricultural output suffered from a drought

Figure 2 - GDP by Sector in 2005 (percentage)



Source: Authors' estimates based on National Institute of Statistics data.

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in some regions. In 2006, abundant and regular rainfall and the timely provision of agricultural inputs contributed towards the best harvest over the last five years, triggering a strong recovery of agricultural production (6.5 per cent growth). It is estimated that cereal production reached 2.1 million tons (maize alone accounting for 1.5 million), which was 10 per cent higher than the previous season. Outputs of pulses and cassavas are estimated to have risen by 10 and 14 per cent, respectively. Notwithstanding this progress, the authorities assessed the domestic cereal deficit at 565 000 tons, mainly due to the lack of wheat and rice.

Assuming favourable weather conditions and the adequate provision of inputs and extension services, a 12.2 per cent increase in agricultural output is expected in 2007, led by rice and maize production.

The production of cash crops (cashew nuts, cotton, sugar and tobacco) also rebounded in 2006, although agricultural diversification remains limited. Sugar remains the leading sector. After an extraordinary 2005 harvest, the best for three decades, sugar-cane production decreased in 2006 by about 3 per cent, due to lower-than-expected rains in Marromeu and Mafambisse. Cashew nut production more than doubled between the 2004 and 2005 seasons, attaining 104 000 tons, reflecting in part a peak in biological productivity. Production is estimated to have fallen in 2006 to around 62 800 tons, but is projected to increase gradually over the following five years. New production areas are being developed in the south. Cotton production declined 15 per cent to 78.5 thousand tons in 2005, but increased to around 110 thousand tons in 2006. Tobacco registered an impressive 30 per cent increase in output in 2005, but declined slightly in 2006 and is expected to level off in 2007.

Fishing accounts for about 2 per cent of GDP. In 2005 the sector rebounded by 3.6 per cent after experiencing a 3.8 per cent contraction in 2004. Aquaculture and traditional fishing were the main drivers of growth, as industrial and semi-industrial fishing declined by 13 per cent, mainly due to a 65 per cent reduction in the tuna catch. Following the expansion of prawn-farming areas, aquaculture

production doubled. The authorities expect fishing to grow by 3.3 per cent in 2006 and 3.5 per cent in 2007. Growth in livestock, which accounts for 1.6 per cent of GDP, remains disappointing, as the sector is disease-prone and suffers from inadequate feeding.

Industry's share of GDP expanded sharply from 16 per cent in 1996 to 26 per cent in 2005; this increase is largely due to mega-projects in the extractive industry sector. Nevertheless, due to high capital intensity, profit repatriation, and fiscal incentives, the mega-projects generate relatively minor benefits in terms of employment, transport linkages, and foreign-currency earnings.

Manufacturing expanded by 8.5 per cent in 2005 and an estimated 5.7 per cent in 2006. The Mozal aluminium smelter in Maputo Province, created with a \$2.1 billion investment by Australian and South African interests, now accounts for half of manufacturing output, and has made Mozambique one of the world's leading exporters of aluminium. Mozal's output edged up to 555 000 tons in 2005 compared with 549 000 in 2004. The feasibility studies for further expansion (Mozal 3), which would increase capacity by an additional 250 000 tons per year by 2009, were completed. The food, beverages, and tobacco sub-sector is the second-largest manufacturing sub-sector. Sugar and molasses production each fell an estimated 1 per cent in 2006, due to lower-than-expected cane production. Ethanol fuel production is still very limited, although the government plans to develop both bioethanol and biodiesel programmes. Petromoc has signed a co-operation agreement with South-Africa's Cofamosa to invest \$150 million in an ethanol plant in Moamba which will use sugar-cane. The Portuguese group Nutasa is building a similar plant in Maputo. The government's decision to promote domestic tobacco-processing by stipulating that growers' use of the most favourable land would be subject to the condition that they constructed processing plants led Alliance One International to close down its operations and withdraw from the country. Mozambique Leaf Tobacco, a subsidiary of the American Universal Leaf Africa Company, was awarded Alliance One International's concession, and opened the first green-leaf processing plant in the country in May 2005.

After expanding by 11 per cent the previous year, output from the extractive industry sector is estimated to have increased by about 15 per cent in 2006, with a strong rebound in coal production following the modernisation of the Chipanga-IX mine. The sector is expected to expand further with the construction of the Moatize coal project and thermal power plant. The Brazilian Companhia Vale do Rio Doce, which has already invested approximately \$80 million in the project over the last two years, has delivered the feasibility studies to the government and should start production in 2010. The development of the mine requires rehabilitation of the Beira-Tete railway and the construction of an export terminal at Beira port. The Moma Titanium Minerals Project, which will produce more than 750 000 tonnes of mineral sands a year, is almost completed, and production should start in 2007. The Irish firm Kenmare Resources has already announced that it intends to expand Moma's capacity in the second half of that year. Sasol plans to double its gas production in Mozambique in the coming years,

while new petroleum exploration began in 2006 in the northern Rovuma Basin.

The construction sector is heavily influenced by mega-projects. This sector expanded by 3.8 per cent in 2005. A new cement factory in Nampula is expected to alleviate the shortage of cement. A stronger expansion in construction is expected in 2006 and 2007, due to the implementation of several public-investment projects, especially the construction of the Zambezi Bridge, and the start of new mining projects.

The service sector, which generates about 46 per cent of GDP, grew by 7.6 per cent in 2005, led by 15 per cent growth of transport and communications. The Minister of Transport and Communications announced plans to review the telecommunications law and the possibility of clearance for a third cellular-telephone operator to compete against state-owned M-Cell and Vodacom. A second fixed-line operator is likely to be licensed before the end of 2007.

Table 1 - Demand Composition (percentage of GDP)

	1998	2005	2006(e)	2007(p)	2008(p)
	Percentage of GDP (current prices)		Percentage changes, volume		
Gross capital formation	24.2	29.9	27.5	15.0	11.7
Public	9.8	12.5	45.0	15.0	8.0
Private	14.5	17.4	15.0	15.0	15.0
Consumption	93.2	82.0	2.3	3.3	5.3
Public	10.4	12.9	8.6	6.2	5.0
Private	82.8	69.1	1.6	3.0	5.3
External sector	-17.4	-11.9			
Exports	10.5	30.9	6.7	6.7	6.2
Imports	-27.9	-42.9	6.7	3.9	7.1

Source: IMF and National Institute of Statistics data; estimates (e) and projections (p) based on authors' calculations.

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The government's large-scale infrastructure programme, investments in the extractive industry, and high mineral exports were the main motors of growth in 2006. Development projects, notably in donor-supported transport infrastructure rehabilitation, led to a jump of about 45 per cent in public capital expenditure in 2006. Due to other large infrastructure projects, especially in urban renewal and road

rehabilitation, public investment is expected to continue to grow by 15 per cent in 2007 and 2008. The expansion in construction that accompanied the new wave of mega-projects and the continued influx of foreign investment have led to a 15 per cent growth of private investment in 2006; private investment is projected to remain strong in 2007 and 2008. Thanks to the results of the mega projects, extractive-industry exports have

increased dramatically over recent years, and are expected to continue to grow substantially in the next two years.

Macroeconomic Policies

Fiscal Policy

Mozambique's development strategy for the next five years is detailed in the *Plano de Acção para Redução da Pobreza Absoluta II* (PARPA II) for 2006-09. The PARPA II's main objective is to reduce the incidence of poverty from the current 54 per cent to 45 per cent in 2009. To achieve this target, the government plans to continue its efforts to consolidate macroeconomic stability and to implement a second wave of structural reforms, encompassing the public sector, fiscal policies, governance, and the business climate. Compared to the earlier development strategy (PARPA I) with its strong focus on investment in social sectors, the new PARPA places more emphasis on promoting growth and the modernisation of the economy, and points to decentralisation and development at the district level as key objectives. PARPA II calls for greater investment in economic sectors, especially agriculture and infrastructure, and for creating a favourable business climate, especially for small and medium-sized enterprises.

Foreign assistance, which already finances more than 40 per cent of the government's expenditures, is expected to rise further. To improve aid effectiveness and accountability, the government and donors have agreed on a series of indicators and targets in the areas of public finance, governance, HIV/AIDS, education, and justice.

The 2006 mid-year joint review between the government and donors in September 2006 noted that the overall performance of fiscal policy was encouraging. A new computerised system for recording expenditure (e-SISTAFE) was implemented in a number of ministries, enabling improved monitoring of expenditures in priority sectors. 57 per cent of expenditures were in the priority sectors of health and education, surpassing the 50 per cent target; the goal

of 65 per cent expenditure execution rate in the priority areas fell just short of target, at about 62 per cent. Nevertheless, investment at the district level improved in the second semester. Public-sector wage expenditures increased considerably, reflecting the recruitment of teachers and health workers.

Public-sector reform was given fresh impetus, first with the creation of the new National Civil Service Authority which reports directly to the President of the Republic, and second, through the preparation of Phase II of the Public Sector Reform Programme (2006-2011), which focuses on strengthening the decentralisation process. Equal allocations of about \$300 000 per district were made during 2006, although execution was lower than expected, owing to delays in issuing the guidelines on permissible uses of these funds. Some ambiguities remain over the division of revenue and spending responsibilities; the effective absorptive capacity of local agencies is also a major problem. To clarify the decentralisation strategy, a proposal to formulate the National Decentralisation Policy and Strategy was prepared in March 2006. Progress was also made with the preparation of the National Decentralised Planning and Financing Programme (PPFD); also, the Administrative Tribunal (TA) performed district audits in four provinces.

On a negative note, the government's rising indebtedness to construction contractors, linked to delays in refunding VAT, remained a major problem in 2006. An assessment of the magnitude of the problem is being carried out for the road sector, and donors have decided to finance an audit to determine the size of the accumulated debt.

At 11.8 per cent, Mozambique's tax revenue to GDP ratio remains much lower than that of its neighbours and than the average of 24 per cent for sub-Saharan Africa. Efforts to increase domestic revenue, which were already substantial in 2005, continued in 2006, and were partly reflected in the collection of corporate tax and VAT. Some progress was made in improving the collection of tax arrears, strengthening tax administration, and broadening the tax base. Nevertheless, the establishment of the Central Revenue

Authority (ATM), which was expected for September 2006, was delayed.

The prospects of widening the tax base further suffer from special tax regimes for mega-projects, including preferential corporate tax rates, tariff exemptions, and tax deductions for social and environmental expenditures, all of which lack transparency. In this respect, donors and the government are reviewing the fiscal impact of these projects. The government is also considering joining the Extractive Industries Transparency Initiative (EITI), but needs first to assess its ability to comply with the associated obligations.

Overall, the fiscal situation improved in 2006. The substantial increase in government spending in priority

areas, and in particular in transport rehabilitation, was mostly covered by large aid inflows and, to a lesser extent, by resources freed up by the Multilateral Debt Relief Initiative. High spending on poverty-reduction projects, including infrastructure, is expected to continue in the medium term, and to be mainly financed by rising aid inflows.

Revenue collection is expected to improve further in 2007 and 2008, reflecting the full implementation of the Central Revenue Authority. Discussion over the fiscal contribution of mega-projects will continue, with the aim of renegotiating the tax regime and reducing fiscal exemptions for new investment. Despite the gradual improvement in revenue mobilisation and in the growth of grants, the overall deficit is expected to deteriorate slightly, reflecting high spending on public-

Table 2 - **Public Finances** (percentage of GDP)

	1998	2003	2004	2005	2006(e)	2007(p)	2008(p)
Total revenue and grants^a	19.5	22.4	20.2	20.0	23.0	23.9	24.1
Tax revenue	10.5	12.0	11.7	11.8	11.8	11.8	11.8
Grants		9.5	7.5	6.3	9.8	10.7	11.0
Total expenditure and net lending^a	21.8	26.9	24.7	22.2	25.1	26.7	26.8
Current expenditure	11.5	14.7	14.5	13.6	13.6	14.0	14.3
<i>Excluding interest</i>	<i>10.5</i>	<i>13.6</i>	<i>13.5</i>	<i>12.9</i>	<i>12.9</i>	<i>13.0</i>	<i>13.3</i>
Wages and salaries	4.5	6.8	6.9	6.8	6.6	6.7	7.1
Interest	1.0	1.2	1.0	0.8	0.8	1.0	0.9
Capital expenditure	9.8	11.7	9.4	8.1	10.5	11.6	11.8
Primary balance	-1.4	-3.3	-3.5	-1.5	-1.3	-1.8	-1.8
Overall balance	-2.4	-4.5	-4.5	-2.3	-2.0	-2.8	-2.7

a. Only major items are reported

Source: Ministry of Finance and Planning and IMF data; estimates (e) and projections (p) based on authors' calculations.

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sector wages and in priority social sectors, as well as large development projects in road rehabilitation and urban renewal. The deficit is therefore expected to average 2.8 per cent of GDP in 2007 and 2.7 per cent in 2008.

Monetary Policy

The Bank of Mozambique has successfully stabilised inflation, following hyperinflation in the early 1990s, by restraining broad money growth. Inflation averaged 6.4 per cent in 2005, compared to 12.3 per cent in 2004. For 2006, the Central Bank fixed a target of 15 per cent for broad money growth, with a target of 7.5 per cent

for average inflation. Nevertheless, inflation registered a steep increase in the first quarter. The combined effect of rising petrol and food prices led to a surge in inflation from 3.2 per cent in May 2005 to 17 per cent in April 2006. In response, monetary policy was tightened through open-market operations in the first half of the year, pushing up the Treasury Bill rate to 17.5 per cent in May 2006, an 8 percentage-point increase since October 2005.

A restrained monetary policy, stable international oil prices, the appreciation of the metical, and a favourable agricultural season all contributed to the

deceleration of inflation in the third quarter of the 2006, reaching a low of 10.6 per cent in August. However, it accelerated again to 12.7 per cent in September, reflecting rising food prices at the start of the lean season from October to March. Inflation then edged up in the last months of 2006, mainly owing to the seasonal price hikes, so that it averaged 12.6 per cent for the year.

Monetary policy is expected to remain tight in 2007 and 2008, with inflation targets of 5.9 per cent and 5.1 per cent for 2007 and 2008, respectively. Despite weaker oil and food inflationary pressures, increased government spending and domestic consumption are forecast to exceed target levels, at 8.1 per cent and 5.7 per cent in 2007 and 2008, respectively.

The authorities are committed to a flexible exchange-rate regime, and in January 2005 they introduced a foreign-exchange auction system. In response to various shocks such as large oil-import transactions, the currency experienced considerable volatility in 2005 and 2006, reflecting the thin foreign-exchange market. To cushion volatility and depreciation pressures, the Bank of Mozambique introduced an exchange-rate band in the inter-bank foreign-exchange market in the last quarter of 2005. Since June 2006, the currency has remained fairly stable against the US dollar.

The Ministry of Planning and Finance instituted a redenomination of the currency, with new metical bank notes equivalent to 1 000 of the old notes. From 1 July 2006, the new and old notes circulated concurrently; the old notes were fully withdrawn by the end of the year. Commercial banks will exchange old notes against new ones until 31 December 2007.

External Position

Mozambique's current account deficit rose to 10.8 per cent of GDP in 2005 from 8.6 per cent in 2004. The trade balance deteriorated in 2005 as exports, which increased from \$1.50 billion to \$1.75 billion, rose less than imports (from \$2.03 billion to \$2.47 billion). A surge in aluminium export prices and

volumes boosted exports in 2006. Preliminary data suggest that merchandise exports reached \$1.75 billion in the first nine months of 2006 (up 39 per cent compared with the same period in 2005), offsetting a 24 per cent growth in imports. The new projects in the extractive industry sector are forecast to boost imports of capital goods in 2007 and 2008, thus causing a deterioration in the trade balance, since their contribution to export growth takes time to develop. Gross international reserves increased from 4.6 months of imports of goods and services in December 2005 to 5.1 months at the end of June 2006.

Mega-projects play a major role in Mozambique's trade, accounting for about 72 per cent of exports and 17 per cent of imports. Base metals are the leading export, accounting for about 60 per cent of export revenue. Aluminium from the Mozal project is the single largest earner of foreign exchange. However, since the smelter uses imported alumina as raw material, its contribution to the net trade balance is limited. Natural gas (associated with the Sasol pipeline to South Africa) is the second-largest export item (14.3 per cent). Other major exports include fish and crustaceans (5 per cent), cotton (3.5 per cent), tobacco (2.5 per cent) and sugar (2.2 per cent).

Mozambique's imports are dominated by mechanical and electrical machinery, vehicles, and iron and other inputs used by mega-projects. Despite an improved harvest, the country remains a substantial importer of cereals, especially wheat and rice.

Preferential exports to the European Union (EU) benefited from the additional Everything But Arms (EBA) sugar quota awarded to Mozambique as the result of other Least Developed Countries (LDCs) being unable to meet their allocations for the year ending June 2006. Sugar exports are expected to grow 35 per cent in volume and 32 per cent in dollar terms. About half of sugar exports benefit from preferential market access agreements, with prices set above those in the world market.

A major concern for the sugar industry is the reform of the EU sugar regime and the associated 36 per cent

reduction in the guaranteed price over the period 2006/07-2009/10. Given the relatively small quota allocated to Mozambique within the Sugar Protocol and the fact that the reference price will still be higher than the international price, the immediate impact of the reform will not be dramatic. A more serious concern is the longer-term competitiveness of the industry once the international sugar market is liberalised. Starting from September 2009, the EU will grant unlimited duty-free access to all LDCs, thus offering an opportunity to expand market access for Mozambican producers. To seize this opportunity, investment is needed to expand production and achieve greater economies of scale.

The three-year fishing agreement with the EU, which gave access to Mozambican waters to European fishing vessels in exchange for fees from each vessel and a 4 million euros annual compensation fund, expired in 2006. The renegotiation of the agreement reached a standstill over the EU's proposal to exclude some less-profitable species.

Frozen fish and crustaceans – mainly shrimps and prawns – generated export revenues of \$84.3 million in 2005. However, the sector has been at risk since a recent EU inspection revealed serious sanitary problems, due to declining human and financial resources allocated to supervision. Prawns farmed by one aquaculture enterprise operating in Beira were banned from Europe. An emergency plan was launched to tackle this problem.

Mozambique's principal export market is the EU, to which 100 per cent of Mozal's aluminium is exported, reflecting Rotterdam's role as a hub for the trans-shipment of aluminium. Other important export destinations include South Africa, Zimbabwe, and Malawi. The largest source of imports is South Africa, followed by the Netherlands, Portugal, India and the United States.

Two major processes will shape the country's trade policy in the coming years, notably regional integration and the negotiation of an Economic Partnership Agreement (EPA) with the EU. Mozambique's membership of the Southern African Development

Community (SADC) means that a schedule of tariff reductions will be imposed on intra-regional imports beginning in 2008, and leading to the complete elimination of tariffs by 2015. In January 2006, the government reduced the maximum tariff rate from 25 to 20 per cent on imports from SADC countries and submitted a proposal to the Assembly to extend this measure to all trading partners. Negotiations with Zambia for a preferential trade agreement were concluded, but a final agreement has not been signed.

The negotiations for the EU-SADC EPA, which began in 2002, entered a new round in September 2005, and are scheduled to be completed in late 2007. The objectives of the EPA include liberalised trade between SADC and the EU in the longer term, and EU support for trade capacity building in the medium term. At present, Mozambique benefits from non-reciprocal tariff-free access to the EU under the EBA initiative for LDCs. Although the EU has made a commitment to grant EBA to LDCs in an open-ended manner, it is not clear yet how the special status will be treated under EPA's reciprocal liberalisation principle. EPA negotiations are at a standstill, mainly because of: the overlapping memberships of participating countries in different regional trade blocs; the role of South Africa (which already has a bilateral trade agreement with the EU and a customs union with other four SADC members); and the issue of special treatment for LDCs.

Abundant natural resources have made Mozambique one of the magnets for foreign direct investment (FDI) in southern Africa. The stock of FDI attained \$2.4 billion in 2005. Following the completion of mega-projects in 2003, FDI inflows slowed down, declining to \$108 million in 2005 compared to \$337 million and \$245 million in 2003 and 2004, respectively. Inflows are expected to increase again as new projects in mining and tourism start. The expansion of Mozal and Corridor Sands are amongst the largest potential investments. BHP Billiton, owner of Mozal, has taken over the Corridor Sands titanium project from WMC Resources in 2005. The development of both projects will be heavily influenced by the outcome of negotiations on long-

Table 3 - Current Account (percentage of GDP)

	1998	2003	2004	2005	2006(e)	2007(p)	2008(p)
Trade balance	-14.5	-14.5	-9.0	-10.6	-6.4	-8.1	-9.7
Exports of goods (f.o.b.)	6.2	21.8	25.5	25.6	29.3	27.5	25.7
Imports of goods (f.o.b.)	20.6	36.3	34.5	36.2	35.7	35.6	35.5
Services	1.0	-1.2	-4.7	-4.5	-1.4	-1.4	-1.6
Factor income ^a	-5.4	-4.1	-5.8	-6.1	-4.7	-9.5	-9.2
Current transfers	4.5	4.9	5.5	5.3	4.1	4.8	5.0
Current account balance	-14.4	-15.1	-13.9	-15.9	-8.5	-14.2	-15.6

a. Factor income is included in services.

Source: IMF and Bank of Mozambique data; estimates (e) and projections (p) based on authors' calculations.

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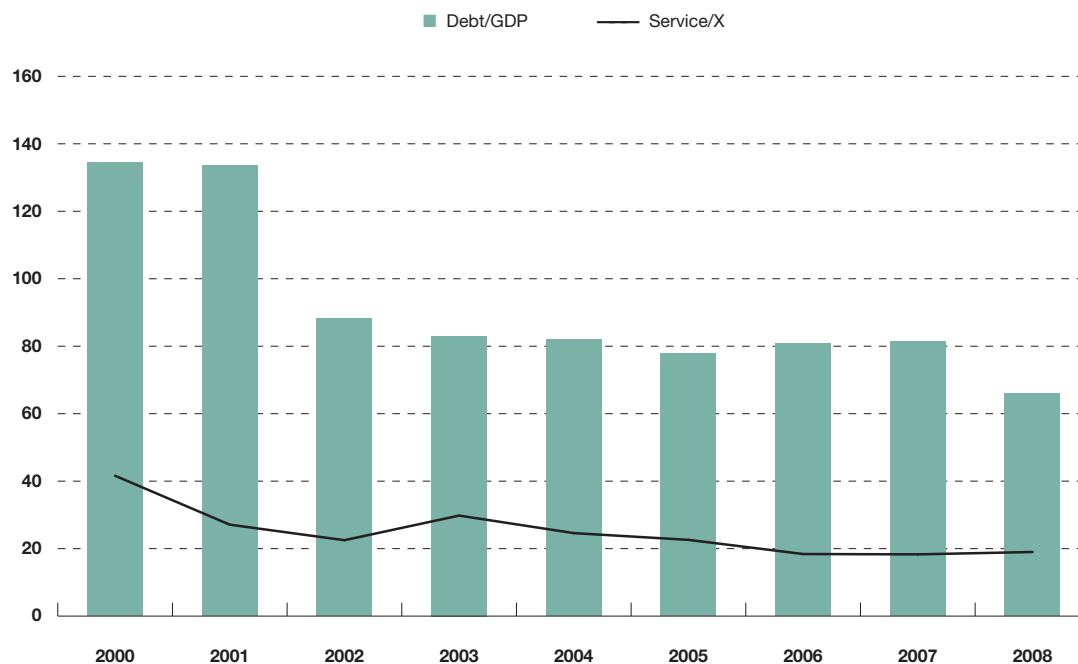
term power-supply contracts. Moreover, given BHP Billiton's partnership with Rio Tinto, the future of the Corridor Sands project will also depend on the latter's decision to pursue the development of its own titanium project in Madagascar.

Mozambique is among the world's largest recipients of Official Development Assistance (ODA). Disbursed net ODA (including from non-DAC donors) amounted to about \$1.3 billion in 2005, a 3.2 per cent increase in nominal terms with respect to 2004 (about 1 per

cent in real terms), yielding a very high aid-to-GNI ratio of 21 per cent. Assistance mainly consisted of grants (78 per cent of the total), and was largely for general budget support. Direct budget and sectoral support in 2006 amounted to \$297.5 million and is expected to rise to \$583 million in 2007. Co-ordination among donors is exemplary.

Mozambique's stock of foreign debt stood at \$4.7 billion in December 2005, a 7 per cent increase over 2004; 54.5 per cent of this debt was owed to

Figure 3 - Stock of Total External Debt (percentage of GDP) and Debt Service (percentage of exports of goods and services)



Source: IMF.

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multilateral creditors. The biggest share of the bilateral debt is held by non-Paris Club countries. In 2006, the country benefited from significant debt relief. The Multilateral Debt Relief Initiative (MDRI) cancelled debt of about \$1.6 billion (of which, \$1.3 billion by the World Bank), while the Japanese government provided full debt relief, amounting to \$60 million. Portugal has expressed its intention to cancel commercial debt too. These operations should bring down the net present value of the debt from 25 per cent to 12 per cent of GDP. Debt service, which amounted to \$24 million in 2005, fell to about \$21 million in 2006, or a mere 1.6 per cent of export revenue. The government has also decided to buy back its remaining outstanding commercial debt, amounting to \$175 million.

Structural Issues

Recent Developments

In order to promote and diversify foreign investment, the authorities are pursuing the development of special or “Rapid Development Zones” (RDZ) in the Niassa province, Nacala district, Mozambique Island, Ibo Island, and the Zambezi Valley. Investments in these zones are exempt from import duties on certain goods and from real property transfer taxes, and are granted an investment tax credit of 20 per cent of total investment. Also, a feasibility study for a free trade zone in the Nacala district has been launched. Despite these incentives, few firms have settled in the Belulane industrial park in Maputo. Businesses claim that operating costs are too high.

The World Bank’s *Doing Business* report classified Mozambique as having one of the world’s least conducive environments for business in 2005. The government is committed to tackling some of the shortcomings. The National Assembly has approved major revisions to the outdated commercial code. In the light of the new code and of complementary legislation, the procedures for company registration have been simplified, so that the time required for registration has fallen from 90 days to only a few days.

Notwithstanding this progress, there remain serious problems related to corporate governance and lack of competition. A weak judicial system has been largely ineffective in resolving commercial disputes and protecting intellectual property rights. Counterfeited goods are widely found in the streets, damaging legitimate producers and tax revenues. Dominant incumbents and lack of competition in the service sector are often mentioned as a major constraint on private-sector development. The mingling of politics and business also contributes to the hostile business climate.

Business representatives complain about high severance payments and the difficulty of layoffs, as well as restrictions on hiring expatriates. The Labour Consultative Commission, a tripartite forum with representatives from government, trade unions, and the employers’ associations, agreed on a draft reform proposal in early 2006. The draft was later unilaterally amended and watered down by the Minister of Labour, and has not yet been submitted to Parliament for approval.

Following the agreement reached in November 2005 with Portugal, the government paid a first instalment of \$250 million to acquire 67 per cent of the Cahora Bassa Hydroelectric (HCB) plant, raising its stake in the company to 85 per cent. The government is obligated to remit an additional \$700 million, which threatens to increase the country’s foreign debt substantially. The authorities claim that HCB will raise all the necessary financing itself, thus avoiding an increase in government indebtedness. Another important development within the energy sector was the signature of a Memorandum of Understanding with the Export-Import Bank of China for an investment of \$2.3 billion in the new Mepanda Nkua Dam and 1 300-megawatt hydro-electric plant on the Zambezi River, which are to be completed in 2011.

Progress on privatisation has slowed down, since the remaining state-owned enterprises are mostly public utilities. In 2006 the Tanzanian firm METL bought Texmoque, a large state-owned textile factory in Nampula which had ceased operations in 1994. METL has promised to invest \$20 million in new equipment and resume production in 2007.

The government has pledged \$500 million to improve infrastructure, and especially to upgrade the port of Maputo by 2008. A specialised sugar terminal was opened in September 2006, and this is expected to double the sugar exports originating in the region being trans-shipped through Maputo. Construction of the Zambezi Bridge, linking the north and south of the country and budgeted at around \$14.4 million, started in 2006, and should be completed by the end of 2009. The South African shipping company Grindrod has taken a 12.2 per cent share in the Maputo Port Development Company, and has announced that it will invest up to \$25 million to upgrade the Matola Coal Terminal's capacity from 1.7 to 6 million tons per year.

Access to Drinking Water and Sanitation

Water-resource management is extremely important in Mozambique, in the light of the country's vulnerability to natural disasters (drought and floods), and of its dependence on neighbouring up-river countries for more than 50 per cent of its surface water. Some 14 million Mozambicans – nearly 75 per cent of the total population – rely on groundwater supply. Wells have an average depth of 50 metres, so allowing the use of hand pumps.

With the approval of the Water Law in 1991, the National Directorate of Water (DNA) within the Ministry of Public Works and Housing (MOPH) was given the central role in water management. Following the publication of the National Water Policy in 1995, responsibility for implementation resides with a number of semi-autonomous regional and sectoral bodies.

Over the last ten years, major progress has been made in water management. The 1995 Water Policy established the principle of delegated management, creating the basis for private-sector participation in urban utilities. Under this framework, two new institutions were created: the Water Regulatory Council (CRA) is responsible for economic and other regulation of water systems that are under delegated management, while the Investment and Assets Fund for Water Supply

(FIPAG) owns the infrastructure in urban areas that is either managed or leased by private operators. For all other urban areas, as well as for rural areas, DNA retains full control of water systems.

Data on the population's access to water is unreliable and out of date¹. Current official figures report both urban and rural water-coverage rates of about 40 per cent. According to the latest household survey, however, rural water access is only 27 per cent, while urban water access is much higher, at 64 per cent. The MDG target is to reach 78 per cent by 2015 in urban areas and 56 per cent in rural areas. Also, according to government estimates, the proportion of the population with sanitation is about 35 per cent in urban areas and 33 per cent in rural areas. The MDG target is set at 80 per cent and 50 per cent access for urban and rural sanitation, respectively.

Despite the progress that has been registered over the past ten years in encouraging and regulating private participation in urban water-supply, achieving the MDG targets remains a challenge. At present, budget execution in the water sector is less than 50 per cent. According to the UNDP Human Development Report, government financing of water-supply and sanitation will have to increase to \$7 million per year (from its current \$2 million level) if the targets set for 2015 in MDG Number 7 are to be met. Effective water management also requires capacity building at the local level, and more predictable financing from donors and the government. The accumulation of debts to construction contractors which has already been mentioned is delaying the realisation of some of the major projects in the sector.

The vast majority of foreign aid to rural water and sanitation is channelled through project financing. Only one donor currently provides general budget support to water, but donors and the government are working towards more harmonised support to the sector by improving planning, monitoring, reporting, auditing, and procurement procedures. The co-ordinating mechanism in the sector features monthly

1. The quality of data on water access is expected to improve with the new census to be carried out in 2007.

Consolidation of the Delegated Management Framework (DMF): increases in connections, coverage, and water availability

The key reason for Mozambique's success in attracting investment into water systems has been the strategy of delegating operations to the private sector, coupled with economic regulation by the Water Regulatory Council, which balances consumer and commercial interests. In 1999, the government awarded a 15-year lease contract for Maputo and a 5-year management contract for Beira, Quelimane, Nampula, and Pemba to the private company Águas de Moçambique (ADM), whose major shareholder is Águas de Portugal. Overall, ADM operates reasonably well and will have to concentrate efforts to reduce non-revenue water and improve customer services.

In 2004, as a result of noticeable improvements in water management in these five cities, the government decided to expand the delegated management framework to southern cities. The water-supply systems of Inhambane, Maxixe, XaiXai, and Chokwe were integrated and delegated to the Dutch company Vitens. In 2006, a further expansion of delegated management contracts took place in the central region.

Donors in 1999 secured to FIPAG funds in the order of 115 million dollars for financing expansion and maintenance of the water supply network. Funds from investments have risen since then to 175 million dollars in 2004 and are currently at 365 million dollars. Further investments are under negotiations with the World Bank.

Increased investment has led to a significant improvement in the coverage, reliability of supply, and water quality in the five cities monitored (Maputo, Beira, Quelimane, Nampula and Pemba). Daily water availability has risen from about 10 hours in 2000 to 16.5 hours in 2006 – which is, however, still below the African average of 17 hours.

In 2007, connections are forecast to increase to about 122 000 in the five cities (about 34 per cent higher than in 2000), which translates into 645 000 people covered. Despite improvements, water losses remain a major problem, and are on an upward trend. In the five cities, the average loss is over 50 per cent, well above the African average of 39 per cent. This poor performance is attributable to physical losses in the distribution network and illegal connections and commercial losses associated to poor metering. Rehabilitation works are under way in all cities but tangible results are yet to be seen. In the cities of Beira, Quelimane, and Nampula the replacement rate of old pumps is less than 50 per cent.

meetings of a Water Working Group of donors and government representatives.

Political Context and Human Resources Development

The 2004 presidential and legislative elections – the third to take place since the end of the civil war in 1992 – brought Armando Emilio Guebuza to the presidency and maintained the Frente de Libertação de

Moçambique (Liberation Front of Mozambique – FRELIMO) in power. The party has had an uninterrupted hold on power for 30 years, during 18 of which Guebuza's predecessor, Joachim Chissano, held power.

Although President Guebuza heralded the fight against corruption as a major goal of his mandate, to the point that in the new FRELIMO constitution it is a party-member duty to fight corruption, not a single major corruption case has been brought to

court. The 2006 mid-year joint review between the government and donors highlighted the absence of progress in implementing the government's Anti-Corruption Strategy. Various reports on governance released in 2006 also pointed to alarming levels of corruption, lack of accountability, and the deficiencies of the justice system. The delays in prosecuting the two high-profile murders associated with the Banco Austral corruption case are a major source of concern for donors and civil-society organisations. A forensic audit for the Banco Austral case was completed, but its findings have not been disclosed. The government has agreed to set up a high-level working group that will include two donor representatives and representatives from the Ministries of Finance and Justice, to move the case forward.

Provincial elections are scheduled for 2007, to be followed by municipal elections in 2008, and presidential and parliamentary elections in 2009. The Parliament passed a bill to set up directly elected Provincial Assemblies, whose role will be to approve the programmes of the provincial governments and monitor their implementation. Independent groups of citizens (and not only registered political parties, as is the case for parliamentary elections) may also propose candidates to stand for provincial elections.

FRELIMO's Ninth Congress did not produce dramatic changes. It confirmed President Guebuza's leadership and the popularity of the Prime Minister within the Party.

While literacy rates remain very low, educational and health indicators have improved dramatically in recent years. However, a slowdown or even a reversal of these positive trends is expected, due to the impact of HIV/AIDS.

According to the mid-2006 government-donors' joint review, primary-school enrolment has substantially improved. The net schooling rate for primary education (EP) in 2006 was 90.3 per cent overall (against a target of 85 per cent) and 87.5 per cent for girls (against a target of 82 per cent). The gross EP completion rate was 33.7 per cent for both sexes (against a target of

34 per cent) and 27.2 per cent for girls (against a target of 28 per cent).

Education accounts for 22 per cent of the government's expenditure. Thanks to the proper implementation of e-SISTAFE, the expenditure execution rate improved to 46.6 per cent in 2006. Nevertheless, the current expenditure execution rate, excluding salaries, was only 38 per cent, and the investment expenditure was a meagre 22.6 per cent, due to delays in disbursements from the central to the local level.

In order to secure a more predictable flow of funds and increase foreign assistance for education, in early 2006 the Ministry of Education (MINED) and donors signed a Memorandum of Understanding on the Fundo de Apoio ao Sector da Educaç o (Education Sector Pool Fund – FASE). The FASE 'pooled fund' is financed by several bilateral agencies supporting the education sector, and is managed by the MINED at national and provincial levels. The objective of the FASE is to finance a portion of the MINED's priorities as presented in the Education Sector Strategic Plans (1999-2003 and 2004-08). In addition, donors and the government signed an agreement for the funding of the Vocational Education Reform Programme (PIREP). According to the PARPA II, the funds allocated to the education sector are expected to grow by 6.5 per cent in real terms per year over the period 2007-09, with an emphasis on the recruitment of new teachers and the construction of new schools.

The health sector registered moderate progress in terms of expansion and access to services, as well as a slight improvement in budget execution. (In the first semester of 2006, global execution was 37.8 per cent, compared to 32.9 per cent in 2005.) Vaccination coverage and physician consultations per capita were on target for 2006 – vaccination of infants 0-11 months was 92 per cent (annual target 2006: 95 per cent), and there were 1.2 consultations per inhabitant (annual target 2006: 0.94).

Despite these improvements, the Mozambican health sector is faced with serious challenges. Health indicators are generally lower than in neighbouring

South Africa, Malawi, Tanzania, Zambia, and Swaziland. It is estimated that only half of the population has access to basic health services. The last available figures show that 15 per cent of all children die before reaching the age of five years, the most common cause of death being malaria. According to the World Health Organization (WHO), 1 out of 16 women die as a result of childbirth. Significant disparities in the availability and quality of health services are observed amongst provinces, the situation being particularly poor in rural areas. Even though the number of staff has increased over the last years, the number of health professionals per inhabitant is among the lowest in the world. About 12.7 per cent of government expenditures are devoted to health, and according to the PARPA II, the allocation to health is expected to grow by 3-4 per cent per annum in real terms over 2006-09, mainly for new rural hospitals, health centres, and training institutions for primary health-care workers.

Donors are increasingly funding health through a Sector-Wide Approach (SWAp). Most of the funds are channelled through three common funds: a general health fund, a common fund for health services in the provinces, and a common fund for medicines and medical equipment; these funds are administered by

the Mozambican Ministry of Health (MISAU), and are used for the implementation of the Mozambican National Health Sector Strategic Plan.

The HIV/AIDS pandemic is the biggest challenge for the country. The HIV/AIDS prevalence is 16.2 per cent, the tenth-highest in the world, and the country has one of the fastest-growing rates, with an estimated 500 new HIV infections each day. Some provincial prevalence-rates exceed 20 per cent, with a peak of about 30 per cent along the Beira Corridor.

Increased political commitment, rising financial resources from the National AIDS Council (CNCS), and better harmonisation and alignment of donor-supported projects provide some hope for progress. Nevertheless, the national response is insufficient due to inadequate human resources and lack of co-ordination. To date, only 10 per cent of people in need of ART receive treatment and less than 5 per cent of pregnant women living with HIV or AIDS receive the full course of prophylaxis for the prevention of mother-to-child transmission. It is widely acknowledged that the role of CNCS as the co-ordinating authority for HIV/AIDS must be strengthened.