

Economics

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Mozambique: Annual economic outlook Energy and price shocks subdue growth

Projections for 2009:

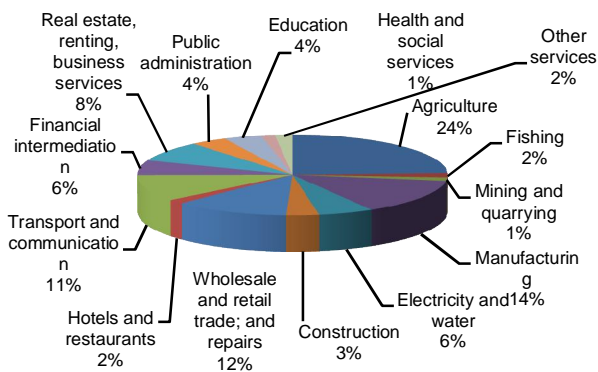
- Real GDP growth is expected to slow to 5.6% in 2009
- Average annual inflation to fall to 5.1% in 2009
- Metical to depreciate to an annual average exchange rate of MZN/USD27.06 in 2009
- Trade deficit is projected to widen to 8.8% of GDP in 2009
- Fiscal deficit (excl. grants) expected to increase to 17.2% of GDP

Recent trends

Production

The Mozambican economy is estimated to have expanded by 6.1% in 2008, largely on account of strong growth in the agriculture and transport and communication sectors. However, this represents a softening in economic activity compared to 2007, when the economy grew by 7%. The contraction of the manufacturing sector is mainly responsible for the slowdown in the economy in 2008.

Figure 1: Gross domestic product by activity (2007)

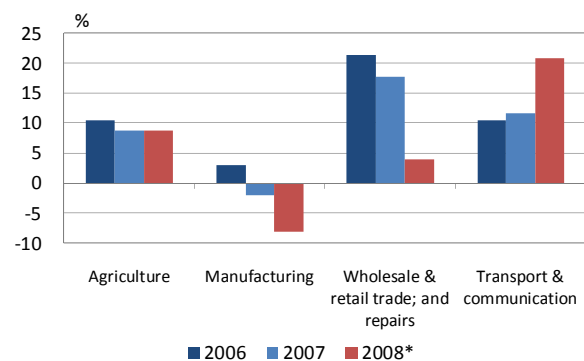


Source: Instituto de Nacional Estatística

Agriculture is the largest economic sector in Mozambique, generating about one-quarter of gross domestic product (GDP) (see Figure 1).

The agriculture sector grew by 8.7% in the first three quarters of 2008 compared to the corresponding period of 2007 (see Figure 2). Mozambique's principal agricultural products are maize, cassava, rice, cotton, cashew nuts, peanuts, sugar cane, tobacco and horticulture. The production of food crops has improved significantly in recent years following the implementation of a series of constructive agricultural programmes by the government, including the import-substituting national food production plan for the period 2008-2011. This has not only enhanced Mozambique's food security but has also contributed to depressing headline inflation, as food constitutes more than half of the consumer price index (CPI).

Figure 2: Real growth of largest sectors



Source: Instituto de Nacional Estatística
*Standard Bank estimates

Transport and communication is the fourth-largest sector after manufacturing; and wholesale and retail trade, and repairs. This services sector grew by a remarkable 20.8% during the first three quarters of 2008, compared to the corresponding period of 2007. On the transportation front, in the third quarter of 2008, the volume of cargo carried by air and railroad increased by 17.8% y/y and 8% y/y respectively. The number of passengers that were transported by the two modes of transport over the same period increased by 34.7% y/y and 13.4% y/y respectively. The continued uptake of mobile phone subscriptions partly explains the expansion in the communication sub-sector.

After agriculture, manufacturing is the largest producer of national output. In 2007, the secondary sector produced 14.1% of GDP. In 2008, manufacturing was severely affected by the fall in electricity production and supply. Owing to an agreement between Mozambique's former colonial power, Portugal, and the previous apartheid government, the output of the Cahora Bassa Hydroelectric plant ("HCB" is the Portuguese abbreviation), Mozambique's main producer of electricity, is transmitted directly to South Africa. Eskom then sells 60% of that electricity back to Mozambique and 35% to Zimbabwe's power utility, ZESA. Significant electricity supply shortages in South Africa led major industrial consumers, including MOZAL, one of Mozambique's largest mega projects, to cut their electricity consumption by 10%. It is estimated that electricity production fell by 18.5% to 6.906 million mega watts (MW) in the first half of 2008, compared to the same period in 2007, owing to rehabilitation work on the Apollo substation in South Africa that reduced electricity exports from the Cahora Bassa to Mozambique. This explains the contraction of the electricity and water sector by 3.6% in the first three quarters of 2008 compared to the corresponding period in 2007.

An electricity supply constraint in 2008 thus impacted industry and, as electricity is a significant input in the aluminium smelter process, MOZAL's production fell. As MOZAL is a major manufacturer in Mozambique, the manufacturing industry contracted by 9.0% y/y, 9.8% y/y and 5.1% y/y in the first three quarters of 2008 respectively. If manufacturing output for the first three quarters of 2008 is compared to that of a similar period in 2007, it shrank by 7.8%.

Two sectors that performed soundly in 2008, albeit off a low base, were construction, and mining and quarrying. The construction sector, which constitutes only 3.4% of GDP, grew by 12.7% in the first three quarters of 2008, compared to the same period in 2007. Most of the activity in the sector occurred in the third quarter of 2008, when the sector expanded by a stellar 20.2% y/y. The main growth stimulus in construction is infrastructure development, especially the rehabilitation of roads and bridges. Railroads are also being constructed, including the Sena railway, which is expected to be fully operational for traffic flow by mid-2009. The Sena rail line is 600 km long and runs between Moatize and the port of Beira. It is being rebuilt to transport coal exports from the Brazilian mining company, Companhia Vale do Rio Doce (CVRD), and the Australian company, Riversdale, to the nearest port.

Domestic expenditure

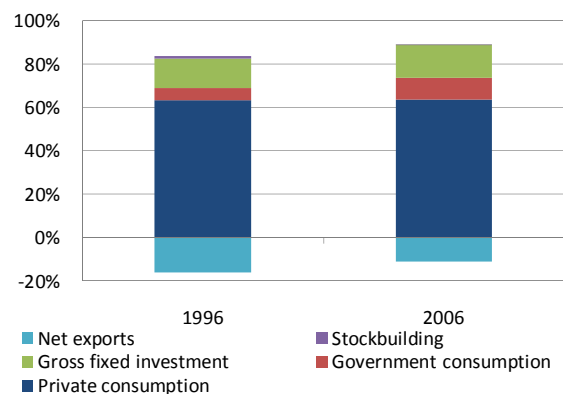
The total value of spending on goods and services in Mozambique, gross domestic expenditure (GDE), is significantly higher than that of GDP because Mozambique an import-dependent economy. It is notable that net imports (imports minus exports) contribution to GDE declined in the 10 years to 2006 to 10.9% in 2006, from 16.1% in 1996 on the back of a more than tenfold increase in exports over that period (see Figure 3). As net imports to GDE ratio, decline government consumption expenditure's contribution to total domestic spending almost doubled to 10.1% in 2006. Gross fixed investment's share of

GDE also increase over this period by 1.4 percentage points to 15.1% of GDP.

The growth in domestic spending is estimated to have slowed in 2008 to 8.1%, from 9% in 2007 owing to a broad-based softening in demand, particularly household consumption expenditure and gross fixed capital formation. Households' expenditure growth is estimated to have moderated to 5.7% in 2008, from 6% in 2007, on account of higher inflation, particularly as a result of surging energy prices. The purchasing power of Mozambican households is also expected to have declined in 2008 on account of the contraction of the second-largest sector, manufacturing, which has resulted in some workers being laid off.

Both the public and private sectors have been strong in fixed investment. Infrastructure programmes, particularly transport infrastructure, have attracted a sizeable share of public sector investment. Private fixed investment has been largely foreign direct investment (FDI) headed for the extractive industry and manufacturing. The mining of coal is probably Mozambique's largest extractive industry, with investments by the mining giant CVRD and Riversdale Mining Limited (Ltd) and with more in the pipeline. In the first half of 2008, Riversdale announced that the company's Benga Licence coal resources in the Moatize coal fields had yielded results that were 58% higher than previously expected, at an estimated 1.94 billion tonnes. Tata Steel Ltd, through the acquisition of a 35% share of Riversdale's Benga and Tete licences for US\$88.2 million, is able to play a key role in the joint venture created to develop the Mozambique Coal Project and get a 40% share of the off-take for coking coal, which will be supplied to the Tata Steel Group's worldwide facilities.

Figure 3: Structure of GDP by expenditure (% of GDP)



Source: International Financial Statistics

The government is seeking to attract FDI into the country's agriculture and tourism sectors, not least because of the sectors' relatively large employment-generating capacity. Despite the large investments of the mega projects, they are considered to be capital intensive, to have created limited employment opportunities and, owing to their nature, to have few linkages.

Government consumption had to be ramped up in the first half 2008 to cater for the incorporation of a subsidy on diesel used by urban

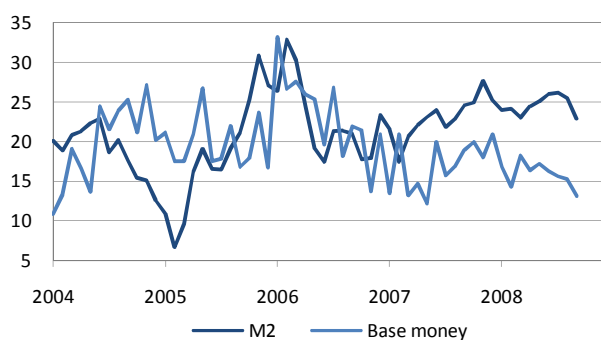
passenger transport operators that were reeling from the fuel price increases. The subsidy was financed by diverting already approved non-priority spending commitments to subsidy payments and from additional budget support from the World Bank. It is estimated that this measure to ease the social burden of higher import prices cost 1.2% of GDP. In the second half of 2008, the November 2008 municipal elections added pressure to the fiscal budget. Government consumption expenditure is thus projected to have grown at a sound 7.5% in 2008, from 7.8% in 2007.

The net imports (imports minus exports) component of domestic spending was impacted by the surge in the international oil price in the first half of 2008 and by the domestic electricity supply constraint. The oil imports' slice of the total import bill burgeoned in the first half of 2008 on the back of soaring oil prices. Concomitantly, an energy shortfall related to South Africa's electricity shortage adversely impacted industry, including MOZAL, a major consumer of electricity and the producer of Mozambique's largest export, aluminium. As such, MOZAL's production dipped in 2008, resulting in a decrease in the export volume of aluminium. The downward slide of commodity prices in the latter half of 2008 further depressed export revenue. That, coupled with the expansion in imports, led to a pronounced expansion of net imports in the first half of 2008; however, the drop in the international oil price in the latter half of the year tempered net imports.

Monetary policy

Price stability is the Bank of Mozambique's monetary policy objective, with reserve money as the intermediate target, in the context of a flexible exchange rate. At the beginning of 2008, the central bank set a base money growth target of 14.4% to achieve the inflation target of 5-6%. The average year-on-year growth rate of reserve money in the first nine months of 2008 was 15.9%, which was stronger than programmed. Reserve money's ceiling targets were subsequently upwardly adjusted to account for extraordinary events that fuelled monetary expansion. Reserve money thus met the end-June 2008 and end-September 2008 adjusted target ceilings of MT17 044 million and MT17 506 million respectively, despite the cut in the liquidity reserve requirements in April 2008 and the extraordinarily large seasonal increase in currency demand that followed the remuneration of tobacco growers in meticaís instead of Malawian kwacha as had previously been the case.

Figure 4: Money supply growth (% y/y)

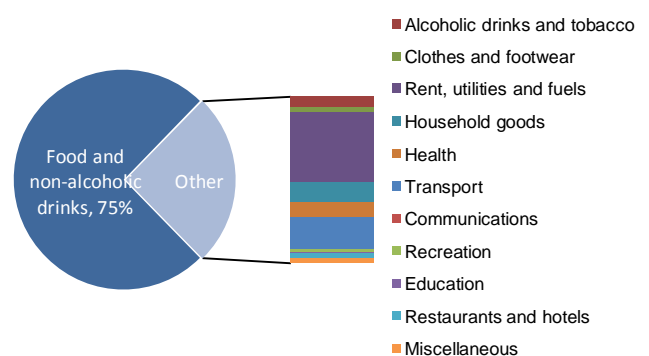


Source: Banco de Mocambique

Monetary expansion was thus not the inflationary pressure in 2008. The reduction in budget spending through monetary financing has helped soften inflationary pressures due to rapid monetary expansion. Fuel and food price pressures, particularly in the first half of the year, explain the stubbornly high inflation rates for the first ten months of 2008. Early in 2008, when energy price pressures dominated, the government raised the fuel price in January, in response to the climb of the international oil price, and this effectively implied that in a period of 12 months the price of petrol and diesel had surged by 46% and 90% respectively. The almost doubling of the diesel price led to protests by commuters in Maputo, when the urban passenger transport operators responded to the diesel price by hiking their fares. The subsidy that was subsequently placed on diesel used by urban passenger transport dampened inflation for the transport sub-index in the CPI. However, the rent, utilities and fuel sub-index continued to reflect the energy price pressures; inflation for this sub-index accelerated to 12.6% y/y in April 2008, before slipping back into the single digits in the latter half of 2008, when the international oil price fell.

Notably, energy price pressures from the rent, fuel and utilities, and transport sub-indices were relatively mute following the imposition of subsidies very early in 2008 on fuel used by urban passenger transport operators and the subsequent fall of the international oil price. As such, non-food inflation was very subdued during 2008, peaking at a modest 4% y/y in September 2008, when headline inflation was 10.7% y/y. The strongest price pressures thus stemmed from food, not only because of its large 51.9% weight in the CPI but also because of greater price increases for this particular consumer good (see Figure 5). Food inflation peaked at 18.7% y/y in February 2008 and, although it slowed during the remainder of the year, it remained in the double digits until November 2008.

Figure 5: Food's contribution to consumer price inflation in 2008



Source: Instituto de Nacional Estatística, Standard Bank estimates

Although headline inflation was mainly due to food prices, non-food inflation was exceptionally low and stable in 2008 and thus softened headline inflation. This meant that monetary policy remained unchanged during the year, with a policy rate (the standing lending facility) that remained flat at 14.5% from the time it was cut by one percentage point in January 2008. The prime lending rate moderated during 2008 and ended the year at 17.99%, down from 18.85% a year

earlier. This narrowed its wide spread with the deposit rate that reflects structural issues that keep the lending rate from declining, including limited scope for secured loans owing to the fact that a private entity cannot own land.

The 91-day Treasury bill interest rate was flat at 13.5% in the first half of 2008 and thereafter it went on an incline and peaked at 14.05% at the end of 2008, which suggests either an increase in Treasury bill issuances in the second half of 2008 or under subscriptions at auctions. To strengthen monetary policy operations the central bank introduced repurchase agreements (repos) in July 2008 and plans to expand their use in place of Treasury bills. A repo is economically similar to a secured loan, with the buyers receiving securities as collateral to protect against default.

International trade

The global economic recession has eroded wealth and created job losses, thus dampening demand. This has in turn depressed commodity prices, as the economic downturn in the advanced world halts the demand for East Asian manufactured goods that are produced from raw materials, of which Africa is a major supplier. For an economy that depends on one commodity for the bulk of its export earnings, the downward spiral of prices has had a pronounced effect on the value of national output as well as foreign exchange earnings.

Aluminium generates about two-thirds of Mozambique's exports' earning. It is the world's second most widely used metal, after iron, and is employed in the aerospace industry, in transportation and in building. The global economic slowdown has subdued the appetite for air travel, vehicles and property development, and led to a trade finance squeeze that has made it difficult to purchase commodities on credit. In response, the demand for aluminium has moderated.

Although bauxite (aluminium ore) is not mined in Mozambique but simply processed in MOZAL's aluminium smelters, the fall in its price, combined with a domestic energy shortage that has adversely affected production, has had a detrimental impact on export earnings. Following the peaking of the aluminium price at US\$3 067.46 per metric tonne at the end of July 2008, the price halved by the end of 2008 to US\$1 504.42. Given that aluminium smelters consume a large amount of energy, the concurrent drop in the energy price index (which includes crude oil, natural gas and coal) of 63%, from its peak in July 2008 to the year-end price, eased the cost of producing aluminium, implying that the margins earned on production were not significantly eroded.

The fiscal stimulus packages put forward by the world's advanced economies to rouse an economic recovery have yet to take effect, especially as several of them involve infrastructure projects that will only be realised over the medium- to long term. On the monetary policy front, the slashing of interest rates by the world's major central banks has not yet unlocked credit, including trade finance, largely due to the persistent lack of confidence in the developed world's financial markets.

As industries decline in some economies, the risk of protectionism has risen. Several countries are subtly pushing for their consumers to buy only local goods and services, to keep underperforming industries above water and keep fellow citizens in their jobs. Protectionism thus restrains trade between nations, through methods such as tariffs on imported goods, restrictive quotas, and various other restrictive government regulations designed to discourage imports and prevent foreign companies from acquiring local markets and companies. The risk of protectionism for small open economies like that of Mozambique is unfair competition on international markets, which would be detrimental for an economy whose market for mega project output and other traditional exports is the international market.

External sector

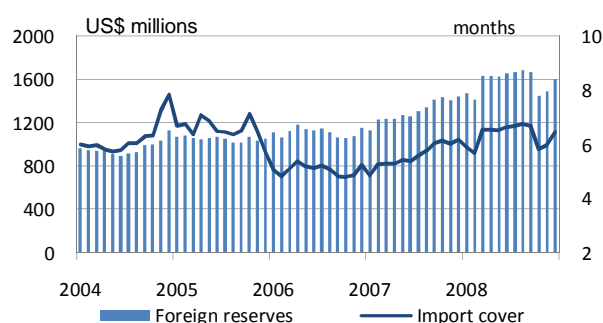
The metical was one of the region's more stable currencies during 2008. The annual average metical to US dollar exchange rate for 2008, MZN24.24/USD, was 6.5% stronger than that of 2007. However, the annual average exchange rate masks the trend of the exchange rate over the course of 2008; the metical depreciated by 3.3% against the US dollar in the 12 months to December 2008, to a monthly average rate of MZN25.00/USD.

The trade deficit is estimated to have widened to 8.6% of GDP in 2008, from 7.8% in 2007, largely on account of a concomitant sharp fall in the price of Mozambique's main export and a decline in production due to an electricity supply constraint. High aluminium prices in the first three quarters of 2008 and the decline in import volumes during the year partly alleviated the effect of soaring food and fuel prices in the first half of 2008 on the trade balance. Although the coming on stream of a new export in 2008, titanium, is expected to have mitigated the decline in earnings from aluminium exports, the decline in electricity exports is expected to have undermined titanium's entry into the trade account. Essential maintenance work at a significant substation is estimated to have cut electricity production by an estimated 15.6% y/y to 6.906 million megawatt hours in the first half of 2008.

The whopping 39.8% y/y surge in the fuel import bill in the first half of 2008, to US\$260 million, was entirely due to the soaring international oil price, because the volume of fuel purchases during this period declined by 12.8% y/y to 262 897 tonnes. It is estimated that the fuel bill for 2008 was US\$635 million, which is 18% of the entire import bill. The rising fuel cost adversely impacted the fishing industry, where eight out of 59 fishing boats were forced not to renew their licences because of burgeoning costs.

Mozambique's current account balance thus came under strain from a deteriorating trade deficit, which was likely mitigated by a moderation of the deficit in the services and income account due to a slowdown in income repatriated by the mega projects.

Figure 6: Gross foreign exchange reserves



Source: Banco de Mocambique, Standard Bank estimates

Strong private capital inflows countered the delays in donor aid and provided financing for the current account deficit, thus supporting the solid build up of foreign reserves in the first three quarters of 2008 to about six months of import cover at the end of August. Foreign reserves declined in October and November 2008, however they picked up in December following an early disbursement from the World Bank of a loan facility intended for agricultural and infrastructure development over the medium term that boosted the reserves at a time when rising risk aversion related to the global financial crisis was spurring the selloff of emerging market currencies (see Figure 6).

Among the projects attracting FDI, and thus attracting foreign exchange inflows, is the construction of a US\$145 million gas compression station by Sasol, on the Mozambican border with South Africa, at Komatipoort. Construction of the station, which is expected to increase the supply of gas by 20%, began in the second half of 2008, and the station is expected to come on stream in 2009. Mozambique's trade with its fellow Southern African Development Community (SADC) member countries is limited. It is estimated that exports to the southern Africa region are at a low US\$83 million and that South Africa is the main destination. South Africa's main exports from Mozambique are electricity and natural gas produced at Temane. Conversely, imports from the region have been growing; however, South Africa once again is the main source, followed a long way behind by Mauritius, Tanzania, Malawi and Swaziland. It is anticipated that the SADC free trade agreement that was signed in mid-2008 will boost Mozambique's trade with its neighbours.

Public and external solvency indicators

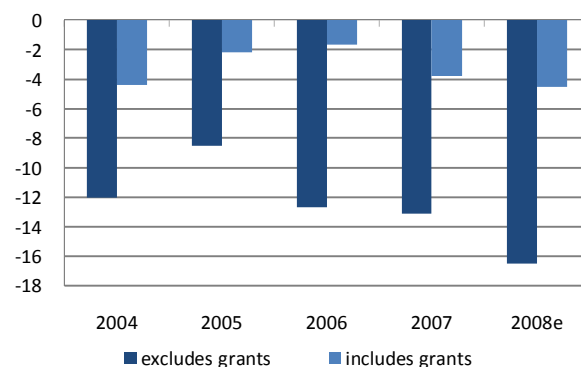
Fiscal operations during 2008 were generally sound as revenue collections came in higher than expected due to significant improvements in the tax collection system and to capital expenditure being less than planned, which implied that although there were delays in budget support the domestic financing requirement was within bounds.

According to the IMF, total revenue is estimated to have increased by 12.5% to MT37.20 billion in 2008, largely on account of strong growth in tax revenue that was made possible by greater revenue

mobilisation. The largest constituent of tax revenue, taxes on goods and services, increased by 19.6% in 2008 to an estimated MT17.28 billion. Non-tax revenue may only generate 12% of total fiscal revenue but it is estimated to have expanded at a greater rate than tax revenue in 2008, at 16.6% to MT4.64 billion, which is testimony to the success in growing non-tax revenue.

Although fiscal revenue exhibited sound growth in 2008, the expansion in government spending was significantly stronger. Total expenditure and net lending is estimated to have surged by 30.1% in 2008. Capital expenditure, which constituted about 40% of the budget, grew at a whopping 44% in 2008 to MT35.01 billion. It nevertheless is estimated to have been 6.1% less than planned owing to delayed aid disbursements. Current spending increased by an estimated 18.5% to MT37.72 billion, half of which is compensation to employees, which grew by 17.2%. Transfer payments were the fastest-growing current expenditure item, at 24.3%, to MT7.62 billion.

Figure 7: Budget balance (% of GDP)



Source: Banco de Mocambique, Standard Bank estimates

The 2008 budget came under strain from spending related to the municipal elections, the hiring of 12 000 teachers and 5 000 health workers, the reinforcement of security forces and the government funds required to complement donor financing for project-related spending. An additional extraordinary expenditure that emerged in early 2008 was the subsidy on diesel used by urban passenger transport operators. The social impact of higher import prices is estimated to have cost 1.2% of GDP. It is thus estimated that the budget deficit, excluding grants, increased to 16.9% of GDP in 2008, from 12.8% in 2007 (see Figure 7).

National policy assumptions and the international environment

The Mozambican government's long-term socio-economic plan is to improve the living standards and welfare of its citizens. Its primary objectives are balanced economic and social development, absolute poverty reduction, the consolidation of peace, national unity, and democracy. These objectives were translated into measurable targets in a medium-term Action Plan for Reducing Absolute Poverty (Plano de acção para a Redução da Pobreza Absoluta, PARPA). PARPA is a government document that is derived from a consultative process with various stakeholders, including civil society and Mozambique's

development partners. It is a medium-term strategic tool that forms the basis from which strategies are developed, including sectoral policies and provincial and operational plans for the year, such as the Economic and Social Plan and the state budget.

The action plan is a working document that can be adjusted and updated annually, through the medium-term fiscal plan and national budget. PARPA establishes the connection between specific priorities and allocation of resources for the programme period. The most recent action plan is PARPA II (2006-2009), which is the successor of PARPA I (2001-2005).

PARPA II's principal goal is to reduce the incidence of poverty from 54% in 2003 to 45% in 2009. The priorities in PARPA I and PARPA II that are in common are human capital development and health, improvement in governance, development of basic infrastructure and agriculture, rural development, and improvement in macroeconomic and financial management. The new objectives in PARPA II are greater integration of the provinces and the enhancement of productivity. The revised action plan sought to focus attention on development at the provincial level by creating an environment that is conducive for productive investments, improving the financial system, facilitating the emergence of small and medium enterprises framed in the formal sector, and developing systems to collect both internal revenue and the allocation of budgetary resources.

Although PARPA II projected an increase in domestic revenue in real terms over the 2006 to 2009 period, it also expected Mozambique to remain dependent on donor aid for about 45% of its budget over this period. This dependency reflects the scale of poverty in Mozambique.

In 2009, the final year of the PARPA II programme, extensive consultations will be conducted regarding the revision of the action plan to accommodate emerging issues and devise an updated programme to accelerate the poverty alleviation process.

Mozambique's economic policy is framed in the IMF's policy support instrument (PSI) that was agreed in 2007. The primary objectives under the PSI are to strengthen macroeconomic stability amid rising external aid; fast track structural reforms, including liberalising sectors dominated by poorly performing public sector monopolies; and implement PARPA II. Other goals that have been carried forward from the pre-2007 poverty reduction and growth facility include strengthening fiscal policy and lowering the cost of doing business. A significant sectoral plan is to implement a US\$333 million import-substituting national food production plan for the period 2008-2011 with a means of boosting food production and improving food security.

International environment

The global economic outlook has deteriorated rapidly since September 2008. The crisis, which originated in the US sub-prime mortgage market, destabilised the US financial system and manifested into a global financial crisis, has stalled global economic activity. In January 2009, the IMF released an update to its World Economic Outlook, which projected 0.5% growth for the global

economy in 2009, down from 3.4% in 2008. Barely two months later, the IMF downwardly revised its global economic outlook to negative growth; the global economy is thus expected to contract in 2009.

The global economic recession outlook is mainly the result of an expectation that the advanced economies will contract by more than -2% in 2009 and thus offset the projection of sluggish growth in the emerging and developing world of about 3%. Recessions in the advanced world imply a significant drop in global demand for exports. This has severe implications for major export-driven economies, like East Asia, which are major importers of raw materials that are used to produce their processed exports, and thus for Africa's primary commodities.

Sluggish economic activity and depressed commodity prices will soften inflation in 2009, from 2008's highs. Inflation of 0.3% is projected for the advanced economies, of which some are at risk of deflation given the severity of the economic slowdown in those economies. The inflation projection for the emerging and developing economies in 2009 has also been downwardly revised to 5.8%, from 9.2% in 2008, despite the structural bottlenecks that exist, thus underscoring the sharp decline in commodity prices and demand destruction.

Table 1: Global economic outlook

	Real GDP growth (year-on-year)			
	2006	2007	2008F	2009F
World	5.1	5.2	3.4	0.5
Advanced economies	3.0	2.7	1.0	-2.0
United States	2.8	2.0	1.1	-1.6
Euro-zone	2.8	2.6	1.0	-2.0
United Kingdom	2.8	3.0	0.7	-2.8
Japan	2.4	2.4	-0.3	-2.6
Emerging and developing economies	7.9	8.0	6.3	3.3
China	11.6	13.0	9.0	6.7
India	9.8	9.3	7.3	5.1
Brazil	3.8	5.4	5.0	2.0
Russia	7.4	8.1	6.2	-0.7
Africa	6.1	6.2	5.2	3.4
Sub-Sahara	6.6	6.9	5.4	3.5
Developing Asia	9.9	10.6	7.8	5.5

Source: IMF's World Economic Outlook, January 2009 Update

Forecast summary

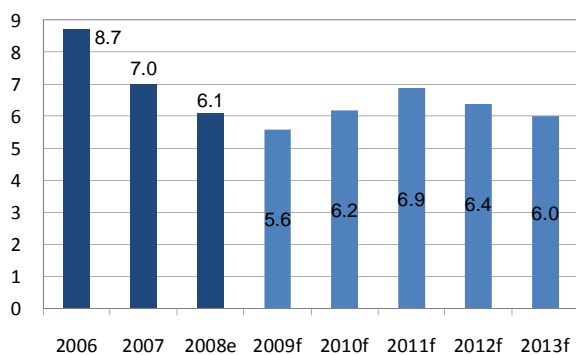
Domestic expenditure

Economic activity in Mozambique is projected to slow in 2009; the economy is thus expected to grow by 5.6% in 2009, a slowdown from an estimated 6.1% in 2008 (see Figure 8). Household spending is expected to moderate in 2009 on the back of layoffs in industries that have been impacted by the global economic recession and electricity shortfall, particularly primary commodity-related industries. BHP Billiton has

already announced redundancies at its MOZAL aluminium smelter and is postponing its US\$700 million Corridor Sands titanium project in Chibuto, Gaza Province. The growth in household spending is thus projected to slow to 5.2% in 2009, from 5.7% in 2008.

Fixed investment activity is likely to fall below potential in 2009 owing to the global credit crunch but it is expected to remain robust on account of the continued investments from CVRD and Riversdale in the Moatize coal basin, which covers about 4 000 hectares and holds an inferred reserve of 1.9 billion tonnes of coking coal. Government's commitment to ongoing electricity expansion programmes in the coal-rich Moatize region and infrastructure developments will only be tempered by a moderation in development aid from donor countries that are in recession. As such, the growth in gross fixed capital formation is expected to soften in 2009 to 4.8%, from 5.4% in 2008.

Figure 8: Real GDP growth (%)



Source: IMF, Instituto de Nacional Estatística Standard Bank estimates

Electricity supply shortages are the primary risk for investors seeking to inject capital into Mozambique's industries. The government is actively seeking to attract FDI towards the agriculture and tourism sectors and into the textile industry; however, it also recognises that infrastructure must be in place for investment to be diversified. As such, investors are being courted by the government for the Temane gas-fired generation project, the Moatize coal power project and the Mphanda Nkua hydropower plant (about 1 000 MW). The government also plans to upgrade the HCB station in the northern Tete Province to increase production levels from the current 2 400 MW. It is estimated that the HCB's potential output is 14 000 MW. Once the credit crunch passes, financing for these infrastructure projects is expected pick up. To support these developments, a major transmission line to distribute electricity to potential export markets will also need to be constructed.

The continued appetite for mineral concessions, particularly coal, suggests that Mozambique's private fixed investment prospects are positive over the medium- to long term. In early 2009, Mozambique awarded coal concessions for two mining blocks with an estimated reserve of 500 million to one billion tonnes of thermal and coking coal to an Indian company, Nacvratna PSU Coal India. Such investments have roused the rehabilitation of Mozambique's railroads to transport the mineral output to the coast for export, thus complementing public fixed investment in infrastructure. The construction of the 600 km Sena railway

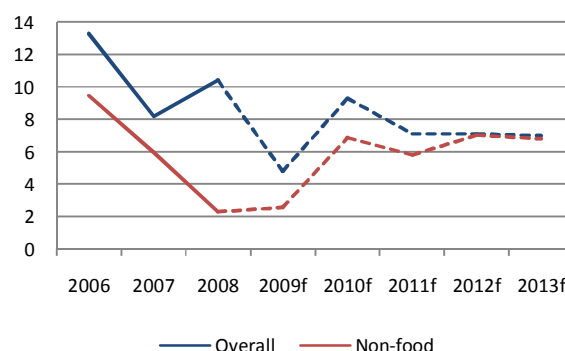
line that will transport CVRD and Riversdale's coal from Moatize to the Beira port is expected to be completed in mid-2009. The Sena rail line is expected to reach full capacity in 2010-2011 when coal exports begin.

Although 2008's high import-price-related subsidies fall away in 2009, the government consumption expenditure is still expected to come under pressure from spending related to the end-2009 general elections and the ongoing public sector wage reforms, which seek to increase the gap between junior and senior level wages. The growth in government consumption expenditure is thus expected to remain strong and move sideways to 7.1% in 2009, from 7.5% in 2008.

Monetary policy

Depressed commodity prices and a high base effect support a lower inflationary environment in 2009. The drop in the international oil price is expected to keep the inflation rates for the rent, utilities and energy, and transport sub-indices, which make up almost one-quarter of the CPI, low. This will translate into a subdued secondary price effect from oil prices. Headline inflation is thus projected to slow to an average annual rate of 5.1% in 2009, from 10.4% in 2008, largely on account of subdued inflation in the first half of 2009 (see Figure 9). The main risks to this outlook are a weakening currency and expansionary government spending in the run up to the end-year elections, which are expected to pull up inflation toward the end of 2009.

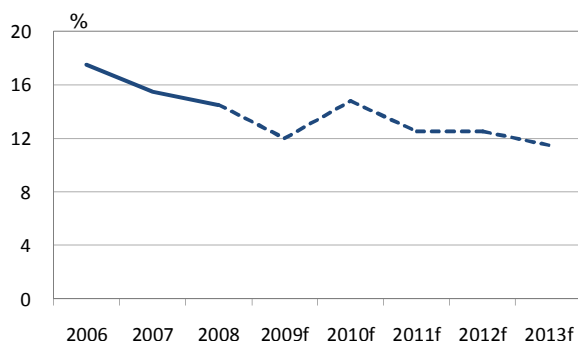
Figure 9: Consumer price inflation (% annual average)



Source: Instituto de Nacional Estatística, Standard Bank estimates

The Bank of Mozambique will aim to contain reserve money growth and maintain a stable exchange rate in 2009 in order to stem imported inflation. Reserve money growth of 11% in 2009 is the central bank's aim, as a means to keeping inflation in the single digits. Monetary policy will be accommodative in 2009, on account of a lower inflationary environment. This has already been signalled by the 1.5 percentage point cut in the policy interest rate, the standing lending facility, in February, to 13%. The policy interest rate is thus projected to decline to 12% by the end of 2009, from 14.5% at the end of the previous year. As the economy recovers in 2010, inflation is expected to incline. The monetary authority is projected to respond by tightening policy.

Figure 10: Interest rates (% annual average)



Source: Banco de Mocambique, Standard Bank estimates

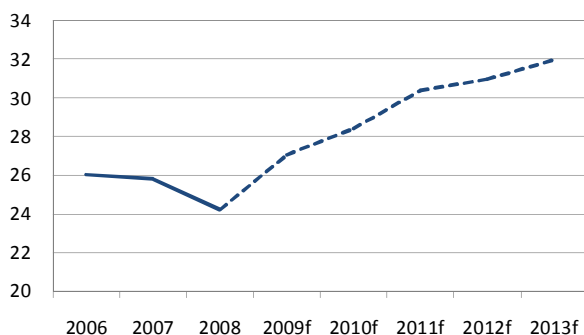
The central bank is likely to retain its preference for employing foreign exchange sales to drain excess liquidity, as opposed to issuances of Treasury bill, as this prevents the crowding out of private sector credit extension. The introduction of repos in 2008 is expected to support the monetary authority's preference for employing Treasury bills as a monetary policy tool. However, in the current environment of risk aversion when there is a strong preference for holding US dollars instead of emerging market currencies, the pressure on foreign reserves, from reduced export revenue and a likely moderation in aid inflows and capital inflows, may compel the Bank of Mozambique to engage in more Treasury bill issuances to control liquidity.

The Bank of Mozambique seeks to move towards an inflation-targeting regime over the medium- to long term, which it is working towards by strengthening its expertise and resources for monitoring, analysing and forecasting macroeconomic and monetary indicators. Technical assistance is being provided by the IMF to the central bank to develop the monetary policy framework and work towards establishing a core inflation indicator by the end of 2009.

External sector

Strong foreign exchange inflows due to high commodity prices and generous donor aid inflows enabled the Bank of Mozambique to build up its foreign exchange reserves and support a stable exchange rate.

Figure 11: Exchange rate, ZMK/USD (annual average)



Source: Bloomberg, Standard Bank estimates

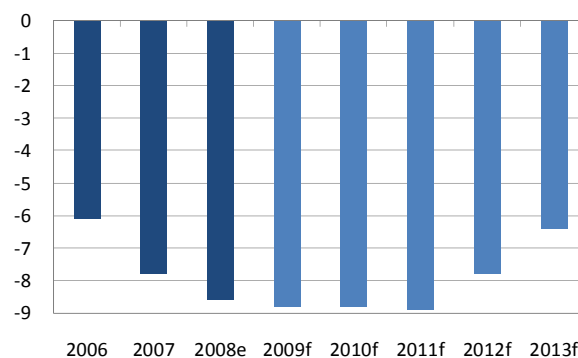
However, a stronger US dollar, a 50% drop in the price of Mozambique's primary export and the likely moderation of aid inflows in 2009 are expected to slow the accumulation of reserves, and thus put pressure on the metical to depreciate. The metical to US dollar exchange rate is thus projected to weaken to an average annual exchange rate of MZN27.06/USD in 2009, from MZN/USD24.24 in 2008 (see Figure 11).

Where the collapse in the international oil price may have improved Mozambique's terms of trade, this was countered by the drop in the price of aluminium. Thus, a change in the terms of trade or prices of exports and imports is not expected to influence the external sector significantly in 2009, as it did in the first half of 2008. Instead demand or the lack of it owing to the current global economic recession is expected to reduce the demand for Mozambique's exports, particularly aluminium and titanium. The construction of a gas compression station on the Mozambique-South Africa border at Komatipoort is expected to boost gas exports by about 20%; however, this gas is only expected to come on stream towards the end of 2009, so it is not likely to have a material effect on 2009's export revenue. Nominal exports' growth is thus projected to soften in 2009 to 6.7%, from 7.4% in 2008.

The fall in the international oil price is projected to slow demand for imports in 2009 and any growth is expected to stem from capital equipment related to the ongoing mining investments and infrastructure developments. The growth of the nominal import bill is thus expected to moderate to 9.2% in 2009, from 10.7% in 2008.

The slowdown in export revenue growth is expected to exceed that of import growth because exports have been impacted by both lower prices and production. The trade deficit is thus projected to increase to 8.8% of GDP in 2009, from 8.6% in 2008 (see Figure 12).

Figure 12: Trade balance (% of GDP)



Source: IFS, Standard Bank estimates

As activity in the mega projects is likely to soften in 2009, the income deficit, which reflects repatriation of earnings, is like to narrow in 2009. A slowdown in inflows into the services account, including tourism earning, is also likely given that Mozambique's largest source of tourists, South Africa, is undergoing an economic downturn. The current account deficit before grants is thus likely to increase slightly in 2009.

Weaker private capital inflows and donor aid inflows suggest a moderation in Mozambique's international reserves by the end of 2009 to 4.5 months of import cover, from 6.7 months in August 2008.

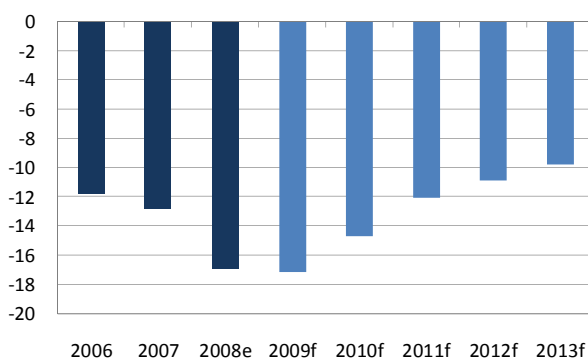
The free trade agreement under SADC is not expected to have a significant effect on exports in 2009 because Mozambican institutions and laboratories are yet to meet the high standards, regarding health norms and standards of certification, leaving little option for local companies but to hire specialised foreign institutions to certify export quality. Certification is expensive and adds an additional cost to producing exports, which is likely to reduce the competitiveness of Mozambican exports in the short- to medium term.

Public and external solvency

The challenge for Mozambique's fiscal authority is to mobilise additional domestic tax revenue to wean itself off donor dependence. Total government revenue is projected to slow in 2009 on the back of a slower economy and the likely moderation of aid inflows and squeeze on external financing, not least owing to governance concerns. The improvements in tax revenue will stem from ongoing administrative reforms in the tax collection process and a decline in fuel subsidies in accordance with the decrease in the international oil price. In particular, the government has re-imposed import duties and value added tax (VAT) on diesel and kerosene and has re-instated the handling fees charged for fuel imports by the publicly owned ports and rail company, *Portos e Caminhos de Ferro de Moçambique* ("CFM" is the Portuguese abbreviation).

The government plans to spend MT90 billion (US\$3.4 billion) in 2009, which is an estimated 25-30% of GDP. Spending is also projected to rise on account of the end-2009 general elections, the implementation of the 2008-11 national food production plan, and the public sector wage reforms that seek to widen the gap between junior and senior levels. The budget deficit is thus projected to increase to 17.2% of GDP in 2009, from an estimate of 16.9% in 2008 (see Figure 13).

Figure 13: Fiscal balance (% of GDP)



Source: IMF, Standard Bank estimates

About half of this budget is expected to be financed with donor aid. Mozambique's donor partner countries pledged about US\$774 million for the 2009 budget, of which US\$445.2 million was direct support for the 2009 budget and the remainder for sector programmes and

common funds. Notably, only four of the donor partners increased their budget, while the bulk of them kept their support at the same level as in 2008, because of governance concerns. Given the severity of the global economic downturn, developing countries will have to compete for donor assistance. Two of Mozambique's 19 donor partners have already announced that they are reviewing their participation because of the financial crisis. This implies delays in the government's infrastructure projects and the social upliftment programmes outlined in the PARPA II document. Perceptions of poor governance coupled with economic distress in donor countries suggest that donor aid may not be as forthcoming as the pledges, which were made in 2008, suggest.

Under the delayed SADC free trade agreement, most goods from member countries will be able to enter Mozambique duty free. Duty free allowances for travellers have also been eased. These revenue-eroding measures are expected to be offset by the new fiscal benefits code that removes or reduces the many tax breaks for future investors. Investors in industrial free zones will retain their benefits, and those in the special economic zones and zones of rapid development will continue to receive benefits. The loss of tariff income as a result of the free trade agreement is expected to be offset by rising VAT income, as the government shifts from taxing imports to domestic transactions.

Over the medium term, the government plans to increase fiscal revenue to 55.7% of the national budget expenditure in 2011, from an estimated 50% in 2009. Donor aid currently finances about 54% of the national budget. In the 2009-11 period, government spending is expected to be strained by the 2008-11 national food production project, general elections, public sector wage reforms and an anticipated recovery of the international oil price.

The government plans to repay domestic debt of 0.1% of GDP in 2009, which is positive for crowding in the private sector. However, underdelivery of budget support and less-than-projected tax revenue growth may result in a deferral of repayment of part of the debt.

Debt relief under the Highly Indebted Poor Countries programme and Multilateral Debt Relief initiative reduced Mozambique's external debt from 190% of GDP in 2000 to 42% in 2006. Mozambique's external debt distress level has since remained low but a global economic recession that could possibly be protracted highlights the country's persistently large fiscal deficit and the risk of public debt increasing to unsustainable levels.

Outlook

Economic activity in Mozambique in 2009 will be subdued by the slump in global demand, depressed commodity prices and a domestic energy shortage. Real GDP growth is thus projected to slow to 5.6% in 2009, from an estimate of 6.1% in 2008. The drop in commodity prices, particularly oil, and a projection of low food prices are expected to slow headline inflation to an annual average of 5.1% in 2009, down from 10.4% in 2008.

The projected slowdown in exports is expected to be more marked than that of imports, because the former has been impacted by both

depressed prices and lower output due to the local energy constraint, while imports have mainly been subdued by a lower price of oil, in particular. The trade deficit is thus projected to widen to 8.8% of GDP, from 8.6%. Although the projected narrowing of the income and services deficit, owing to a moderation in income repatriation and a softening in tourism revenue, is expected to mitigate the deterioration of the trade deficit, the likely slowdown in private capital inflows and aid inflows will put downward pressure on reserves in 2009. The metical is thus projected to depreciate to an annual average exchange rate of MZN27.06/USD in 2009, from MZN24.24/USD in 2008.

Government revenue growth is expected to slow in 2009 on account of a softening in economic activity and a likely moderation of aid inflows, owing to governance concerns and financial crises in donor economies. Election-related spending, public sector wage reforms and the national food programme are just some of the expenditure items that are expected to strain government spending. As such, the fiscal deficit excluding grants is expected to widen to 17.2% of GDP in 2009, from an estimate of 16.9% in 2008.

Mozambique

Standard Bank Group forecasts of selected indicators

	2006	2007	2008	2009	2010	2011	2012	2013
National Accounts								
Gross Domestic Product (millions of constant LCU)	108 907.2	116 554.6	123 664.4	131 131.7	139 262.8	148 820.4	158 337.3	167 844.1
% change	8.7	7.0	6.1	5.6	6.2	6.9	6.4	6.0
Final Consumption Expenditure of Households (millions of constant LCU)	81 509.5	86 426.4	91 386.2	96 183.5	100 714.0	104 987.4	109 132.9	113 240.2
% change	6.1	6.0	5.7	5.2	4.7	4.2	3.9	3.8
Gross Fixed Capital Formation (millions of constant LCU)	23 333.6	24 706.2	26 047.5	27 295.4	28 396.8	29 342.0	30 193.4	31 011.6
% change	6.1	5.9	5.4	4.8	4.0	3.3	2.9	2.7
Final Consumption Expenditure of Government (millions of constant LCU)	13 249.7	14 285.0	15 352.7	16 450.4	17 573.8	18 716.7	19 872.0	21 032.3
% change	8.2	7.8	7.5	7.1	6.8	6.5	6.2	5.8
Gross Domestic Expenditure (millions of constant LCU)	136 471.9	148 776.0	160 850.3	173 100.4	184 717.3	195 750.3	206 463.9	216 938.0
% change	9.2	9.0	8.1	7.6	6.7	6.0	5.5	5.1
Agricultural production (millions of constant LCU)	22 448.1	24 395.6	26 537.2	28 847.8	31 295.2	33 841.5	36 447.4	39 077.1
% of GDP	24.3	24.0	21.1	21.6	21.8	22.1	22.4	22.6
Prices								
Inflation (annual average, %)	13.3	8.2	10.4	5.1	9.5	7.1	7.1	7.0
Monetary sector								
Policy interest rate, standing lending facility (end year, %)	17.5	15.5	14.5	12.0	14.8	12.5	12.5	11.5
Exchange rate, annual average (LCU/USD)	26.04	25.82	24.24	27.06	28.41	30.38	30.98	31.96
External sector								
Exports: goods and services (millions of LCU)			68 198.4	73 823.2	80 852.1	88 663.1	97 253.8	106 514.0
% change			7.4	6.7	6.0	5.5	5.2	4.9
Imports: goods and services (millions of LCU)			94 992.4	103 777.1	114 464.1	125 459.3	133 406.1	141 093.6
% change			10.7	9.2	10.3	9.6	6.3	5.3
Trade balance (millions of LCU)	-11 908.5	-17 862.7	-26 794.0	-29 953.9	-33 612.0	-36 826.2	-36 152.2	-34 579.6
% of GDP	-6.1	-7.8	-8.6	-8.8	-8.8	-8.9	-7.8	-6.4
Public and external solvency indicators								
External debt (% of GDP)	48.6	44.2	44.1	45.7	39.9	35.1	33.9	29.9
Fiscal balance, excluding grants (% of GDP)	-11.8	-12.8	-16.9	-17.2	-14.7	-12.1	-10.9	-9.8

Source: IMF, Banco de Mocambique, Instituto de Nacional Estatística, Standard Bank estimates

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