

MOZAMBIQUE ECONOMIC UPDATE

Facing Hard Choices



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The World Bank’s biannual Mozambique Economic Update (MEU) series is designed to present timely, concise assessments of current economic trends in Mozambique in light of the country’s broader development challenges. Each edition includes a section on recent economic developments and a discussion of Mozambique’s economic outlook, followed by focus section(s) analyzing issues of particular importance. The focus sections for this edition address debt, inflation and fiscal risk from public corporations. The MEU series seeks both to inform discussions within the Bank and to contribute to a robust debate among government officials, the country’s international development partners, and civil society regarding Mozambique’s economic performance and key macroeconomic policy challenges.

The cut-off date for the current edition of the MEU is 20th of November 2016.

Contents

Abbreviations and Acronyms	v
Acknowledgements	vi
Executive Summary	1
Part One: Recent Economic Developments	4
International Developments	4
Exchange Rate and Inflation	5
Economic Growth	6
Fiscal Policy	7
The External Sector	11
Monetary Policy	13
Outlook	15
Focus one: In the shadow of debt	18
The debt position: then and now	19
The outlook is fragile	20
Where to next	22
Focus two: Inflation at record highs	23
A perfect storm: depreciation, drought and conflict	24
The policy response has had a limited impact so far	26
A disproportionate impact on the poor	27
Focus three: Risky business - fiscal risk from state-owned enterprises	28
Government's involvement in the public corporations has heightened fiscal risks	28
Reforms to strengthen oversight and manage fiscal risks from public corporations are urgent	30

FIGURES

Figure 1: Growth has been sluggish among some of Mozambique's major trading partners	4
Figure 2: ...and global commodity prices remain low	4
Figure 3: Depreciation has accelerated significantly since the start of 2016	5
Figure 4: ... and has outpaced other African economies	5
Figure 5: Manufacturing and services contributions to growth have fallen	7
Figure 6: ... whilst confidence indicators suggest a sharp decline in perspectives since debt revealed ..	7
Figure 7: Over execution of recurrent expenditures at end-September is of concern	8
Figure 8: Cuts across all SES with the exception of health	8
Figure 9: The cost of borrowing for government has increased significantly	10
Figure 10: ...and average yields on Eurobonds have far exceeded peer countries	10
Figure 11: Reserve levels have fallen as the non-megaproject current account widens	12
Figure 12: The trade deficit has decreased following a contraction in imports	12
Figure 13: ...and an increase in megaproject exports	12

Figure 14: FDI inflows have been falling despite a pick-up in megaproject FDI	12
Figure 15: Monetary tightening kept commercial rates positive in real terms	14
Figure 16: Metical deposits have been falling whilst foreign currency deposits increased	14
Figure 17: Government borrowing was driving credit growth but began slowing after debt revelations	14
Figure 18: Nominal credit to the economy continued to increase in early 2016 but declined sharply in real terms ..	14
Figure 19: Debt profile is dominated by foreign currency denominated debt	20
Figure 20: ...which has increased with the addition of Proindicus/ MAM and currency depreciation	20
Figure 21: Mozambique's debt position has deteriorated when compared to other African countries	21
Figure 22: Higher debt service is placing the economy under severe strain	21
Figure 23: ...and the outlook may deteriorate depending on the trajectory of the metical	21
Figure 24: Commercial loans accounted for less than a fifth of debt stock at end of 2015	21
Figure 25: ... but will represent 40 percent of debt service in the medium term on current terms	21
Figure 26: Rising food prices are driving inflation after an extended period of stable prices	24
Figure 27: Inflation in the center of the country is high but has recently been overtaken by the south	24
Figure 28: The hike in food inflation is accentuated when compared to most peer countries	24
Figure 29: A myriad of factors have contributed to localized price increases	25
Figure 30: Disparity between food and non-food items is evidenced when accounting for tradeable effects	26
Figure 31: ...with increases in prices for key food items rising nearing 100 percent	26
Figure 32: Determinants of CPI variability	26
Figure 33: Food products consumed by poor households experienced sharper price increases	27
Figure 34: The majority of public enterprises are under-performing	28
Figure 35: Borrowing has been the main method of government financing for public corporations	29
Figure 36: Guarantees have been mostly awarded to companies with weak financial performance	29
Figure 37: Heavy borrowing in foreign currency exposes public corporations to currency depreciation ...	29

TABLES

Table 1: Government Finances 2016	10
Table 2: Spending on Social and Economic Sectors	10
Table 3: The Balance of Payments	13
Table 4: Outlook	17

BOXES

Box 1: Main Monetary Policy Committee measures taken since July 2015	14
Box 2: Financial vulnerabilities in Mozambique's banking sector	15
Box 3: Mozambique's hidden debt	18
Box 4: Measuring inflation: the Consumer Price Index	23

Abbreviations and Acronyms

ADM	Mozambique Airports (<i>Aeroportos de Moçambique</i>)
AIM	Mozambique News Agency (<i>Agência de Informação de Moçambique</i>)
BdM	Bank of Mozambique (<i>Banco de Moçambique</i>)
CAD	Current-Account Deficit
CFM	Mozambique Ports and Railways Company (<i>Caminhos de Ferro de Moçambique</i>)
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
EDM	Mozambique Electricity (<i>Electricidade de Moçambique</i>)
EMATUM	Mozambican Tuna Company (<i>Empresa Moçambicana de Atum</i>)
FDI	Foreign Direct Investment
FGD	Deposit Guarantee Fund (<i>Fundo de Garantia de Depósitos</i>)
FPC	Standing Lending Facility (<i>Facilidade Permanente de Cedência</i>)
FPD	Standing Deposit Facility (<i>Facilidade Permanente de Depósito</i>)
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
IGEPE	State-owned Equity Holdings Management Institute (<i>Instituto de Gestão das Participações do Estado</i>)
INE	National Statistics Institute (<i>Instituto Nacional de Estatística</i>)
IMF	International Monetary Fund
LNG	Liquefied Natural Gas
MAM	Mozambique Asset Management
MASA	Ministry of Agriculture and Food Security (<i>Ministério da Agricultura e Segurança Alimentar</i>)
MCEL	Mozambique Cellular
MEF	Ministry of Economy and Finance (<i>Ministério da Economia e Finanças</i>)
MMBTU	Million British Thermal Units
Mt	Metric tons
MZN	New Mozambican Metical
OECD	Organization for Economic Co-operation and Development
PETROMOC	Mozambique Petroleum (<i>Petróleos de Moçambique</i>)
PPP	Public-Private Partnership
REER	Real Effective Exchange Rate
SCF	Standby Credit Facility
SIMA	Agricultural Market Information System (<i>Sistema de Informação de Mercados Agrícolas</i>)
SSA	Sub-Saharan Africa
SOE	State-Owned Enterprise
VAR	Vector Auto Regression
VAT	Value Added Tax
VTB	Vneshtorgbank
WDI	World Development Indicators
WEO	World Economic Outlook
WB	World Bank

Acknowledgements

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Executive Summary

Mozambique is navigating a complex crisis.

This has been a testing year for Mozambique. An ongoing downturn, brought about by low commodity prices, drought and conflict, was compounded by the fallout from the discovery of hidden debts in April 2016. The revelation of USD 1.4 billion in previously undisclosed commercial loans dented confidence in the country and derailed its track record for high growth and economic stability.

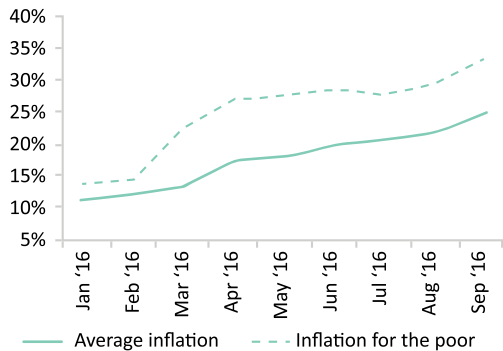
The level of debt took an explosive path with the addition of the previously undisclosed loans, making Mozambique one of the countries in Africa with the highest debt to GDP ratios. The onerous terms of the loans and the pace of currency depreciation created severe liquidity constraints that are placing Mozambique’s capacity to meet debt service obligations in question. The outlook is uncertain and rests on the outcome of Mozambique’s negotiations with commercial creditors, with complex discussions ahead in 2017. In the meantime, the fiscal outlook is under immense pressure and budget plans face significant uncertainty.

These events contributed to the sharp pace of currency depreciation. The metical depreciated by 42 percent against the US dollar in the first ten months of the year, and 57 percent when compared to the start of 2015. The rate at which the Mozambican currency depreciated outpaced that of most other African commodity exporters, including Nigeria and Angola, where economic pressures have also been acute. The weaker metical accelerated the pace of inflation, making high prices the most acutely felt symptom of the ongoing economic downturn by Mozambicans, with a disproportionate impact on the poor. Year-on-year inflation reached 25 percent in October,



The economic downturn is having a disproportionate impact on the poor

CPI inflation (12-month % change), 2016



Source: INE and World Bank staff estimates

with food price inflation hitting 40 percent. Inflation has been higher for the poor as food products account for a dominant share of their consumption basket. The weaker metical has also increased the debt burden significantly. The previously undisclosed loans pushed public debt up to 86 percent of GDP at end 2015. By end 2016, this debt is forecast to reach 130 percent of GDP, with a large share of this increase being due to the exchange rate effect.

It did not take long for the effects of the ongoing economic turmoil to register on Mozambique’s growth record as GDP began to contract sharply in the second and third quarters of 2016. Foreign direct investment (FDI), and exports, are projected to fall by 17 and 8 percent respectively in 2016. These declines, coupled with falling consumer demand, and fiscal and monetary tightening, are contributing to a sharp reduction in GDP growth. Following three consecutive quarters of slowing economic activity in 2016, growth for the year is forecast at 3.6 percent.

Clearly, Mozambique’s macroeconomic stability has been shaken-up. But equally as important, the sharp deterioration in economic conditions is having a deep impact on Mozambican households, especially the poor, and its nascent small and medium sized business sector which, along with agriculture, underpins the non-megaproject part of the economy. The financial sector is also under pressure as the failure of two banks in the second half of 2016 underscores the vulnerabilities of the sector.

The policy response is picking up pace.

The policy response picked up pace in the second half of 2016. A revised budget for 2016 was a first step in adjusting the fiscal framework to the new realities. This budget revised revenue projections downwards and restructured the spending program. A step in the right direction albeit limited and subject to significant downside risk. The initiation of debt restructuring talks by the Government of Mozambique is also a significant move and shows efforts to tackle the debt burden head-on.

The *Banco de Moçambique* stepped-up its monetary tightening regime with eight consecutive rate increases since October 2015, amongst other measures. There are signs that pressures on the external position are easing. Policy rate increases have kept commercial bank rates above inflation and credit levels show signs of adjustment. Goods imports are expected to decline by 33 percent in 2016, signaling an adjustment driven by a weaker metical and reduced foreign currency liquidity. The rate of currency depreciation has also slowed as the metical remained relatively stable in October and November 2016.

Progress is also being made on the governance front. The initiation of an independent audit of the Empresa Moçambicana de Atum (Mozambique Tuna Company, EMATUM), Mozambique Asset Management (MAM) and Proindicus loans is a key step in rebuilding confidence, and signifies the focus of the authorities on restoring relations with the International Monetary Fund (IMF) and other partners.

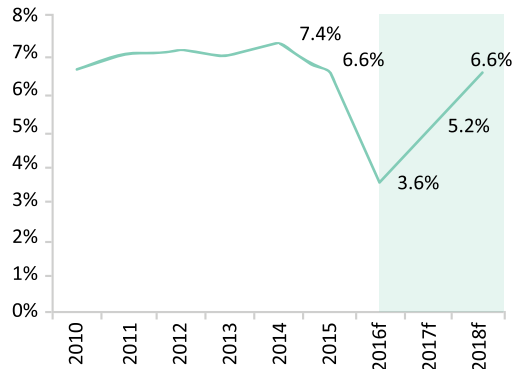
The potential for growth remains strong.

Mozambique’s gas production prospects shape expectations for a recovery in growth to 6.6 percent by 2018. Recent developments indicate progress with the Rovuma basin gas megaprojects, such as the approval of the investment plan for the Coral South offshore facility, which brings the final investment decision for this multi-billion project closer in sight.



Megaprojects shape growth expectations

Real GDP (% change), 2010-18



Source: INE and World Bank staff estimates

In the meantime, existing megaprojects are showing resilience and may benefit from a boost in the near term from an improving outlook for key commodity prices. Both megaprojects exports and FDI are set to increase in 2016 compared to the previous year. In terms of the commodity outlook, prices for aluminum and gas, two of Mozambique's largest exports, are expected to begin recovering in 2017. Similarly, a rally in coal prices and the recently completed railway improve the prospects for coal exports. This is encouraging, but the challenge remains for Mozambique to ensure that future wealth from these sectors is deployed, with transparency, to spur growth in the non-megaproject economy and lift the poor to prosperity.

Rebuilding confidence and restoring stability.

The agenda for restoring economic stability and confidence will stretch into 2017 and possibly

beyond. In the short term, much rests on the outcome of the debt negotiations initiated by the Government of Mozambique and the transparent handling of the independent audit. Beyond this, key items on this agenda include setting a medium term framework for restoring fiscal sustainability, anchored in a target for reducing debt and a credible fiscal adjustment program. Enhanced financial sector surveillance and the strengthening of crisis management instruments is also a priority, particularly if further monetary tightening is in the pipeline in the near term. Moreover, the current economic circumstances highlight the need to manage fiscal risks and contingent liabilities better. In this regard, reforms to develop effective oversight over state-owned enterprises and other public entities are urgent, along with reforms to overhaul the framework for managing guarantees.

Part One: Recent Economic Developments

International Developments

Sluggish global growth.

The global economy remains fragile in 2016. Global GDP growth has slowed down in the first half of the year, partly due to sluggish growth in the Chinese economy which has impacted global trade and demand for commodities. Similarly, several advanced economies have continued to struggle with a weak economic outlook whilst uncertainty in financial markets related to the UK's Brexit has dampened growth in the Eurozone area.

The effects of low commodity prices, adverse weather conditions and political uncertainties, have continued to weigh on African economies. Growth in the region is slowing, reflecting the

challenging economic conditions in the largest economies and commodity exporters—Angola, Nigeria, and South Africa—as they continue to face low commodity prices and suffer the effects of regional drought. Growth in South Africa, Mozambique’s main trading partner, has decelerated considerably in the last two years (Figure 1) and is estimated at only 0.6 percent in 2016, with downside risks seeming imminent amid faltering agricultural production, rising inflation and high unemployment.

Pressures persist for commodity exporters as prices remain low. Average prices for coal and oil were 44 and 31 percent lower in the six months to June than a year earlier, respectively. Aluminum and gas prices have fallen 14 percent in the same period (Figure 2).

Figure 1: Growth has been sluggish among some of Mozambique’s major trading partners...

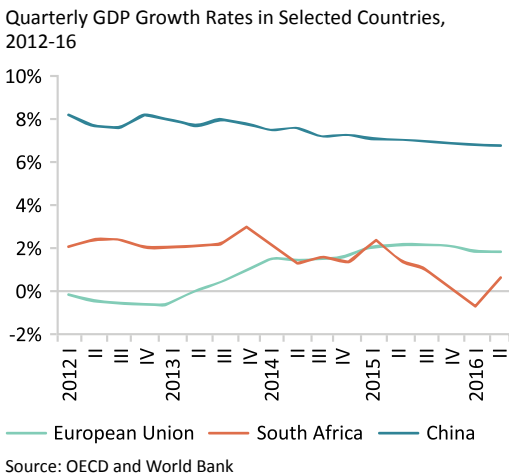
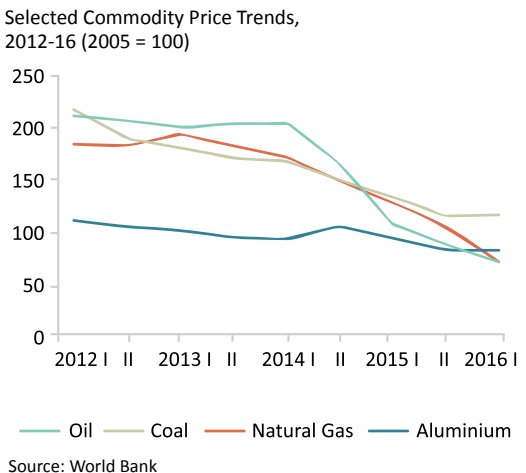


Figure 2: ...and global commodity prices remain low



Exchange Rate and Inflation

Sharp currency depreciation has altered the playing field for Mozambique.

Mozambique’s currency has lost significant value over the last 12 months. The metical depreciated by 42 percent against the US dollar in the first ten months of 2016, and 57 percent when compared to the start of 2015 (Figure 3). The rate at which the Mozambican currency depreciated outpaced that of most other African commodity exporters, including Nigeria and Angola where economic pressures have also been acute (Figure 4). The real effective exchange rate (REER) has shown a similar trend, with real currency depreciation at the end of October recorded at 42 percent since January 2015.

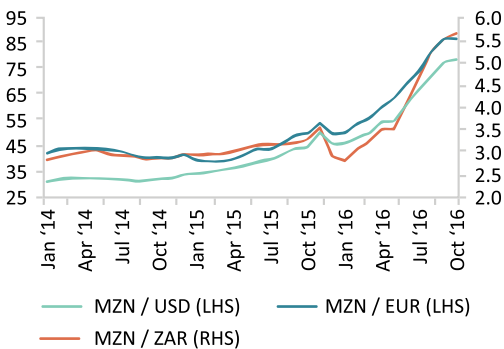
Several factors have accelerated the depreciation of an already weakening metical. The volume of foreign currency inflows which was on a declining trend, given the falling commodity prices, contracted further after

significant volumes of additional debt were revealed in April 2016. These revelations created increased uncertainty amongst donors and foreign investors regarding the real state of public finances. As a result, donors put their budget support on hold, while FDI and external credit lines to the private sector contracted. Expectations are also playing their part. Holding the metical in the face of persistent depreciation and high inflation has become increasingly unappealing to Mozambicans. This is evident in the informal currency exchange market, where the gap between the official and informal rate has recurrently exceeded 10 percent.

The depreciation contributed to an acceleration in inflation. Average year-on-year inflation reached 25 percent in October, with food price inflation climbing up to 40 percent. The situation is made complex by a confluence of domestic and external shocks. Dependency on imports made currency depreciation a key driver of inflation. Regional drought and internal political conflict¹ have also contributed to the spike in prices (see focus section 2 for a further discussion on inflation).

Figure 3: Depreciation has accelerated significantly since the start of 2016...

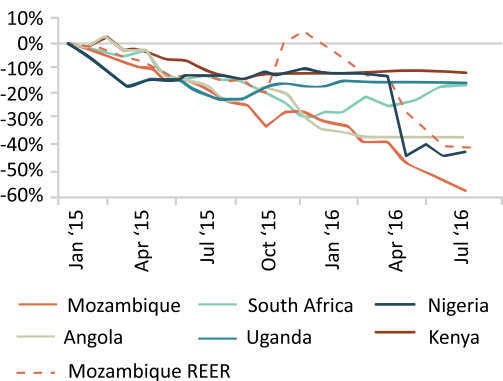
Nominal exchange rates, 2014-16



Source: BdM

Figure 4: ... and has outpaced other African economies.

Local currency unit / USD and Mozambique Real Effective Exchange Rate, (% change since Jan 2015)



Source: BdM and INE

¹ Conflict between the ruling party, Frente de Libertação de Moçambique (FRELIMO) and its main opposition, Resistencia Nacional de Moçambique (RENAMO), has erupted owing to disagreements about the results of the 2014 general elections. The intensification of armed conflict in central regions in recent months has resulted in mediation from foreign envoys including the European Union and former SADC heads of state.

Economic Growth

Lower confidence in the economy after the recent debt revelations derailed Mozambique's growth trajectory as investment, exports and consumer demand decline.

It did not take long for the effects of the ongoing economic turmoil to register on Mozambique's growth record. A continued gradual downturn was expected as Mozambique entered 2016 with slowing growth, low commodity prices and slackening investment.² Instead, output recorded a sharp decline since previously undisclosed debts surfaced. Second and third quarter growth dipped to the slowest quarterly rates on record in eight years at 3.4 and 3.7 percent (Figure 5), placing the growth forecast for 2016 at 3.6 percent, down from 6.6 percent in 2015.

Lower investment, falling exports and decreasing confidence are key drivers of lower growth. Falling investment, caused, in part, by an uncertain outlook for commodity prices, was compounded by a drop in investment as Mozambique's debt position worsened (Figure 6). The country faced successive downgrades by credit ratings agencies, which have weakened investor confidence.³ Foreign direct investment is falling and is expected to record a 17 percent annual decline by end 2016. This decrease comes as a result of a slowdown in the non-megaproject⁴ economy largely due to a pullback on investment in real estate, construction and financial services. Lower exports, public sector consolidation and monetary tightening are also contributing to the slowdown in growth.

Services, where momentum had been building during the boom years, are struggling to weather the downturn. Mozambican consumers are understandably holding back as they adjust to higher prices and uncertain prospects. Growth in tourism is checked by a low outlook for South African and European visitors. External demand for professional services is also shrinking as FDI stalls. Adding significant contraction in the public administration sector, services' average contribution to GDP in the first three quarters was 43 percent lower than in 2015.

Mozambique extractive and manufacturing sectors are also slowing down. The extractive sector marked a 60 percent decrease in its contribution to growth in the first three quarters as it climbs down from its peak at the height of gas exploration, and as final investment decisions for the Rovuma basin gas megaprojects remain pending. The manufacturing sector's average contribution to growth in the first three quarters declined by 3 percentage points compared to 2015, driven by decelerating utility and construction sectors.

The agricultural sector continues to be an important contributor to growth, but has suffered the effects of the regional El-Niño drought. Agriculture's average contribution to GDP contracted by 6 percent in the first three quarters of 2016 as producers in the southern regions of Mozambique were affected by dry conditions. The impact of the drought was mitigated by the low share of these regions in the total agricultural production.

² Growth in 2016 was forecast at 5.8 percent in the previous Mozambique economic update, prior to the debt revelations.

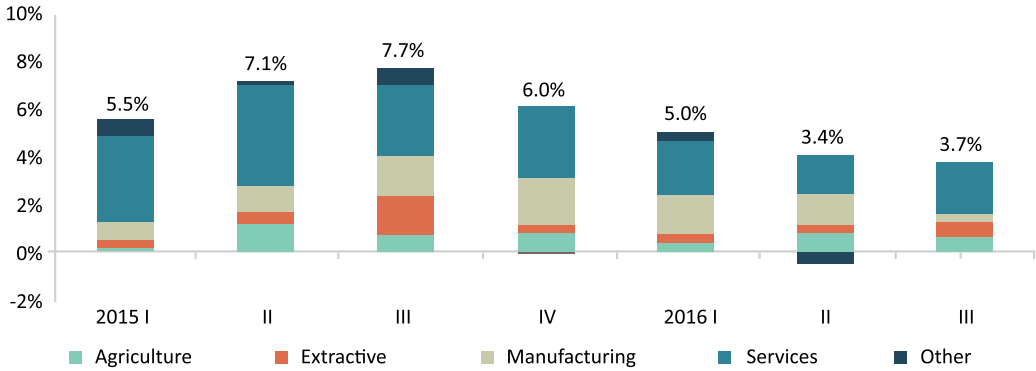
³ Mozambique's rating has downgraded several times by Fitch, Moody's and S&P to CC, Caa3 and CC respectively, during the course of the year. Outlook on ratings by Moody's and S&P remain negative.

⁴ Mozambique's megaproject economy includes extractive industry such as coal, heavy sands and gas. It also includes activities from a large aluminum smelter as well as electric energy from the Cahora Bassa Hydroelectric Dam.



Figure 5: Manufacturing and services contributions to growth have fallen ...

Quarterly contribution to growth by sector, 2015–16

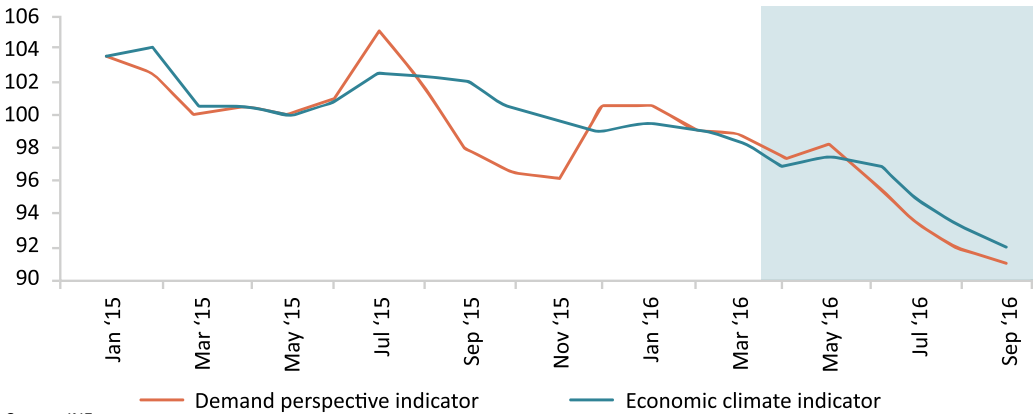


Source: INE



Figure 6: ... whilst confidence indicators suggest a sharp decline in perspectives since debt revealed

Trend in economic confidence indicators, 2015–16 (2004 = 100)



Source: INE

Fiscal Policy

The revelations of USD 1.4 billion in previously undisclosed debt have changed Mozambique’s fiscal landscape as higher debt service, a plunge in donor support and a lack of room for borrowing shrink fiscal space.

The debt revelations have placed the fiscal outlook under immense pressure. The revelations triggered an immediate suspension of the IMF program⁵ and donor support to the budget. These sources financed 6 percent of the budget on average over the last three years (2 percent of

GDP). The additional debt and ensuing currency depreciation also implied a sharp increase in debt service obligations, potentially adding a further 2 percent of GDP in debt service per year. Further pressures were felt in revenue collection as the slowing economy yielded a 7 percent shortfall in revenues in the first half of 2016. Taken together, budget support cuts, higher debt service and lower revenues are estimated to have reduced fiscal space by at least 5 percent of GDP in 2016. Although the authorities had embarked on a fiscal consolidation program, and even though the restructuring of the EMATUM bond in March 2016 brought some relief, a sharp adjustment to

⁵ The IMF’s program with Mozambique, which is currently suspended, consists of a Policy Support Instrument (PSI) and Standby Credit Facility (SCF) of about USD 283 million.

the 2016 budget plans became necessary.

The plans for fiscal adjustment so far are a step in the right direction, but the 2016 budget is subject to significant downward risk.

The macroeconomic assumptions underlying the budget are optimistic. The budget estimates GDP growth at 4.5 percent in 2016, which is an ambitious target, given economic performance in the first three quarters of the year. A further risk stems from the assumed exchange rate, which at an annual average of 52 meticals to the dollar, has already been exceeded by the evolution of the currency since the adoption of the budget.

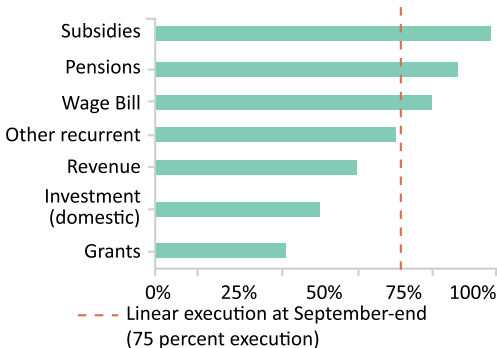
Shortcomings in revenue collection will continue to pose a risk to the revised projections. Revenues and grants are now projected to be 9 percent lower than in the initial budget. Although the downward revision is appropriate, the extent of the economic contraction so far and continued currency depreciation suggest that the revised 2016 budget might still overestimate revenues. Tax collection has been subpar in the first three quarters due to lower import levels resulting from the currency depreciation. Megaproject contributions to revenue have also fallen as a result of low commodity prices and a fall in aluminum production. Similarly, income tax receipts may be lower than the revised estimates due to the difficult environment for local businesses.

The total budget cut was modest and will be confronted by spending pressures. The revised budget presents a 0.3 percent nominal reduction in total spending against the original budget for 2016. Sharp cuts in the domestic investment and goods and services budgets (which fell by 30 and 14 percent, respectively) were offset by higher debt service and contingency allocations, along with a rise in the metical value of external funding due to currency depreciation. When externally funded spending is excluded, the total spending cut amounts to 3 percent. The budget also faces pressures in key spending areas, including the wage bill, pensions and transfers. For instance, civil servants' salaries and pensions registered 91 percent and 100 percent execution rates respectively by end-September, which is a cause for concern (Figure 7).

Spending on the social and economic sectors,⁶ which account for almost two thirds of total expenditure (excluding interest), was also affected with an overall cut of 4.7 percent. All sectors have been subjected to budget cuts, with the exception of the health sector, which experienced a 10 percent increase driven by external financing (Figure 8). Education spending, which accounts for 20 percent of the budget, had the smallest nominal reduction followed by agriculture and rural development (3 and 4 percent, respectively). The largest contraction was felt in the infrastructure sectors: roads (16.5 percent), water and public works (9.1 percent) and mineral resources (12.2 percent).

Figure 7: Over execution of recurrent expenditures at September-end is of concern

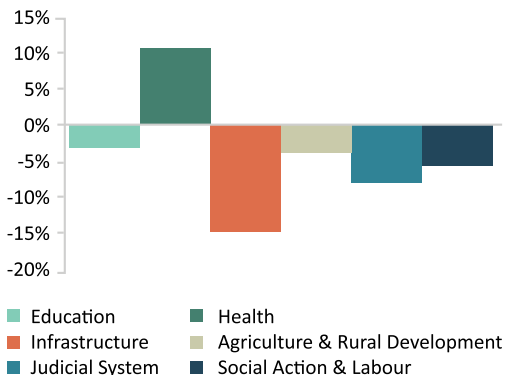
Budget execution for selected items as at Sep 2016



Source: MEF

Figure 8: Cuts across all sectors with the exception of health

Changes to sectoral expenditure in revised 2016 budget



Source: MEF

⁶ This includes education, health, infrastructure, agriculture and rural development, the judicial system and social welfare and work.

The route back to debt sustainability is complex, requiring a sharp fiscal adjustment to achieve macroeconomic stability.

Much depends on the outlook for debt restructuring already initiated by the government.⁷ The Proindicus and MAM debt raised the government's stock of debt to 86 percent of GDP at end 2015. The debt service obligations of these loans impose a heavy burden that pushes the cost of debt service well above 40 percent of revenue and grants until 2020. The Government of Mozambique is pursuing a restructuring of these loans, and estimates debt stock to reach 130 percent of GDP in 2016. Hence, the fiscal outlook would be influenced by the outcome of any deal. In its absence, the debt service looms as a substantial fiscal risk.

Even after debt restructuring, the pressure to realize a sharp fiscal adjustment will continue. Mozambique has retained steadily growing primary and overall fiscal deficits since 2005 as fiscal expansion built momentum in the boom years. Restoring fiscal stability will require a deviation from this trend. Rather than being a short term exercise, fiscal consolidation is a prolonged endeavor that requires a strong medium term fiscal framework. And in high debt situations, achieving a primary surplus is, in most instances, a vital part of the effort to consolidate the budget and reduce the debt burden. This is a high bar in Mozambique's case, given the high levels of inflation, in that it implies nominal reductions in spending when expenditures are all already falling in real terms. But it may be necessary given the diminished capacity to finance the budget and the sharp increase in governments cost of borrowing. At almost 20 percent in October 2016, interest

rates on government treasury bills more than doubled since January 2016 and bond yields have followed suit (Figure 9 and Figure 10).

Controlling wage bill growth, which had gathered pace in recent years, will be important for fiscal adjustment. The government wage bill increased by 140 percent since 2010. On average, between the period 2010 to 2014, annual compensation adjustments accounted for 73 percent of the increase in the wage bill (a rate much higher than inflation over this period), followed by new recruitments at 21 percent, and promotion and progression of public servants at 6 percent. A large part of the wage bill is comprised of non-wage benefits, which accounted for an average of 60 percent of all spending on compensation of employees from 2008 to 2012. Moreover, compared with peer countries, Mozambique's wage bill is large, as a share of both GDP and domestic revenue.⁸ These trends, if carried forward would pose a challenge to fiscal adjustment. Looking ahead, it will be important for the government to check the momentum that has been building in wage bill growth by setting limits to manage demands for salary increases and control growth in the wage bill in non-priority sectors.

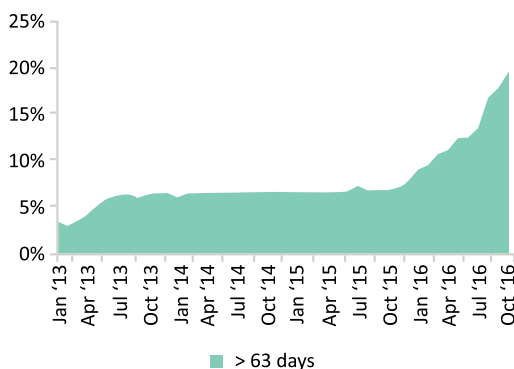
Improving the management of the public sector pension scheme is equally as important to ensure the sustainability of the system. The civil service pension scheme, operated by the *Instituto Nacional de Previdência Social*, is a pay-as-you-go scheme in which payments paid to current pensioners are financed from contributions paid by current workers, with any emerging deficit being a liability of the state. An analysis of the sustainability of the system, including the long term potential for a mismatch, is important in the context of a fiscal consolidation program.

⁷ http://www.mpd.gov.mz/images/Presentation_to_Creditors_by_the_Ministry_of_Economy_and_Finance_-_25_October_2016.pdf

⁸ World Bank. Mozambique Public Expenditure Review. 2014.

Figure 9: The cost of borrowing for government has increased significantly...

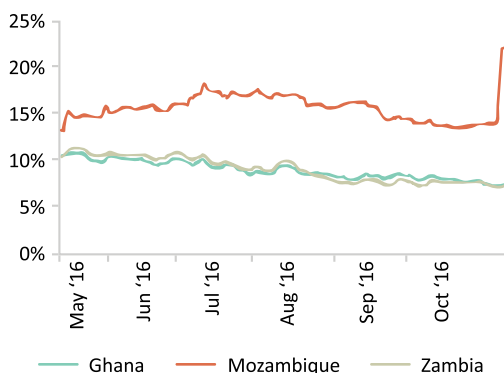
T-bills auction (average interest on term > 63 days), 2013-16



Source: MEF

Figure 10: ...and average yields on Eurobonds have far exceeded peer countries

Average yield (tenor 2023 +/- 1 year), May – October 2016



Source: Bloomberg

Table 1: Government Finances 2016

(percent of GDP)	Initial Budget	Revised Budget
Total Revenue	25.9	24.1
Tax Revenues	22.3	21.0
Non Tax Revenue	3.7	3.1
Grants	3.6	2.6
Total Expenditure	32.3	32.0
Current Expenditure	20.0	20.9
Of which:		
Compensation to employees	10.5	10.2
Interest on public debt	1.8	2.2
Capital Expenditure	12.3	11.1
Domestically financed	6.1	4.2
Externally financed	6.2	6.9
Net Lending	1.2	1.1
Overall Balance	-4.0	-6.3
Primary Balance	-0.9	-3.1
GDP (nominal, MZN billions)	680	687

Source: MEF

Table 2: Spending on Social and Economic Sectors 2016

(MZN billions)	Initial Budget	Revised Budget	% Δ
Education	45,801	44,400	-3.1
Health	21,608	23,896	10.6
Infrastructure	40,895	34,951	-14.5
Roads	28,725	23,986	-16.5
Water and Public works	9,138	8,303	-9.1
Mineral Resources	3,033	2,661	-12.2
Agriculture and Rural Development	15,340	14,726	-4.0
Judicial system	4,272	3,943	-7.7
Social action and Labor	5,648	5,337	-5.5

Source: MEF

The External Sector

With imports falling faster than exports, the current account deficit for the 2016 is expected to narrow to 39 percent of GDP.

A sharp decline in imports signals an adjustment driven by a weaker metical and reduced foreign currency liquidity. Goods imports are contracting and are expected to be 33 percent lower in 2016 than in the previous year. The fall in imports is largely driven by declining non-megaproject imports. Consumer goods have been widely affected, including basic imports such as cereals, sugar and cooking oil, along with items such as imported vehicles which are set to experience an over 50 percent decline by year end. This indicates an adjustment in the import bill as currency depreciation and foreign exchange scarcity make imports increasingly unaffordable.

Total exports are set to contract by 8 percent in 2016. The overall drop in exports is heavily driven by a contraction in agricultural exports during the first half of 2016. With the exception of cashew nuts, exports decreased for all agricultural products as the sector suffered the effects of the regional El-Niño drought. Ongoing military tension may have also contributed to the decline by limiting circulation on main highways linking production hubs to domestic and international markets. Megaproject exports, which accounted for 60 percent of total exports in the last five years, have shown some resilience and are projected to increase by 9 percent by end 2016. Earnings from coal exports have risen due to a significant boost from the completion of the Moatize - Nacala-a-Velha railway. Electricity, heavy sands and gas exports are also on the increase. Together, increased earnings from these exports are projected to offset the anticipated 14 percent decline in aluminum exports (almost 40 percent of total megaproject exports) reflecting the sluggish recovery in prices.

A drop in donor assistance, increased debt service, along with persistently high service

imports, were an additional source of pressure on the current account. However, the large drop in consumer imports will be sufficient to lower the current account deficit from 41.6 percent of GDP in 2015 to 38.9 percent in 2016. Although this trend eases pressures on the external position, it is an adjustment caused by a reduction in purchasing power and reduced consumption of essential goods, and is telling of the extent of the economic downturn.

Central bank reserves remain under pressure.

Low investor confidence has had a significant impact on investment in the non-megaproject economy. FDI is expected to contract by 17 percent by the end of 2016 (Figure 14) as non-megaproject investment declines, with the brunt being felt by the construction, real estate and financial sectors.⁹ Final investment decisions for the Rovuma basin gas projects are yet to be reached, although hopes remain that one of the Rovuma basin gas projects¹⁰ will reach this milestone by the end of 2016. Despite this, other megaprojects continue to advance with activities such as the launch of Sasol's new drilling campaign in Inhambane, bolstering investment in the second quarter of 2016, and continued investments in coal production. As a result, megaproject FDI is anticipated to register a 25 percent increase in 2016.

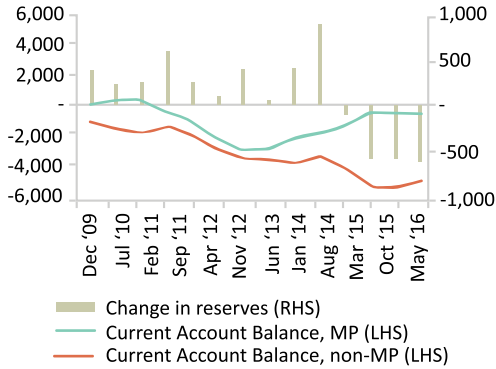
Central bank reserves continued to fall during the first nine months of the year. Net international reserves fell from USD 1.99 billion, or 3.2 months of non-megaproject imports, at the end of 2015 to USD 1.72 billion, or about 2.9 months of imports, by September 2016. The central bank increased foreign currency reserve requirement to 15 percent in June, which shored up the central bank's international reserves by USD 207 million, and a subsequent increase in November 2016 may contribute further. However, downside risks are looming given shortfalls in balance of payments financing, and the continued call on reserves as a source of foreign currency for some basic food and fuel imports as well as the government's debt service obligations.

⁹ In the 12 months to the end of September 2016, real estate, financial services and construction FDI fell by 82, 62 and 60 percent respectively.

¹⁰ The ENI led consortium's investment in the Coral south gas field.

Figure 11: Reserve levels have fallen as the non-megaproject current account widens ...

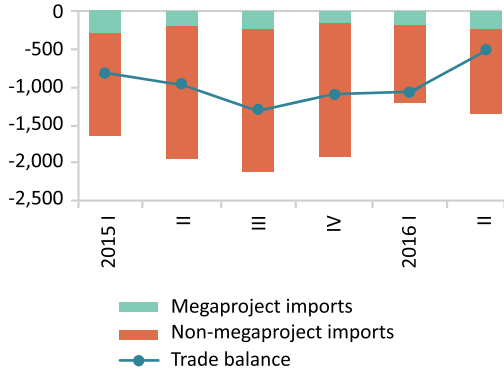
Mega and non-megaproject current account balance and change in reserves; year-on-year 2009-16 (USD millions)



Source: BdM

Figure 12: The trade deficit has decreased following a contraction in imports...

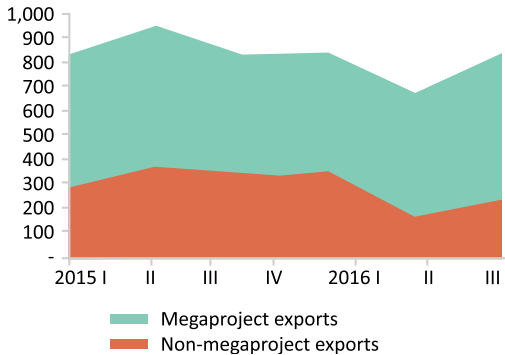
Imports and trade balance, quarterly 2015-16 (USD millions)



Source: BdM

Figure 13: ...and an increase in megaproject exports

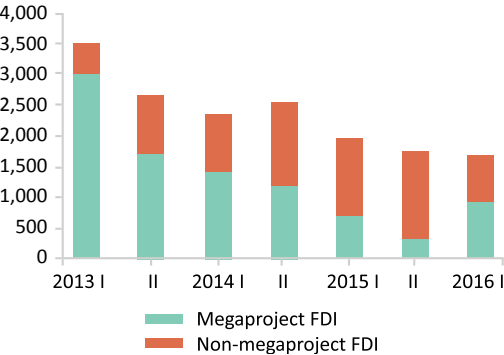
Exports, quarterly 2015-16 (USD millions)



Source: BdM

Figure 14: FDI inflows have been falling despite a pick-up in megaproject FDI

Net FDI, semesterly 2013-16 (USD millions)



Source: BdM

Table 3: The Balance of Payments

(USD millions, unless otherwise stated)	2015 Actual	2016 Projection	△ 15/16
Current Account (% of GDP)	41.6	38.9	...
Current Account	-6155	-4076	-34%
Trade Balance	-6785	-4285	-37%
Goods, net	-4164	-1925	-54%
Exports	3413	3132	-8%
<i>Megaproject</i>	2057	2244	9%
<i>Non-megaproject</i>	1356	888	-35%
Imports	7577	5057	-33%
<i>Megaproject</i>	917	841	-8%
<i>Non-megaproject</i>	6660	4216	-37%
Services, net	-2622	-2360	-10%
Income and transfers, net	630	209	-67%
Capital & Financial Account	-5566	-3653	-34%
FDI, net	-3711	-3098	-17%
<i>Megaproject</i>	-1117	-1400	25%
<i>Non-megaproject</i>	-2594	-1698	-35%
Other, net	-1567	-399	-75%
Overall Balance	-589	-423	-28%

Source: BdM and World Bank staff estimates

Monetary Policy

The central bank continued tightening its monetary stance since the last quarter of 2015, as foreign-exchange and inflationary pressures accelerated.

The *Banco de Moçambique* stepped-up its monetary tightening regime with eight consecutive rate increases since October 2015.¹¹ The monetary policy stance sought to slow the metical's depreciation and attenuate the pass-through effect on inflation, whilst limiting the draw on central bank reserves. It led to a shift away from the interventions in foreign exchange markets seen in late 2015 to a focus on maintaining positive real interest rates and reducing excess liquidity. This has required regular and steep increases in policy rates to keep up with inflation and deteriorating confidence in the metical. Policy rate hikes have been accompanied by series of other measures, including higher bank reserve requirements (Box 1).

Policy rate increases have kept commercial bank rates above inflation and credit levels

show signs of adjustment (Figure 15). Deposit rates have followed suit, but with what seems to be a diverging trend between domestic and foreign currency and deposits. A decline in metical deposits starting at the end of 2015 was accompanied by an increase in foreign currency deposits, suggesting a preference for hard currency amongst depositors as confidence in the domestic currency decreased (Figure 16). Financial system credit grew at a 12-month average of 38 percent in nominal terms. Inflation and loose government credit policy through to April 2016 (when debt levels spiked) contributed to this growth (Figure 17). It is important to note, however, that given the high levels of inflation, credit levels have been falling in real terms. Credit to the economy, an indicator of demand, began contracting in real terms from April 2016 onwards, signaling a shift in the capacity of the economy (Figure 18). Monetary tightening, together with lower demand and liquidity constraints, may have also contributed to a currency depreciation as the metical remained relatively stable in October and November 2016.

¹¹ The standing lending facility rate (*facilidade permanente de cedência*, FPC) has been raised from 7.5 percent to 23.25 percent. Similarly, the standing deposit facility rate (*facilidade permanente de depósito*, FPD) has followed suit, increasing from 1.5 percent to 16.25 percent.

Box 1: Main Monetary Policy Committee measures taken since July 2015

Increase in key Central Bank reference rates

- *Standing Lending Facility* increased 1575 basis points to 23.25 percent
- *Standing Deposit Facility* increased 1475 basis points to 16.25 percent

Adjustments to Commercial Bank reserve requirements

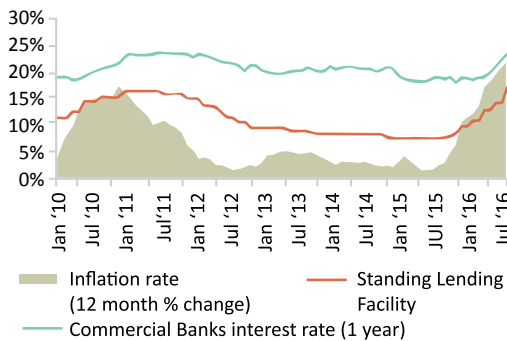
- Reserve requirement on domestic and foreign currency increased from 8 to 15.5 percent

Other

- MZN 700 thousand limit on spending abroad
- Intervention in the interbank markets to ensure compliance with the monetary base target
- Limit Commercial Bank usage of standing lending facility window for financing to twice a week
- Compulsory daily exchange rate reporting from Commercial Banks increased to 3 times a day

Figure 15: Monetary tightening kept commercial rates positive in real terms

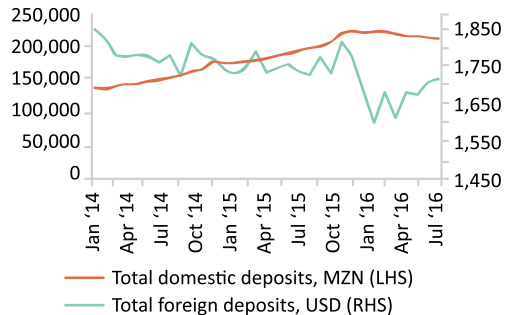
Central Bank and Commercial Bank interest rates and CPI, 2010-16 (12 month % change)



Source: BdM and INE

Figure 16: Metical deposits have been falling whilst foreign currency deposits increased

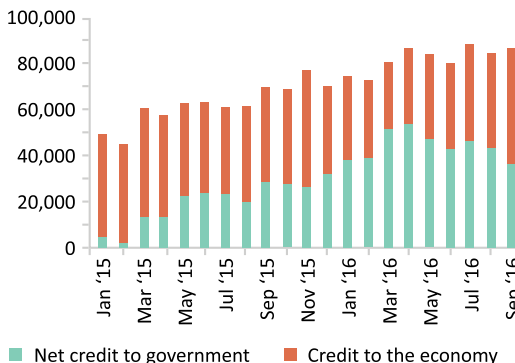
Commercial Bank deposits, 2014-16 (millions)



Source: BdM

Figure 17: Government borrowing was driving credit growth but began slowing after debt revelations

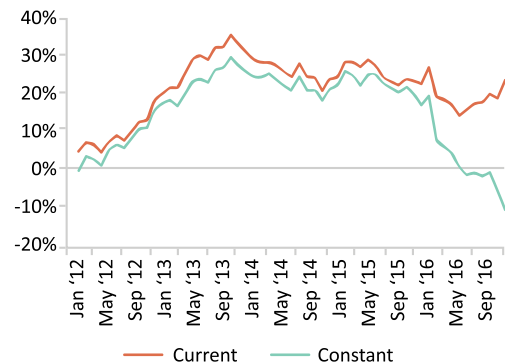
Decomposition of nominal credit growth, 2015-16 (MZN millions)



Source: BdM

Figure 18: Nominal credit to the economy continued to increase in early 2016 but declined sharply in real terms

Credit to the Economy, 2012-16 (12-month % change)



Source: BdM

Box 2: Financial vulnerabilities in Mozambique's banking sector

The Central Bank's intervention in Moza Banco, Mozambique's fourth largest bank, and the revocation of license of the smaller Nosso Banco, underscores how quickly vulnerabilities in the financial sector can emerge. A combination of slower growth, currency depreciation, and tighter monetary policy have heightened the exposure of Mozambique's banks to risks. Increased lending rates are raising the cost of financing, leaving borrowers and adjustable rate loan holders more exposed. This occurs as the economic downturn and falling demand take their toll on Mozambican businesses. Moreover, currency depreciation has increased debt-servicing costs for foreign loans. As a result, non-performing loans in the banking sector (which averaged 4.3 percent on aggregate and 7 percent for smaller banks as of September 2015) may be on the rise. Updated figures will likely reveal a higher degree of asset impairment requiring additional provisioning, which reduces bank profitability and could undermine capital adequacy. Balance sheet mismatches are also on the rise as foreign currency denominated deposits have grown while lending has remained limited due to regulatory restrictions.

Uncertainty surrounding the restructuring of external commercial debt poses significant risk to the investors holding these loans, which could include domestic

financial institutions. As a result, some banks may limit their government exposure, and provision against default. This could exacerbate credit concentration risk in banks willing to accept guarantees. Limited understanding of counterparty exposure could also lead to higher interbank lending rates, which may accentuate liquidity risks, particularly for weaker banks. The central bank's decision to limit access to its overnight window to two days a week will entice banks to improve liquidity management.

Heightened surveillance and effective crisis management tools are needed. In the short term, focus on diagnosis including strengthening surveillance of banking sector, stress-testing, asset quality review, bank resolution and crisis management arrangements will be crucial to managing vulnerabilities. More medium term measures such as bank supervision enhancements and development of an emergency liquidity assistance framework could be instilled once the economic downturn subsides. The intervention in Nosso Banco has also elevated the role of the deposit guarantee fund (FGD). Reimbursements to individual depositors resident in Mozambique have begun, with an insured coverage level of MZN 20 thousand. Corporate, foreign currency, and non-resident accounts are excluded from deposit insurance.

Outlook

Growth prospects amongst Mozambique's main trading partners are weak, but slowly recovering commodity prices may bring some relief in the near term.

Growth prospects for Mozambique's main trading partners are sluggish. Growth rates for the European Union, South Africa and China, which are three of Mozambique's main trading partners, is projected to decline in 2016 and 2017. Although Sub-Saharan Africa's growth is

expected to begin recovering in 2017, South Africa's prospects diverge from the regional trends. Political and economic woes in this important trading partner for Mozambique are having significant implications for its growth, expected at just 1.1 in 2017.

Commodity prices are expected to mount a gradual recovery by mid-2017. Prices for some of Mozambique's main exports are expected to increase, with aluminum and gas prices projected to rise by 3.2 percent and 6.8 percent respectively. Meanwhile, prices for coal

are experiencing a sharp, recent surge¹² that, if persisting, could yield a significant increase in the value of this export. In contrast, tobacco prices are expected to contract slightly in 2017. A stronger US dollar and tighter US monetary policies will maintain downward pressure on commodity prices.

Mozambique's growth for 2016 is projected at 3.6 percent and is subject to downward risk, but LNG prospects shape expectations for a recovery in growth to 6.6 percent by 2018.

Growth in 2016 is projected to decelerate to 3.6 percent. The slowdown in 2016 reflects the extent of the debt driven downturn, along with the effects of the recent regional drought. This outlook is subject to significant downward risk as monetary and fiscal tightening pick up pace and as the business environment becomes increasingly restrictive, while private sector expectations weaken. Adverse climatic conditions, brought on by La Niña, may also pose a risk. Should this materialize, the costs of flood damage and impact on food production would pose a significant challenge for the agricultural sector. Short term inflationary pressures are also likely to persist, given the country's dependence on food imports from South Africa, where inflation is on the rise. Continued political tensions in central and northern regions may further hamper growth.

Mozambique's LNG prospects shape expectations for a recovery in growth to 6.6 percent by 2018. Recent developments indicate progress with the Rovuma basin gas projects, such as the forward purchase agreement for gas from the Coral South Floating facility,¹³ which brings the final investment decision for this multi-billion project closer in sight. In the meantime, existing megaprojects are showing some resilience and may benefit from a boost in the near term from an improving outlook for key commodity prices. Both megaproject exports and FDI increased in mid-2016. In terms of the outlook, prices for aluminum and

gas, two of Mozambique's largest exports, are expected to begin recovering in 2017. Similarly, a rally in coal prices and a new railway improve the prospects for coal. Spillover effects of the megaproject economy are also anticipated with services' contribution to growth gaining further prominence. Despite accounting for roughly 20 percent of output, contribution to growth from the agricultural sector is expected to remain large and supply side policies to boost production and climate resilience, such as investment in technological inputs and infrastructure can help propel the sector.

The fiscal outlook will be shaped by the outcome of debt restructuring negotiations, with a sharp adjustment needed under any scenario.

Budgetary pressures will be acute in the medium even if debt is restructured. Mozambique's Ministry of Economy and Finance estimates a revenue impact from the Rovuma basin gas production starting in 2021. In the meantime, the country's fiscal position is likely to remain under stress and deep consolidation reforms will be required. A thorough reassessment of investment spending and inefficient recurrent expenditures will be necessary. Measures to contain spending pressures from the public sector wage bill and the subsidy programs will be needed. In addition, a thorough review of the state enterprise sector, including liquidation and sale of un-strategic assets, should be considered as an option to reduce fiscal risk and increase government resources.

Short term pressures on the external position are likely to spill into 2017.

The current account deficit may expand to over 55 percent of GDP by 2018 as LNG megaprojects are expected to kick-off and triple both FDI and import levels. Flows to other megaprojects are anticipated to follow suit as coal production ramps up in Moatize and Sasol's investment in Inhambane province continues to expand. However, megaprojects

¹² Prices of coking coal have rallied more than twofold this year amid China's push to curb overcapacity and pollution. Premium hard coking coal prices in Australia, which dominates global exports, rose to USD 289.30 a ton at the start of November, up from about USD 85 at the beginning of June.

¹³ BP signed a deal with ENI, Italian multinational oil and gas company, agreeing to buy all output from the consortium's Coral South Floating facility in Mozambique. Annual production is expected to reach 3.3 million tons.

alone are unlikely to ease external pressures in the short term given the outflow of their FDI to capital imports. As such, the non-megaproject balance will continue to face pressures from the import bill, with rising petroleum prices

posing a significant risk. Moreover, non-megaproject investment may remain subdued in 2017 as uncertainty and macroeconomic instability persists.



Table 4: Outlook

	2015	2016p	2017p	2018p
External Scenario				
Real GDP (% Δ)				
European Union	1.6	1.6	1.6	1.5
China	6.9	6.7	6.5	6.3
Sub-Saharan Africa	3.0	2.5	3.9	4.4
South Africa	1.3	0.6	1.1	2.0
Nominal Commodity Price (% Δ)				
Aluminum \$/mt	-10.8	-5.4	3.2	3.3
Coal, Australia \$/mt	-18.0	0.9	-5.2	1.1
Natural gas, Europe \$/mmbtu	-27.7	-39.7	6.8	7.0
Tobacco \$/mt	-1.7	-2.2	-0.7	-0.7
Domestic Scenario				
Real GDP & Current Account Balance				
Real GDP (% Δ)	6.6	3.6	5.2	6.6
Current Account Balance (% of GDP)	-41.6	-38.9	-37.4	-56.1

p = Projection
 Source: World Bank



Focus One: In the shadow of debt

Almost two decades ago, Mozambique was amongst the first round of countries which proved itself as an economic reformer in return for debt relief. Under the Heavily Indebted Poor Countries (HIPC) initiative, the external debt stock reduced from 160 percent of Gross National Income in 1998 to a far more manageable 33

percent ten years later. Soon after HIPC, the stock of debt began rising again, coinciding with the government's plans to pursue an ambitious public investment program. And, by 2016, revelation of hidden debt definitively reversed Mozambique's post-HIPC gains.

Box 3: Mozambique's hidden debt

The hidden loans saga surged on the heels of a restructuring deal for the already highly controversial EMATUM loan, in April 2016. Mozambique contracted a previously undisclosed sum of USD 1.4 billion in non-concessional debt between 2009 and 2014 by issuing guarantees to state controlled companies and through direct borrowing from bilateral lenders. This debt includes two guarantees for loans contracted by commercial companies formed with state equity participation, amounting to USD 1.16 billion. In addition to these guarantees, the recently disclosed debt includes four direct loans from bilateral lenders contracted between 2009 and 2014. This debt, equivalent to approximately 10 percent of GDP, had not been previously disclosed to the World Bank and IMF. The debt is additional to the EMATUM company bond, which was originally issued in September 2013 backed by a state guarantee, then restructured as a sovereign bond in April 2016.

The borrowing was intended to tap into the gas industry through two large projects. The first, Proindicus, intended to use a USD 622 million loan from Credit Suisse to provide integrated security services (aerial, maritime and terrestrial) to gas companies, marine vessels and other sea traffic as well as providing search and rescue services. The second company, Mozambique Asset Management (MAM), was created to build / install shipyards in the ports of Pemba and Maputo with finance from a USD 535 million loan facilitated by VTB. Maintenance and logistical services would be provided to Proindicus and other large LNG operators. The final maturity dates on each loan are March 2021 and May 2019, respectively.

A final set of loans, tallying up to about USD 220 million were contracted during the period 2011 to 2014. Funds were made available by bilateral lenders, however, the originating country and terms of the loans remain undisclosed.

*The debt position: then and now.***Mozambique set-off on a path of accelerated borrowing after receiving HIPC debt relief.**

Scaled-up borrowing to finance ambitious public investment plans from 2012 onwards launched Mozambique's debt profile on an upward trajectory (Figure 19). The debt to GDP ratio quickly increased from 40 percent of GDP in 2012 to 73 percent of GDP by end 2015 before the hidden debts were taken into account. The increase in debt ratios are at odds with the plans since the authorities had embarked on a program of fiscal consolidation with support from the IMF program. Debt service obligations were also easing as the restructuring of the EMATUM bond to a bullet payment in 2023 lowered annual debt service by approximately USD 110 million.

The ratio of public sector debt to GDP took an explosive path with the addition of large previously undisclosed external loans.

The debt revelations pushed public debt to 86 percent of GDP in 2015 and shifted the country to an unsustainable position. With 90 percent of the country's debt being denominated in foreign currency, the steep depreciation of the metical in 2016¹⁴ has compounded the debt burden. Public debt levels are now expected to exceed 100 percent of GDP until 2020.

With solvency indicators already under strain, the additional debt, and continued depreciation created severe liquidity constraints, placing Mozambique's capacity to meet debt service obligations in question.

Soaring debt levels have worsened the country's liquidity and solvency ratios.¹⁵ Solvency indicators, which include the debt-to-GDP ratio, were already under significant stress at end-2015¹⁶ and bordering the debt sustainability thresholds of economies at high risk of debt distress.¹⁷ The Proindicus and MAM loans transformed the situation into

a liquidity crisis: the capacity to service debt. The sheer size of the loans, their commercial interest rates, and the fact that both loans are on amortizing schedules starting in 2015 and 2016 mean an additional USD 233 million in debt service annually over the next five years.¹⁸ The depreciation of the metical further compounds this burden, inflating the debt service obligations of these loans in metical terms. The outcome of this is overwhelming: if Proindicus and MAM's debt service fall due as state obligations, the overall debt service would jump from 7.3 percent of revenue in 2012 to over 40 percent in the medium term.

Mozambique is now one of the most indebted countries in Africa.

At the start of the decade, the ratio of public sector debt to GDP in Mozambique was similar to other countries experiencing increasing growth, including Angola, Ethiopia, Ghana and Kenya. Mozambique's debt to GDP ratio quickly surpassed many African countries and has now exceeded that of Ghana.¹⁹ Angola and other African peers who have also experienced both credit growth and declining commodity prices in recent years (Figure 21).

Although commercial loans account for 18 percent of external debt, they represent 40 percent of external debt service between 2016 and 2021.

Commercial external debt is dominated by the Mozambique bond, and the MAM and Proindicus loans. Multilateral debt represents just over 40 percent of the debt stock, but concessional terms lower its load in terms of debt service. The third category, bilateral debt, is more heterogeneous. It is composed of a combination of concessional and non-concessional loans, with a handful of large loans for infrastructure projects raising total bilateral debt service to 42 percent of the total²⁰ (Figure 24 and Figure 25).

¹⁴ The metical depreciated from an average 48.5 in December 2015 to an average 76.6 in September 2016.

¹⁵ Liquidity ratios measure the country's ability to meet (short term) maturing obligations with available financing, whilst solvency ratios indicate ability to meet long term financial commitments. A government is solvent if the present value of future primary balances is greater than or equal to the public debt stock.

¹⁶ Based on the Debt Sustainability Analysis (DSA) carried out at the end of 2015.

¹⁷ For Mozambique, the threshold for present value of public and publicly guaranteed external debt as percent of GDP is 40 percent and 150 percent as a percentage of exports. In the 2015 DSA, the ratio of present value external debt-to-GDP in 2015 stood at 39.9 percent and external debt to exports at 143.4 percent.

¹⁸ Average for 2016-2021.

¹⁹ Ghana's DSA classification changed to high risk in March 2015 due to a rapid increase in domestic debt levels and a series of Eurobond issuances, as well as a large depreciation in the local currency.

²⁰ These include loans to finance investments in Maputo and Nacala airports, and the Katembe bridge in Maputo.

The outlook is fragile.

Mozambique faces a medium term fiscal predicament given the large volume of debt obligations due before gas production begins to have a significant impact on state revenue.

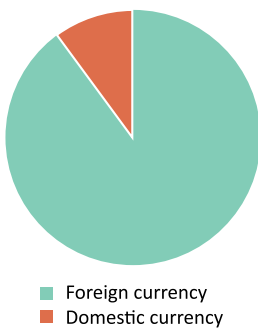
The anticipation of a booming gas industry and massive revenue from gas sales underpinned the government’s plans to expand public investment, financed in part through commercial borrowing. Reality has been far from this: the commodity price crunch and persistent delays in making final investment decisions for the large gas projects have pushed back production dates. Whilst recent developments indicate progress, production before 2021 seems unlikely and maybe subject to further delay. Hence, given the aggressive repayment profile for both the Proindicus and MAM loans²¹ (Figure 22), the authorities are under significant pressure in the medium term.

Continued currency depreciation, fiscal risk from state-owned enterprises and an exposed banking sector are major risk factors. The debt outlook is highly sensitive to the trajectory of the

metical. Figure 23 presents the debt to GDP ratio at different exchange rate scenarios. An end of 2016 exchange rate of MZN/USD 75 would see debt levels spike to almost 116 percent of GDP and a rate of GDP MZN/USD 80 would see debt levels reach 123 percent of GDP by end 2016. The sources of pressure to the metical are not exclusively domestic. With a much anticipated Federal Reserve meeting scheduled before the end of 2016, the possibility of an increase in US interest rates is distinct and continuing through 2017. It represents an exogenous pressure on the metical that adds to the significant domestic short term and structural pressures on the currency. Contingent liabilities from state-owned enterprises and the domestic banking sector are also sources of instability for the debt outlook. Most of Mozambique’s state-owned enterprises have a weak financial position and many have over borrowed in foreign currency (focus section three). Coupled with the banking sector’s exposure to the economic downturn (Box 2), Mozambique may be under pressure to shoulder significant contingent liabilities in the near term.

Figure 19: Debt profile is dominated by foreign currency denominated debt...

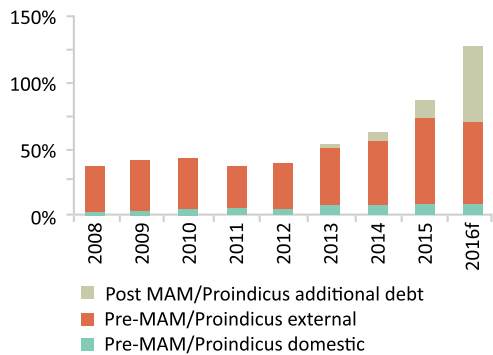
Composition of public debt, 2016



Source: MEF

Figure 20: ...which has increased with the addition of Proindicus/ MAM and currency depreciation

External and domestic debt, after debt disclosure, 2008-16 (% of GDP)



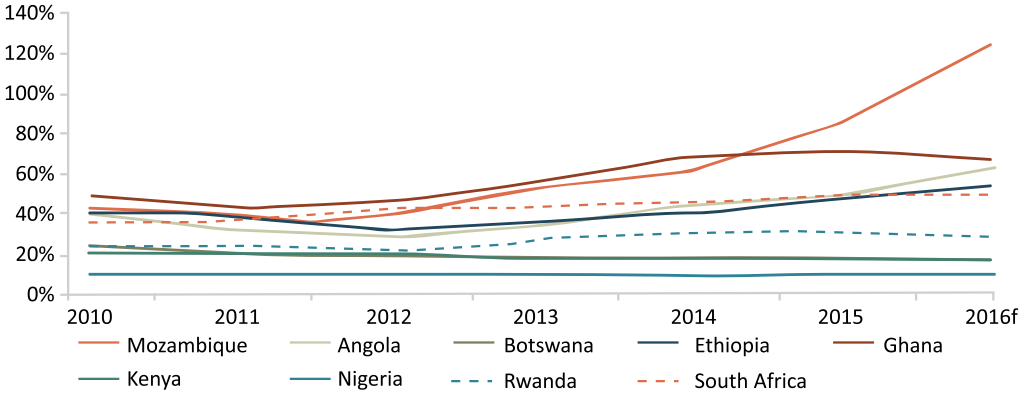
Source: MEF

²¹ MAM annual repayments are USD 134 million plus interest (7.8 percent) and Proindicus are USD 119 million plus interest (3.75 percent).



Figure 21: Mozambique’s debt position has deteriorated when compared to other African countries

Public sector debt to GDP ratio, 2010–16

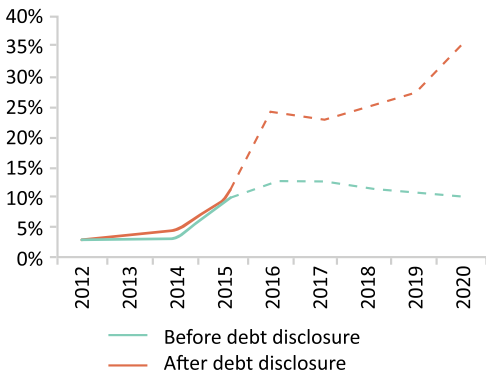


Source: World Bank and IMF



Figure 22: Higher debt service is placing the economy under severe strain...

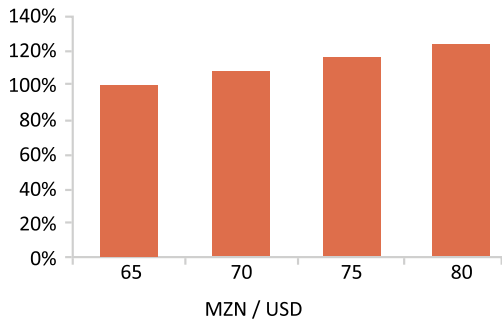
External debt service to revenue ratio, 2012-20



Source: MEF

Figure 23: ...and the outlook may deteriorate depending on the trajectory of the metical

External debt to GDP ratio with varying exchange rate scenarios, end of period rate, 2016

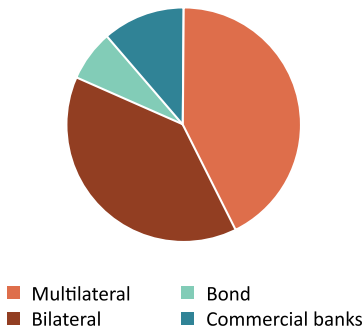


Source: MEF and World Bank staff estimates



Figure 24: Commercial loans accounted for less than a fifth of debt stock at end 2015...

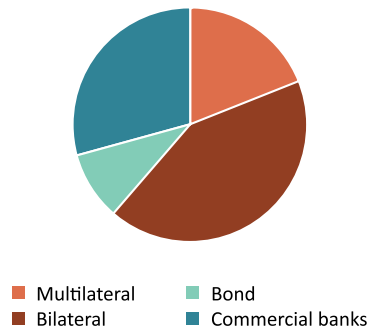
Composition of external debt stock, 2015



Source: MEF

Figure 25: ... but will represent 40 percent of debt service in the medium term on current terms

Composition of external debt service, average 2016-21



Source: MEF

Where to next.

Alleviating liquidity pressures. The Mozambican government has commenced restructuring talks with its creditors to help restore liquidity, and the outcome of this process will shape the fiscal outlook. Realism and prudence in estimating the state's capacity to repay its debt will be critical. This implies full awareness of the potholes ahead when estimating the capacity to service debt, including the considerable level of fiscal risk from state-owned enterprises, the banking sector, fuel subsidies, and pressures from civil service remuneration (and pensions) in an inflationary context. It also implies a conservative approach to estimating when gas revenues will flow in. Successfully restructuring may bring much needed relief now, but could produce an accumulation of deferred payments in the early 2020s amidst uncertainty around production timelines and the outlook for gas prices.

Restoring fiscal sustainability. Setting a path back to debt sustainability will require further fiscal adjustment. Restoring fiscal sustainability rests on firm targets for reducing debt and a falling primary deficit, backed by a program of fiscal adjustment. Public debt consolidations tend to be more successful when based on recurrent budget cuts and when accompanied by accommodating monetary policy to stimulate growth. The composition of the adjustment also matters, with those concentrated in transfers and the government wage bill being more consistent with growth than ones driven by tax increases and cuts in the investment budget. A sound adjustment strategy will help restore credibility and anchor market expectations about fiscal sustainability. In Mozambique's case, this means an overhaul of the country's fiscal planning to a framework that bridges the period to when gas revenues can be prudently expected and by establishing a credible Medium Term Fiscal Framework underpinned by a sustainable public sector debt strategy.

Managing contingent liabilities. The current circumstances have highlighted the importance of developing effective oversight over state-owned enterprises and other public entities

that are a source of contingent liabilities to the state. The existing oversight arrangements are fragmented and patchy. For instance, there is currently no entity responsible for overseeing fiscal risks in companies where the government is a shareholder.²² This applies to a list of over 100 companies, in which the state has direct and indirect shareholding, including Proindicus, MAM and EMATUM. Establishing a single oversight unit, which would assess and advise on fiscal risks from the entire public corporation sector, would help to address this shortcoming. Similarly, fiscal risks from the banking sector are increasingly significant as the effects of the economic downturn become more visible, as well as in the absence of financial system safety nets such as a fully capitalized deposit insurance scheme.

Overhaul the framework for managing guarantees. The current legal framework for awarding guarantees is highly discretionary, with little in terms of a guiding framework for risk based evaluation. Budget laws set a nominal annual guarantee limit that is not backed by firm criteria for the acceptable risk profile, the terms of the guaranteed loan, the strategic relevance of the project, or clear links to a medium term debt strategy. To improve this, the legal framework should be revised to include criteria for assessing the feasibility of a guarantee and the conditions of strategic relevance under which a guarantee would be considered. Guidelines should be established for risk assessment based on the feasibility of the proposed project, the financial viability of a company, and compatibility with a sustainable debt strategy. Particular attention, in line with these principles, is merited if the kick-off of Mozambique's gas megaprojects generates demand for sovereign guarantees. Furthermore, provisions should be established for the potential realization of these contingent liabilities through mechanisms such as guarantee fees charged to the borrowing entity and a Contingency Fund specifically for guarantees. The checks and balances must also be put in place. This includes collective responsibility in the authority to approve guarantees and institutionalized disclosure of the terms, outstanding amounts, as well as the underlying risk assessment.

²² The oversight unit based in the National Treasury is responsible for only a small number of enterprises, and its operations are at a nascent stage. The remaining companies fall under IGEPE, an institution with a prime role to manage the state's shares – i.e. IGEPE has an investor function rather than a supervisory role.



Focus Two: Inflation at record highs

Inflation has been the most acutely felt symptom of the ongoing economic downturn by Mozambicans. Inflation has accelerated considerably over the past year, after a three year period of stable and low prices. Average year-on-year inflation reached 25 percent in October, with food price inflation reaching 40 percent (Figure 26). Non-food inflation has also picked up as the weakening currency has made imports

costlier, but at a more modest pace (14 percent). The price hikes are country- wide. Food inflation in Beira has hovered near 40 percent over the last four months. More recently, a combination of low production and costlier imports has aggravated price hikes in the south, with food inflation in October registering at a record high of 43 percent in Maputo (Figure 27).

Box 4: Measuring inflation: the Consumer Price Index

The Consumer Price Index (CPI) measures the evolution of prices for a basket of goods and services deemed to be representative of the average consumer. Goods and services are divided into 12 main groups, ranging from food and transport to health and education. Foods and non-alcoholic beverages account for over 45 percent of the basket. The national average rate of inflation is calculated based on retail prices in three cities in southern, central

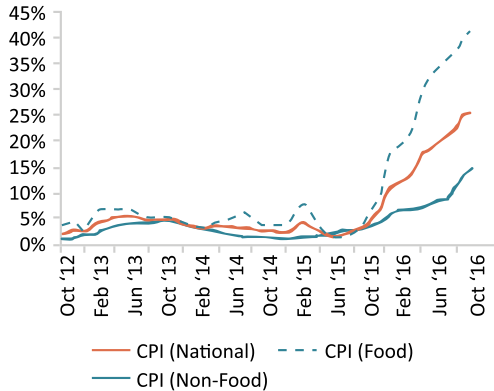
and northern Mozambique: Maputo, Beira, and Nampula, with Maputo prices being weighted at 50 percent. Recently, the CPI has also been calculated for Tete, Quelimane and Chimioio. Mozambique’s CPI largely tracks urban prices. Data collection is carried out at urban or semi-urban markets every week, whilst shops and other service providers are visited on a monthly basis.

Whilst many neighboring and peer countries have experienced rising prices in 2016, the increase has been most accentuated in Mozambique and Angola (Figure 28). Southern African countries exposed to the El-Niño drought (such as South Africa, Zimbabwe and Botswana) registered milder price inflation. Food inflation in South Africa was 13 percent in August 2016. Similarly, Mozambique’s African resource-

rich peers fared somewhat better: Nigeria has experienced a notable increase in food prices but these have remained below Mozambique’s levels. Angola’s price levels, like Mozambique, gained an alarming momentum in the third quarter of the year, with year-on-year food inflation registering above Mozambique’s level in September.

Figure 26: Rising food prices are driving inflation after an extended period of stable prices

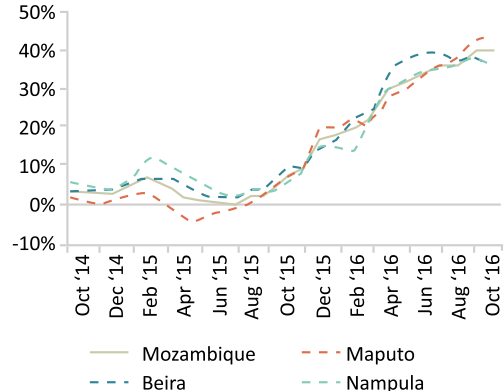
CPI inflation rate, 2012-16
(12-month % change)



Source: INE

Figure 27: Inflation in the center of the country is high but has recently been overtaken by the south

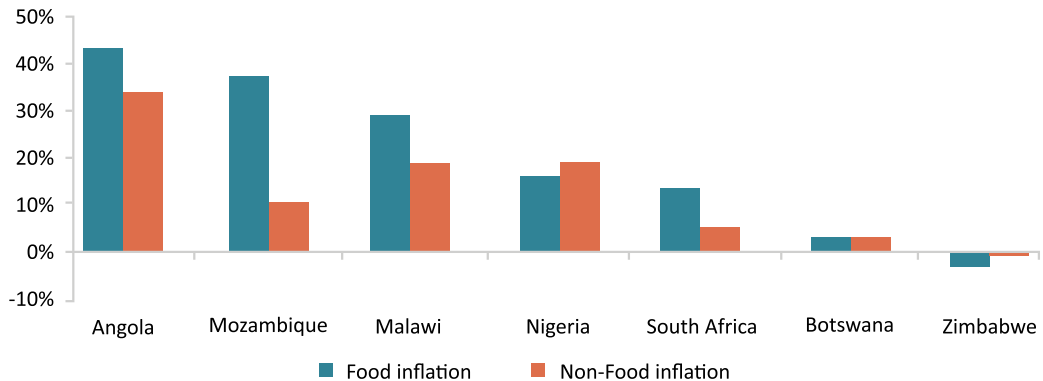
CPI Food inflation rate by location; 2014-16
(12-month % change)



Source: INE

Figure 28: The hike in food inflation is accentuated when compared to most peer countries

Regional CPI inflation rate; August 2016 (12-month % change)



Source: Country Statistics Agencies

A perfect storm: depreciation, drought and conflict.

The heightened depreciation of the metical has played a major role in driving inflation. Imports account for a large share of Mozambique’s consumption basket, and have become more expensive as the metical weakens. This tendency is evident when the price trend for tradables is distinguished from non-tradable goods and services.²³ Tradable items, which make up roughly 40 percent of the CPI basket, include imported food products and medication, alcoholic beverages

and tobacco, furniture and electronic items. Trends show a clear divergence, with spiking prices for tradables juxtaposed against milder inflation for non-tradable (Figure 30).

The regional drought has also contributed as the El-Niño phenomenon causes shortfalls in food supply in Mozambique and neighboring countries. Mozambique sources the bulk of its food imports from South Africa, which has suffered from a drought and seen its own agricultural output contract by 6.5 percent in the first quarter of the year. South African food price inflation accelerated

²³ Tradable refers to goods and services that are primarily sourced abroad.

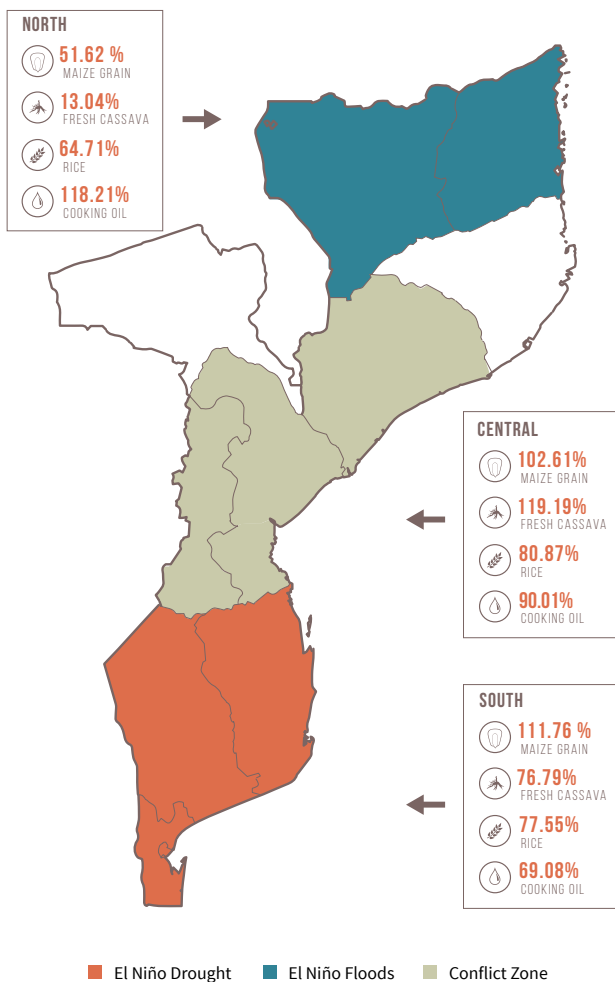
as a result, spilling over to Mozambican prices. Zimbabwe and Mozambique’s southern producing regions also experienced low rainfall and lower food production. The resulting price increases are staggering: the average retail price for a kilogram of maize grain increased 92 percent, in the twelve months to September 2016, whilst rice increased 85 percent. Cooking oil, one of the items included in the government’s list of basic goods, increased by over 76 percent during the same period and fresh cassava by 87 percent (Figure 31). Together, the items represent over 25 percent of total food household expenditures.²⁴

Escalating military tensions in central regions are placing further pressures on prices. Provinces north of Inhambane are suffering limited circulation of goods along major trade routes and have restricted access to goods imported from Malawi and South Africa. Convoys under armed escort have been reported on highways linking to neighboring countries.²⁵ With this, frequency of travel has reduced giving rise to increased uncertainty in supply and further stoking inflation in central regions.



Figure 29: A myriad of factors have contributed to localized price increases

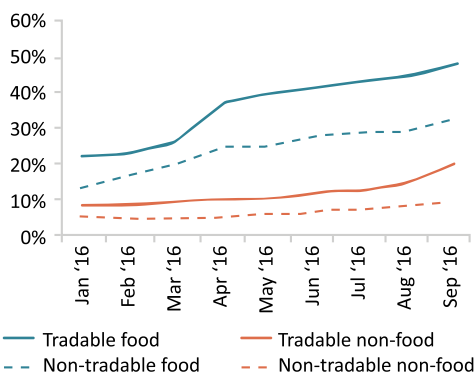
Prices of select food products, 12 month % change, September 2016



²⁴ The proxy for national expenditure is based on an aggregated food bundle, weighted by maize flour, which accounts for 17.2 percent, whilst cassava flour represents 8.5 percent.
²⁵ Following a series of attacks, Mozambican authorities introduced convoys under armed escort on a 200km section of the National Highway Seven (EN7) that carries traffic from neighboring countries such as Zambia and Malawi through Tete and Manica and onto the port of Beira (AIM).

Figure 30: Disparity between food and non-food items is evidenced when accounting for tradable effects...

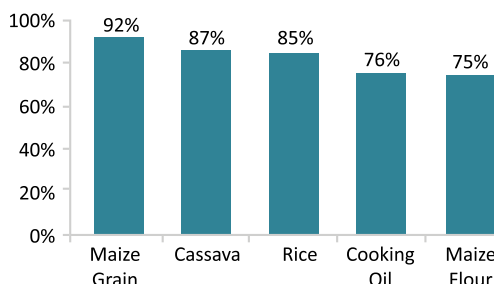
Tradable and Non-tradable CPI inflation rate; 2016 (12-month % change)



Source: INE, World Bank staff estimates

Figure 31: ...with increases in prices for key food items rising rapidly

Price variation for selected products; September 2016 (12-month % change)



Source: SIMA, MASA

The policy response has had a limited impact so far.

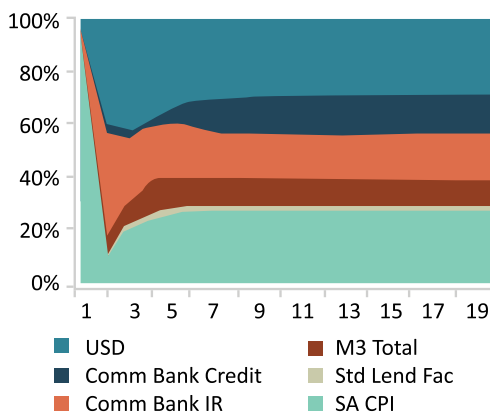
The authorities' attempt to subsidize and administer prices of certain food products has brought little respite. In April 2016, the Mozambican government introduced a list of reference prices for main imported food products in order to mitigate the high prices.²⁶ The list covers over 60 goods: roughly 20 fresh food products and over 40 grocery goods such as tooth paste and butter. It is an approach that has yielded partial results at best, and that is difficult to enforce in the face of market pressures. For instance, although the reference price for potatoes and onions was lowered by 42 and 24 percent respectively, retail prices have not followed suit. In the meantime, subsidies for wheat have been reinstated amid threats of bread price increases. However, with global wheat prices projected to increase slightly and a weakened currency, it is likely that pressures will remain into the near term.

Monetary policy tightening has also had little impact on inflation so far. Weak monetary policy transmission channels and external drivers of inflation are potential explanations. To explore this, Figure 32 presents the results

of a vector auto regression (VAR) model that measures the extent to which monetary policy can influence the CPI in Mozambique. This VAR model captures the linear interdependencies among monetary policy and external drivers of inflation such as foreign exchange trends and prices in trading partner countries to show the lagged impact of a given shock on inflation.

Figure 32: Determinants of CPI variability

In percentage of total variance explained, months after a shock



Source: World Bank staff estimates based on BoM data

²⁶ The list was prepared by Customs and Ministry of Industry and Commerce, in collaboration with different trade associations including *Associação Mukhero*, *AMIM* and *Frescata*. Reference prices are given in South African Rand (ZAR) on a FOB basis.

The estimation results show that the US dollar exchange rate explains the largest share of the variability of the consumer price level nominal exchange rate variations - affecting about 4 percent of price variability in the near term, and over 30 percent in the medium term. South African CPI also has a significant effect on price variability due to the effect on food prices. Monetary policy instruments do have an impact on price level variations, but with a more muted effect and with a lag of 2 to 6 months. The total share of the variance explained by commercial bank's interest rate is small in the near term, but it becomes more substantial and increasingly important after two months. Broad money gains further importance after four months whilst banks' credit to the private sector gains importance after 7 months.

A disproportionate impact on the poor.

Inflation is taking a heavy toll on the poor.

On average, food expenditure represents over 70 percent of the consumption basket for the bottom 40 percent²⁷ making them extremely susceptible to food price shocks. In Nampula and Zambezia, two of Mozambique's poorest provinces, food represents 78 and 72 percent of the poor's consumption - well above the 48 percent share apportioned to food in the CPI. In effect, since the CPI represents the average consumer, it underreports the impact of higher prices on the poor when food inflation is the driving element. A simple restructuring of the index is indicative in this regard. Adjusting the weight of food products that have a significant share of expenditure for the bottom 40 percent provides a broad estimate of food inflation for the poor.²⁸ Increasing the overall weight of food in the CPI to approximately 70 percent,²⁹ the average for the bottom 40 percent, shows significant and sustained deviation between

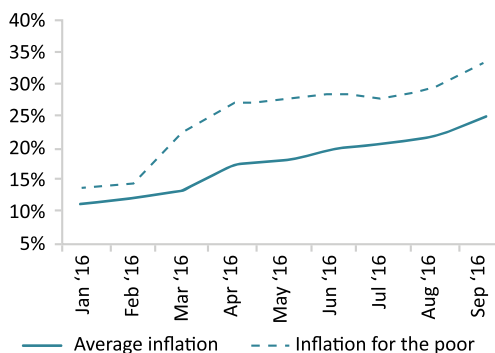
average inflation for the poor and actual inflation levels in the last 6 months (Figure 33).

Mozambique's inflation problem is complex and multi-faceted. The overwhelming influence of both domestic and external factors means that there is no quick fix. Still, two lessons can be drawn from the current circumstances. Firstly, policies to boost domestic food supply will reduce dependency on imports and exposure to exchange rate fluctuations. Investment in technological inputs and infrastructure can help propel Mozambique's sluggish agricultural sector. Similarly, investments in agricultural research and extension, and irrigation infrastructure will continue to be an important source of crop yield improvements and climate resilience. In parallel, more should be done to protect Mozambicans from episodes of high inflation through investment in social safety nets. Examples of safety nets include school feeding programs, support in-kind and cash transfers through public works programs.



Figure 33: Food products consumed by poor households experienced sharper price increases

Poverty weighted CPI inflation rate; 2016 (12-month % change)



Source: INE, World Bank staff estimates

²⁷ Based on the 2008/2009 poverty assessment. Data from the latest poverty assessment had not been published at the time the analysis was carried out.

²⁸ Weights for select food items in the CPI's food group (with an expenditure share above 5 percent) were adjusted using expenditure weights for a computed national food bundle, based on 13 poverty food bundles.

²⁹ The increase in weight on the food poverty index mirrors the significance of food expenditure for the bottom 40 percent. Weights for remaining CPI categories have been adjusted but proportions to overall non-food weight are kept constant.

Focus Three: Risky business - fiscal risk from state-owned enterprises

Mozambique’s public corporation sector has been underperforming and, given current economic conditions, is posing an increasing level of fiscal risk to the economy. In scaling-up its investment program, Mozambique increasingly used public corporations to contract non-concessional debt, state guarantees, and other finance through public-private partnerships (PPPs). These investments are largely being undertaken by public corporations with a weak financial track record, and in the absence of a unified framework for monitoring performance and overseeing risk. These developments, and the fragile economic outlook, underscore the importance for Mozambique to prioritize efforts to strengthen fiscal risk management, with a particular focus on the activities of the public corporation sector.

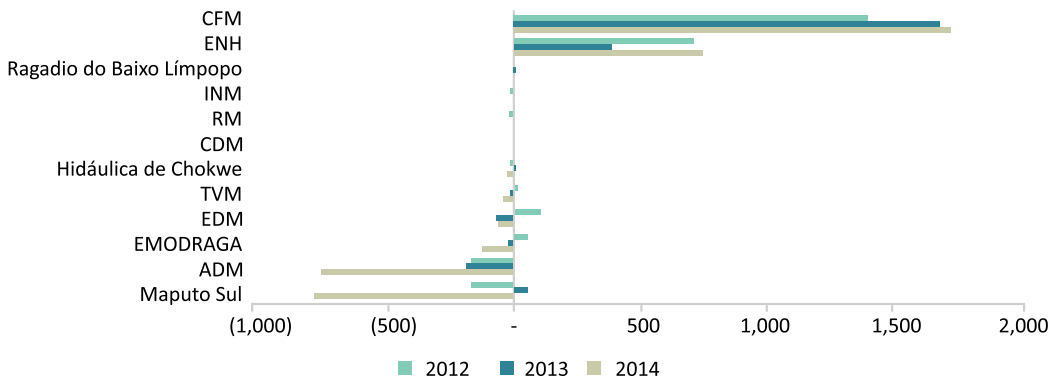
Government’s involvement in the public corporations has heightened fiscal risks.

Mozambique’s public corporation sector has been growing in size and complexity, and is

characterized by a weak financial position (Figure 34). The portfolio consists of 13 public enterprises and 109 companies in which the state has shareholding. Available data indicates that the state holds a further stake in at least 112 private companies through indirect shareholding or subsidiary arrangements. The state’s investments are spread across numerous sectors without a specific strategy guiding investment decisions. In some cases public enterprises are also exercising a regulatory function, presenting a conflict of interest. Lack of a clear dividend policy makes it challenging for the state to plan for this revenue stream. Often, dividends payments are waived to support internal investment activities. At present, a large share of the sector suffers from a weak financial position and under-reporting. Moreover, the portfolio is dispersed and a clear mapping of the entities and their relationships is not available, making it difficult to assess the state’s exposure to fiscal risk.

Figure 34: The majority of public enterprises are underperforming

Company annual profit / loss, 2012-14 (MZN millions)



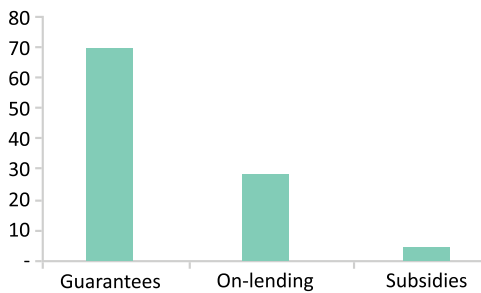
Source: MEF

Borrowing is the main source of financing for public corporations and a leading contributor to fiscal risk. Subsidies are provided to some enterprises but the volume has been relatively limited. Subsidies have represented 0.2 percent of GDP on average since 2012.³⁰ On-lending and guarantees are the largest source of state financing and have been typically issued to entities that are poorly performing (Figure 35 and Figure 36), indicating a lack of assessment and due diligence procedures. In recent years, guarantees have far surpassed the annual

guarantee limit, published in the Budget Law. Fiscal risks have been heightened further by the current sharp depreciation of the metical given that a large share of the public corporations' loan portfolio is denominated in foreign currency (Figure 37). In this context, it is of concern that information on the stock of public enterprise debt is not systematically monitored, consolidated or made publically available. It is also a concern that the controls applicable to public corporation borrowing are thin, and that the framework for governing guarantees is lacking.

Figure 35: Borrowing has been the main method of government financing for public corporations

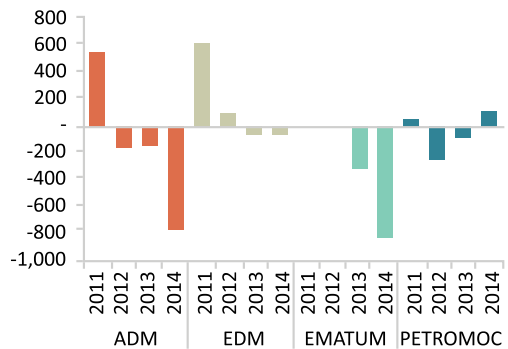
Total flows, 2012-15 (MZN billions)



Source: MEF

Figure 36: Guarantees have been mostly awarded to companies with weak financial performance

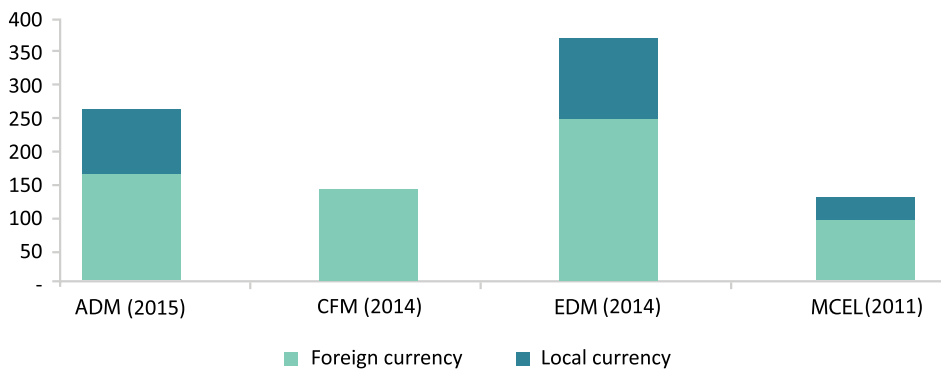
Company net earnings, 2011-14 (MZN millions)



Source: MEF and company financial statements

Figure 37: Heavy borrowing in foreign currency exposes public corporations to currency depreciation

Outstanding loan amounts for key public corporations based on latest financial statement, 2011-15 (USD millions)



Source: Latest available company financial statement

³⁰ A large share of total subsidies has gone to public enterprises in the communication and transport sectors.

In this context, fragmented oversight over public corporations is of particular concern.

Current oversight arrangements are fragmented and need to be strengthened in order to manage the complexities of an under-performing public corporation sector. A unit based in the National Treasury Directorate in MEF is responsible for overseeing the 13 public enterprises, but only to a limited extent. What is more concerning is that currently no entity has oversight responsibilities for managing fiscal risks in the 109 shareholding companies or the 112 companies in which the state holds indirect shareholding. The role of IGEPE (the agency for managing the state's shareholdings) is focused on representing the interests of the state in its capacity as Shareholder, rather than holding the mandate to manage fiscal risks. This fragmentation and the gaps in oversight disable the state's capacity to govern the sector.

Weak reporting practices from public corporations make oversight and decision-making on fiscal risks challenging.

Despite existing legal requirements explicitly stating that financial reports should be publicly disclosed, this practice is not adhered to by a large number of public enterprises and shareholding companies. When available, it is not common practice amongst the corporations to include a financial risk assessment in their reports. This, coupled with the fragmented oversight arrangements, impedes the authorities' capacity to prepare and disclose the consolidated financial position of the sector, including the position in terms of public corporation debt.

Reforms to strengthen oversight and manage fiscal risks from public corporations are urgent.

A clearly defined strategy for government participation in the sector is of paramount importance.

The strategy would set out the rationale for state ownership and define public policy objectives that companies are required to achieve. The strategy would also provide a basis for a revision of the government's current portfolio, with the aim of focusing on companies with clearly defined economic and social objectives. Rationalization of the current portfolio can only be achieved once a

comprehensive mapping exercise of the sector has been undertaken. The exercise should include details of public enterprises and private companies with shareholding companies, as well as their subsidiary companies and any inter-company shareholdings.

The establishment of a single oversight unit, covering both public enterprises and shareholding companies, is a critical reform measure.

Establishing the unit would bring Mozambique in line with good practices followed in the region. The degree of oversight and control exercised by the unit should be guided by the financial viability of an entity and potential exposure to fiscal risk. Enhanced oversight arrangements would be applied to entities that are experiencing financial vulnerabilities, while greater autonomy could be awarded to entities that are well-performing. Reporting and disclosure of public corporations' financial information needs to be strengthened to provide an informed basis for decision-making, fiscal risk evaluation and accountability of government assets and liabilities. A key step in this regard is the preparation of a memorandum statement that presents consolidated information on the government's investment in public corporations and their financial position, to be included in the annual state accounts.

The ongoing revision of the legal framework governing public corporations presents an important opportunity to strengthen fiscal risk management and to implement some of the above mentioned reforms.

It is recommended that the coverage of the public enterprise law be clearly defined to encompass all entities that are owned or controlled by the state, including subsidiaries and indirect shareholdings. It would be important that mechanisms for fiscal risk management are incorporated into the law, specifically: (i) establishing the state's role in overseeing all public corporations through a dedicated unit reporting to the Minister of Economy and Finance; (ii) setting adequate controls to govern borrowing and guarantees; (iii) establishing provisions for improved transparency and reporting; and (iv) requiring the development of financial and operational performance targets.

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