

MOZAMBIQUE ECONOMIC UPDATE

A Two Speed Economy



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The World Bank's biannual Mozambique Economic Update (MEU) series is designed to present timely and 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 a focus section analyzing issues of particular importance. The focus section for this edition addresses the impact of the economic downturn on Mozambique's private sector. The MEU series seeks both to inform discussions within the World 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 cutoff date for the current edition of the MEU was June 30, 2017.

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Abbreviations and Acronyms

AIAS	Administration for Water and Sanitation Infrastructure (<i>Administração de Infraestruturas de Água e Saneamento</i>)
BoP	Balance of Payments
BdM	Bank of Mozambique (Banco de Moçambique)
CAD	Current-Account Deficit
CEMPRE	Business Survey (<i>Censo de Empresas</i>)
CPI	Consumer Price Index
EMATUM	Mozambican Tuna Company (<i>Empresa Moçambicana de Atum</i>)
FDI	Foreign Direct Investment
FIPAG	Water Supply Investment and Heritage Holding (<i>Fundo de Investimento e Património do Abastecimento de Água</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
GFSM	Government Finance Statistics Manual
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
IPI	Industrial Production Index
LNG	Liquefied Natural Gas
MAM	Mozambique Asset Management
MCT	Ministry of Culture and Tourism (<i>Ministério da Cultura e Turismo</i>)
MEF	Ministry of Economy and Finance (<i>Ministério da Economia e Finanças</i>)
MBTU	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>)
PPI	Producer Price Index
PPP	Public-Private Partnership
REER	Real Effective Exchange Rate
SSA	Sub-Saharan Africa
SOE	State Owned Enterprise
VAT	Value Added Tax
WDI	World Development Indicators
WEO	World Economic Outlook
WB	World Bank

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Executive Summary

The Mozambican economy is showing some signs of recovery.

After a difficult 2016 which saw a sharp slowdown in growth and shocks to both the currency and inflation, early trends in 2017 show signs of improvement. First quarter GDP growth in 2017 picked up to 2.9 percent, more than double the growth rate of the preceding quarter. The metical, which had been steadily depreciating against the dollar in the first ten months of 2016 is now more stable after having strengthened by 28 percent against the US dollar over the last 9 months. A strong monetary policy response was key to this shift, which also helped inflation to slowly begin easing by mid-2017. In addition, international reserves are recovering as exports accelerated whilst imports remained subdued. Improving commodity prices and a recovering coal industry are central to these trends and also contribute to the outlook for growth. Strengthening prices for coal, aluminum and gas, a post el Niño recovery in agriculture, and progress in the peace talks, could steer growth to 4.6 percent in 2017, and towards 7 percent by the end of the decade.

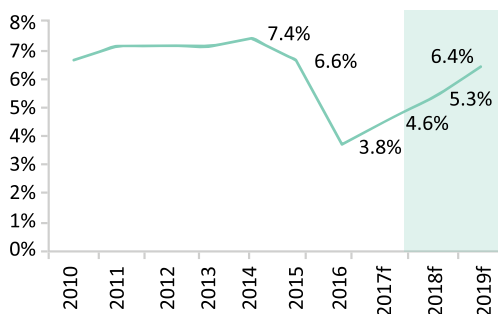
But economic conditions remain challenging.

Despite these improvements, the Mozambican economy remains weakened and exposed to significant risks. Although up on the previous quarter, first quarter growth in 2017 remains below the levels seen in recent years. And with much of the growth outlook hinging on developments in the extractives sector, commodity price fluctuations will continue



A positive outlook for growth

Real GDP (% change), 2010-19



Source: INE, World Bank staff estimates; f=forecast.

to pose large risks to the economy. Inflation remains very high at 18 percent, with direct implications for Mozambican households and for monetary policy, which seeks to ensure a stable price environment. Monetary policy remained tight and has supported a significant adjustment in the external sector. But Mozambique’s reference lending rate is now amongst the highest in sub-Saharan Africa, and average commercial bank lending rates in the region of 30 percent are prohibitively high for much of the private sector. More needs to be done to help Mozambique’s economy recover, but the monetary tightening cycle may have peaked. A stronger exchange rate, easing inflation, and lower credit levels suggest that the monetary policy cycle could begin to loosen as the economy continues to adjust. However, making this transition smoothly will require a coordinated and robust fiscal policy response.

A sharper fiscal policy response in needed.

Although progress had been made, Mozambique’s fiscal position continues to be unsustainable and the overall fiscal adjustment has been limited. Without progress in the debt restructuring process to date, the country’s debt position remains untenable. Subsidy reforms, a difficult area to tackle, have advanced and will contribute to easing fiscal pressures. But accumulating arrears and domestic financing are impeding the fiscal adjustment. The wage bill continues to be a significant source of pressure whilst recent cuts to the investment budget are affecting the economic and social sectors, and potentially worsening the composition of the budget. In addition, fiscal risks, particularly from some of Mozambique’s large state-owned enterprises, are materializing and may compromise fiscal recovery efforts if not managed proactively.

Clearly, a large agenda lies ahead in restoring the health of Mozambique’s public finances. Progress with the debt restructuring negotiations is critical for reestablishing fiscal stability and halting the accumulation of arrears to creditors. Consolidation reforms to control the wage bill and strengthen revenue administration would also help to ease pressures on the budget and limit the build-up of arrears to suppliers. Equally as important for restoring sustainability would be a commitment from the authorities to pursue policies that help Mozambique build fiscal buffers and ingrain prudence in the management of public finances in the long-term. Such a policy agenda would involve pursuing targets towards a primary surplus and a sustainable debt profile in the long-term. It would also involve reforms to strengthen the legal frameworks for managing debt and fiscal risks from SOEs and other public sector entities.

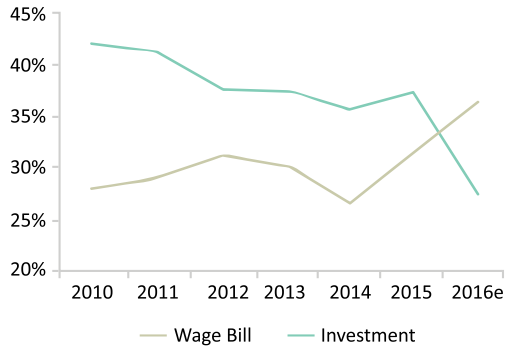
Supporting the private sector through the crisis.

Part two of the Mozambique Economic Update explores the profile of the formal private sector



A growing government wage bill

Wage bill and public investment spending (% of total expenditures), 2010-16



Source: MEF, World Bank staff estimates

and the impact of the ongoing economic downturn on its performance. It notes growth and increased dynamism amongst firms as Mozambique underwent a resource driven growth acceleration. The number of firms in the formal sector has doubled since 2002. These businesses now employ twice as many workers as in 2002, and much of this expansion happened in the non-extractive private sector. In addition, the share of small and medium enterprises is growing, a phenomenon that bodes well for overall productivity growth. These are positive signs. However, the ongoing economic downturn is likely to have a disproportionately negative impact on these emerging micro, small and medium enterprises. A review of the emerging evidence indicates that while extractives, other megaprojects, and large industries are showing some resilience, the rest of the private sector, the green shoots of the economy, are facing reduced growth in demand, higher costs, and more difficult access to credit. Hence, reestablishing macroeconomic stability through a balanced mix of fiscal and monetary policy is a priority for private sector growth. Lastly, given its openness and continued exposure to external shocks, reforms to increase the long-term resilience of the private sector are important if Mozambique is to meet its potential for a diversification and job growth.



Part One: Recent Economic Developments

Economic Growth

After a sharp slowdown in growth in 2016, the first quarter of 2017 shows signs of improvement driven by the extractive sector.

GDP growth picked up to 2.9 percent in the first three months of 2017 (year-on-year) after slowing to 1.1 percent in the last quarter of 2016, but remains below recent levels. A large share of this improvement comes as Mozambique’s recovering coal industry overcomes several structural problems. The Nacala logistics corridor became fully operational by early 2017, and along with the increase in coal prices, has boosted exported volumes of coal. The ceasefire has been equally important for the agricultural sector as improvements in security and the ability to circulate since early 2017 is helping farmers in central Mozambique to market their goods. Despite these improvements, first quarter growth remains below its level during the previous year and is well below growth rates seen in Mozambique in recent years due to lower investment, weakened demand, and policy tightening. Spending restrictions in public investment also contributed to a contraction in the public administration’s contribution to growth¹ (Figure 1).

The ongoing economic downturn reveals the vulnerability of the service sector, which is dominated by low-productivity activities, to demand shocks. Over the past 15 years, an expansion took place in the service sector as commerce and low-skill services grew with consumption. It generated a large share of employment growth in the economy. Two thirds of jobs created in the formal economy since 2002 were created in services.² Including the informal service economy would further raise this figure. Output from services contracted the most in 2016, with a notable slowdown in all services subsectors except financial services³ extending into the first quarter of 2017. Being a low-skill/ low-productivity sector that is exposed to domestic demand shocks, services took the brunt of the economic fallout with large potential implications for jobs and small enterprises.

The downturn also highlights a fragile manufacturing sector that is exposed to declining domestic demand. Manufacturing’s contribution to growth contracted by over two thirds when compared to 2015, and continued to decline in the first quarter of 2017. This trend is confirmed by the Industrial Production Index (IPI), which shows falling production levels for non-durable consumables, intermediary goods and equipment. Employment levels in industry have also faltered. According to the Economic

¹ The public sector’s contribution to growth fell from 1.6 percent of GDP in 2015 to 0.6 percent in 2016. Real government consumption grew by 5 percent, down from a 12 percent growth in the previous year.

² According to firm census data, 207,906 jobs were created in the formal economy between 2002 and 2015, 133,705 of which were in the services sector.

³ Financial sector output grew by 15 percent, largely a result of the effect the exchange rate depreciation had on the sector’s deflator.

Activities Index⁴ prepared by the National Institute of Statistics (INE), the largest contraction in employment was experienced in the industrial sector, especially food manufacturing where the average employment index fell by almost 7 percent between 2015 and 2016.

Agriculture’s performance has been driven by climatic conditions. Agriculture, which accounts for 21 percent of GDP and employs around 75 percent of the labor force, faced adverse climatic conditions in 2016 with the onset of the regional el-Nino drought. The sector’s growth slowed from 3.1 percent in 2015 to 2.5 percent in 2016, and it registered a negative contribution to growth in the first quarter of 2017. Agricultural export earnings fell and productivity levels for domestically consumed foods remained low. A weaker metical may have presented an opportunity to the sector through more competitive prices, but climatic conditions were a countervailing force and structural constraints

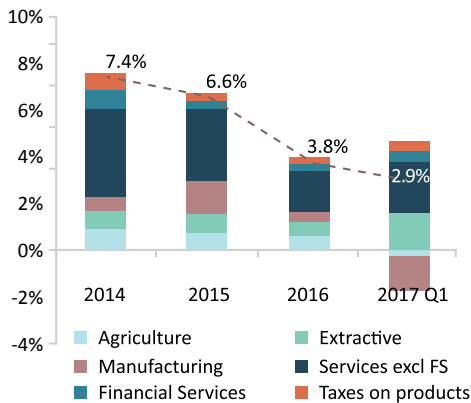
such as low access to inputs and high transport costs may have delayed or prevented a supply response in the short-term.

The extractive sector has been a pocket of resilience and a driver of the recent improvement in growth. Extractives maintained double-digit output growth in 2016.⁵ This trend continued in early 2017 with a 41 percent expansion in output, making extractives the driver of the pick-up in first quarter GDP growth. Sizable foreign direct investment (FDI) inflows and recovering commodity price were behind this. It is a welcome trend, given the importance of this sector for crowding in investment and creating jobs (see Box 1). However, it is indicative of the extent of concentration in the economy, especially in exports (Figure 2). It also calls for renewing the focus on diversifying exports through a more dynamic private sector (see part two for a discussion of the impact of the economic downturn on the private sector).



Figure 1: First quarter growth in 2017 shows signs of improvement driven by the extractive sector ...

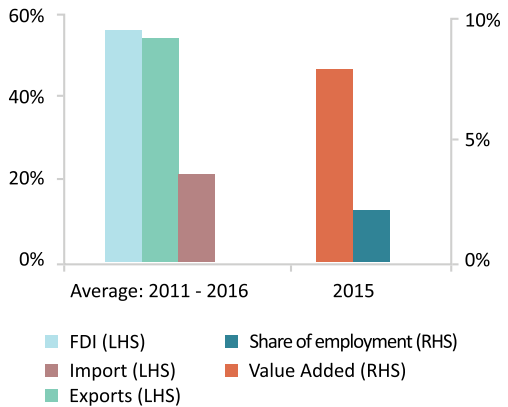
Sectoral contribution growth, 2014-17



Source: INE

Figure 2: ... which continues to play a key role in shaping the Mozambican economy.

Extractives and aluminum contribution to the economy, 2011-16



Source: INE, BdM

⁴ A short-term index looking at the behavior of three major monthly indicators: turnover, employment and wages.

⁵ Extractives grew by 16 percent in real terms in 2016.

Box 1: Extractives FDI and job spillovers

What happens to foreign direct investment when a developing country makes an unpredictable giant oil or natural gas discovery? A recent analysis of developing and emerging economies from 2003 to 2014 found that FDI booms related to natural resources lead to a bonanza of other diversified FDI projects in manufacturing, services, construction and other sectors.

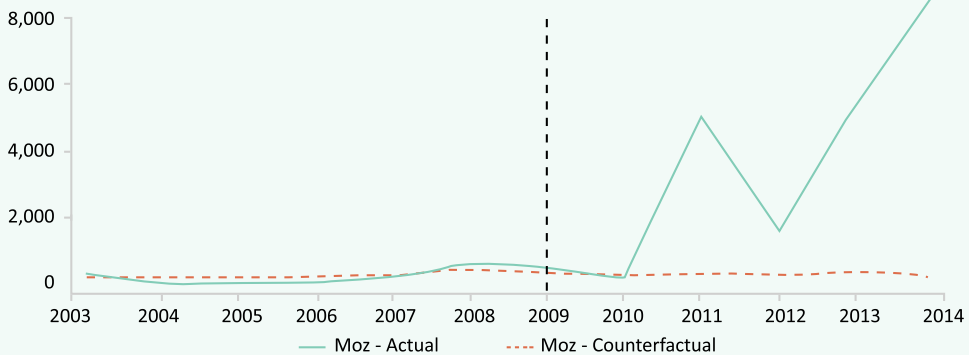
Mozambique’s FDI inflows have boomed since 2010 and in 2012 Mozambique received 15 percent of all sub-Saharan African FDI (while it accounts for a little less than 1 percent of SSA GDP). In 2013-2015 FDI amounted to 70 percent of Mozambique’s GDP, the highest share of all African countries. A recent study by Toews and Vézina notes that over 100 greenfield non-extraction project announcements were recorded from 2009 to 2014, 45 of which in Maputo. These projects are expected to have a cumulative worth of around USD 21 billion and to create 25,500 jobs, mostly in construction, manufacturing and services. The study suggests that these inflows were stimulated by Mozambique’s natural resource discoveries. Using the weighted average of jobs created through FDI in countries with no natural resource discoveries as a control, the authors find that this represents a 50-fold increase in jobs created due to FDI (Figure 3).

The authors also matched information on individual jobs to FDI projects across cities, sectors and years, and estimated the impact of these FDI projects on jobs by city and sector. The results indicate that one additional FDI project in a particular city and sector, e.g. a new British bank in Beira or a new South African supermarket in Tete, created at least 434 jobs on average. Additionally, the authors found that the average wage in a particular city in a particular sector increased by 0.8 percent with each extra FDI project.



Figure 3: The discovery impact of FDI on job creation in Mozambique

Non-extractives FDI jobs created (annual), 2003-14



Source: Resource discoveries, FDI bonanzas, and jobs: evidence from Mozambique. Gerhard Toews (University of Oxford); Pierre-Louis Vézina (King’s College London). 2016.

Exchange Rate and Inflation

The exchange rate appreciates as the economy adjusts, but inflation remains high.

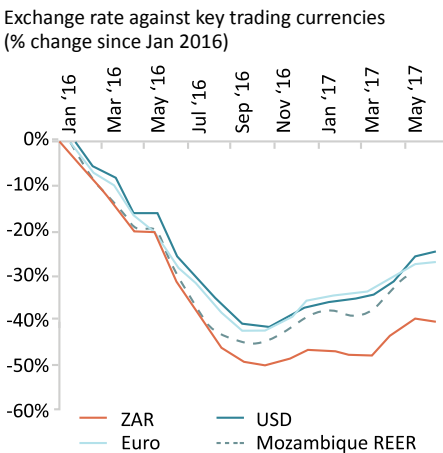
The metical has made considerable gains since the last quarter of 2016 supported by increased export earnings and monetary policy tightening. Mozambique’s currency appreciated 28 percent against the US dollar between October 2016 and June 2017 and by almost 29 percent against the main trading currencies over the same period⁶ (Figure 4). Increased export earnings due to recovering commodity prices are key to this trend. Reduced liquidity resulting from an increase in the reserve requirement has also lessened supply of the metical.

Headline inflation declined to 18.1 percent in the 12 months to June 2017, down from a peak of 26.3 percent in November 2016, as the stronger metical helped reduce the cost of imported goods. The metical’s appreciation against the US dollar and the South African rand is a major contributor to the easing in inflation

given Mozambique’s reliance on imported goods, including foods.⁷ As a result, food inflation began cooling in November 2016 driven by a reduction in the cost of imports (including rice and wheat) and improved climatic condition post the el-Nino drought, which has helped to drive overall inflation down.⁸

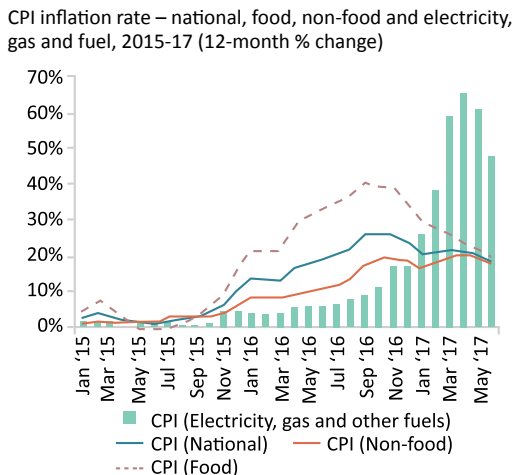
Price increases for energy and fuel items pushed non-food inflation up since February. A package of fiscal reforms aimed at rolling back subsidies and administered pricing have put non-food inflation on an upward trend since the start of the year. Electricity tariffs increased in October 2016, and fuel prices at the pump, which had been fixed since 2011 were since raised twice⁹ in efforts to eliminate subsidies. This, combined with a spike in charcoal prices, led to a 66 percent increase in the price index for electricity, gas and other fuels by April 2017 (Figure 5). Transport prices also increased over this period, with a significant part of the increase coinciding with the upward revisions in fuel prices.

Figure 4: The metical began recovering in October 2016...



Source: BdM

Figure 5: ...but inflation remains sticky as pressures from electricity and fuel prices are pronounced ...



Source: INE

⁶ Mozambique’s multilateral nominal exchange rate, a weighted-average of the currencies of major trade currencies.
⁷ The base effect in the CPI has also contributed to the deceleration in the 12-month inflation rate: the sharp increase in the CPI in December 2015 means the basis for comparison in December 2016 was much higher than that for November 2016. In addition, the CPI has recently been rebased and the downward revision of the weight applied to food items may have contributed further.
⁸ Food accounts for 33 percent of the basket of goods in the consumer price index.
⁹ In October 2016, then in March 2017.

The External Sector

The current account deficit narrowed to 38 percent in 2016 as the economy underwent an adjustment through lower imports and falling investment flows.

Mozambique registered a positive goods balance in the last quarter of 2016 for the first time in over two decades, which helped to lower the current account deficit by 30 percent. The current account deficit narrowed to 38 percent of GDP, down from 40 percent of GDP in 2015. A 36 percent drop in goods imports was the most important factor behind this shift. This adjustment in imports was sufficiently strong to counter a drop in current income from donor financing and an increase in service imports.¹⁰ A 17 percent increase in exports, driven by megaprojects, also helped to narrow the current account.

As in previous years, the current account deficit was largely financed by foreign direct investment. Net FDI financed approximately three quarters of the current account deficit in 2016. Mega-project FDI increased by 4 percent in 2016 (Figure 10). This contrasts with the rest of the economy, which saw a 32 percent drop in investment driven by a slowdown in real estate, financial services and construction (Figure 11).

Trends in early 2017 suggest a further narrowing of the current account deficit as imports remain subdued despite the stronger metical. An increase in global oil prices was the main driver of a 9 percent increase in goods imports in the first quarter (year on year), whilst the underlying demand for fuel and other imports remained subdued. Rallying coal and aluminum prices are supporting a continued growth in exports,¹¹ which is likely to offset shortfalls in agricultural export performance (Figure 8).

The sharp adjustment in imports eased pressure on external reserves.

Gross international reserves recovered to USD 2.3 billion by May 2017, enough to cover almost 4.3 months of imports or 6.1 months excluding megaprojects (Figure 9). Mozambique's balance of payments (BoP) deficit is largely driven by imbalances in the non-megaproject economy and is often a source of pressure on the country's external reserves.¹² The decline in non-megaproject imports helped ease pressure on external reserves. The BoP deficit narrowed by 22 percent in 2016 corresponding to the shift in the current account balance, which helped reduce demand for reserves. This, coupled with monetary policy measures (discussed below), supported a steady recovery in reserves from March 2017.

¹⁰ Current income inflows to the central government are estimated to have contracted by 70 percent, whilst other income inflows fell by 45 percent in 2016.

¹¹ Coal prices increased by 54 percent and aluminum prices by 24 percent in the twelve months to March 2017.

¹² This includes support to ensure consistent supply of food and fuel imports, and payment of public sector debt service.

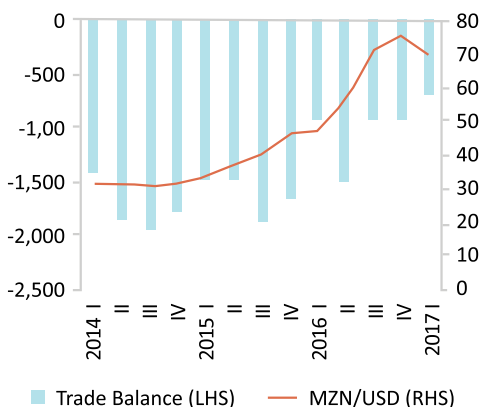
Table 1: The Balance of Payments

(USD millions, unless otherwise stated)	2015 Actual	2016	Δ 15/16
Current Account (% of GDP)	39.9	38.1	...
Current Account	-5,968	-4,195	-30%
Trade Balance	-6,469	-4,250	-34%
Goods, net	-4,163	-1,459	-65%
Exports	3,413	3,355	-2%
<i>megaproject</i>	2,057	2,413	17%
<i>non-megaproject</i>	1,356	942	-31%
Imports	7,577	4,814	-36%
<i>megaproject</i>	917	771	-16%
<i>non-megaproject</i>	6,660	4,043	-39%
Services, net	-2,306	-2,791	21%
Income and transfers, net	502	55	-89%
Capital & Financial Account	-5,342	-3,704	-31%
of which			
FDI, net	-3,867	-3,093	-20%
<i>megaproject</i>	-1,273	-1,322	4%
<i>non-megaproject</i>	-2,594	-1,771	-32%
Other, net	-1,188	-472	-60%
Overall Balance	-625	-491	-22%
<i>megaproject (e)</i>	1.9	18.4	...
<i>non-megaproject (e)</i>	-627.2	-509.4	...

Source: BdM; e=estimates

Figure 6: The trade balance has been narrowing...

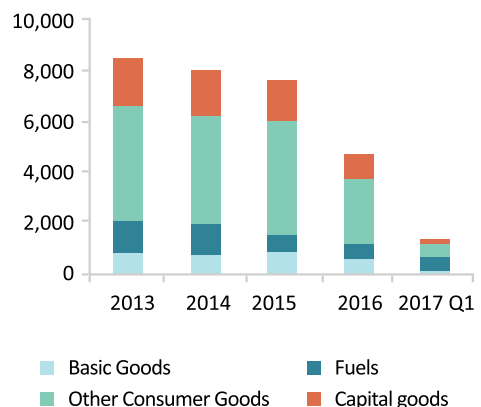
Quarterly trade balance (USD millions) and metical/dollar nominal exchange rate, 2014-17



Source: BdM

Figure 7: ...as imports of non-essential consumer and capital goods fell.

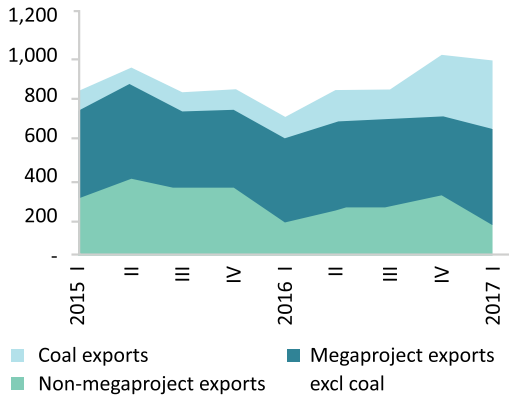
Goods imports, 2013-17 (USD millions)



Source: BdM

Figure 8: A surge in coal prices improved overall exports...

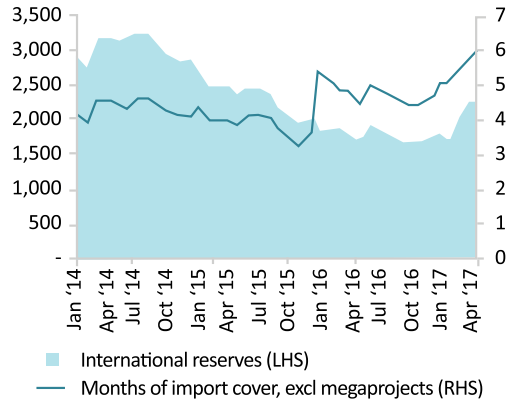
Quarterly goods exports, 2015-17 (USD millions)



Source: BdM

Figure 9: ... and helped augment central bank reserves

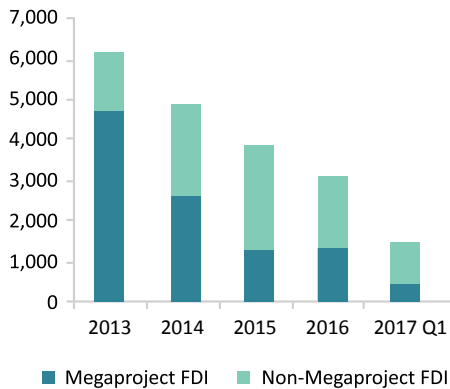
International reserves and monthly cover, 2014-17 (USD millions)



Source: BdM

Figure 10: Contraction in non-megaproject FDI has dampened overall FDI levels...

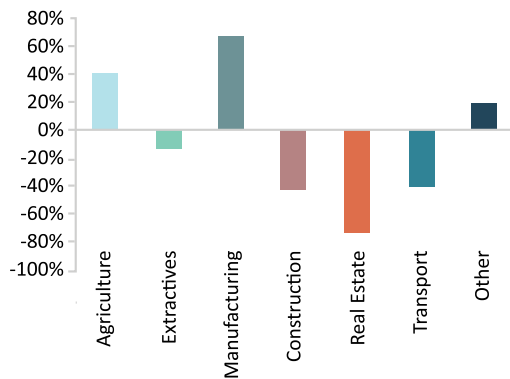
Net FDI, 2013-17 (USD millions)



Source: BdM

Figure 11: ...as investment falls in key sectors

FDI growth in key sectors, 2016 (12 month % change)



Source: BdM

Monetary Policy

The monetary policy tightening cycle may have peaked as the economy continues to adjust.

Interest rates remain high, but signs of easing inflation and a stronger exchange rate may support monetary policy loosening in the medium-term. Mozambique's reference lending rate – the *facilidade permanente de cedência* – is amongst the highest in sub-Saharan Africa at 22.75 percent. Commercial bank lending rates stood at 28.6 percent¹³ in May 2017, 870 basis points higher than the previous year (Figure 13). Lending rates were raised to these levels by end 2016 to keep interest rates positive in real terms, stabilize a depreciating currency, and reduce inflation. As monetary policy took effect, the metical gained value and inflation eased slightly. As a result, recent policy fine-tuning measures slightly loosened the position, suggesting that the policy tightening cycle may have peaked by early 2017. The *Banco de Moçambique* removed the MZN 700 thousand (approximately USD 10,000) credit card spending limit whilst abroad in early 2017 and eased the reference lending rate in April 2017 by 50 basis points based on expectations of a downward trend in inflation. Simultaneously, the central bank introduced a benchmark policy rate for the interbank market to promote transparency and improve monetary policy transmission.

With an appreciating currency, shrinking credit and growing reserves, monetary policy has supported a significant adjustment. Credit to the economy contracted by 15 percent in real terms in the 12 months to May 2018, and began decelerating in nominal terms since October 2016 (Figure 12). Gross international reserves recovered to approximately USD 2.3 billion by end of May 2017, representing an estimated 4.3 months of goods and non-factor services import cover (6.1 months when excluding mega-projects). Increases in commercial bank reserve requirements¹⁴ contributed to

the accumulation of reserves. It also reduced metical liquidity, which allowed the central bank to accumulate forex in response to liquidity needs. Nevertheless, pressures on the reserve position also persisted; provisions for fuel imports and government debt servicing represent roughly ninety percent of total outflows (Figure 16).

The authorities are enhancing banking sector stability as key indicators deteriorate.

Financial indicators show a banking sector under increasing strain. The financial system's solvency ratio (capital as a proportion of liabilities) contracted by 5.8 percentage points between October 2016 and January 2017¹⁵ following the central bank's intervention in Moza Banco and failure of Nosso Banco. The average non-performing loan ratio for Mozambique's banking sector increased by 1.2 percentage points in the 12 months to January 2017, with almost half of the increase in the last three months.¹⁶ Rising interest rates and a weakened economy contributed to this increase.

Recent reforms to strengthen banking sector resilience are important but come at a difficult time. The *Banco de Moçambique* raised commercial banks' minimum capital requirement from MZN 70 million to MZN 1.7 billion (USD 1 million to USD 25 million, based on the exchange rate at the time). The solvency ratio requirement was also revised upwards from 8 percent to 12 percent. Banks have been given three years to comply with this change, although some of the larger banks already conform to the new solvency ratio. These measures come at a time when the banking sector faces significant risks from declining private sector demand and weak repayment capacity in the public sector, especially amongst state-owned enterprises. These measures may lead to some consolidation and may strengthen foundations if the sector can navigate through these turbulent times.

¹³ Average for one-year maturity loans.

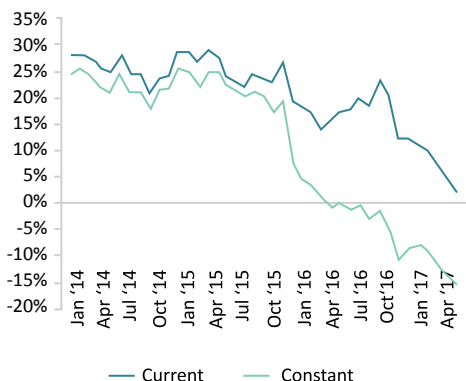
¹⁴ The reserve requirement sets the minimum amount of reserves that must be held by a commercial bank. The requirement increased from 10.5 percent at the start of 2016 to 15.5 percent by the end of the year.

¹⁵ The average solvency ratio for the banking system decreased from 14.8 percent in October 2016 to 9 percent in January 2017.

¹⁶ The ratio increased from 4.5 percent in January 2016 to 5.2 percent in January 2017.

Figure 12: Growth in credit to the economy continues to decline...

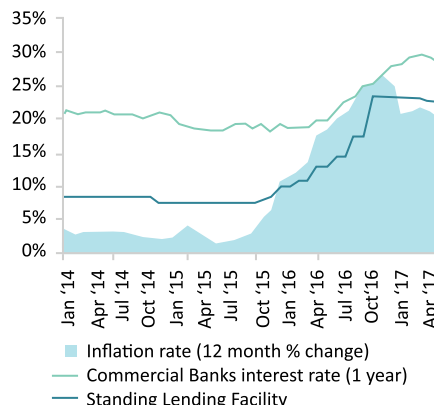
Credit to the economy, 2014-17
(12 month % change)



Source: BdM

Figure 13: ... as commercial bank interest rates continue to rise

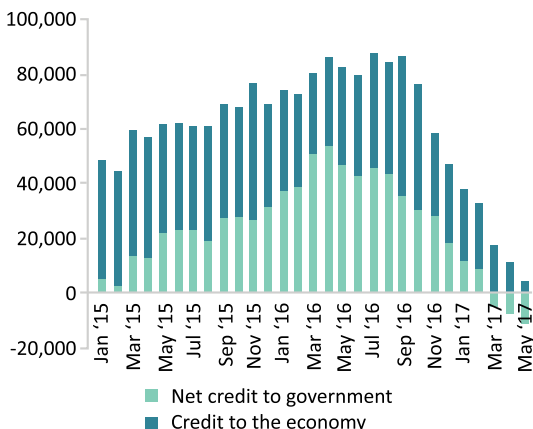
Central and Commercial Bank interest rates and CPI, 2014-17
(percentage, unless otherwise stated)



Source: INE, BdM

Figure 14: Government borrowing has fallen in 2017

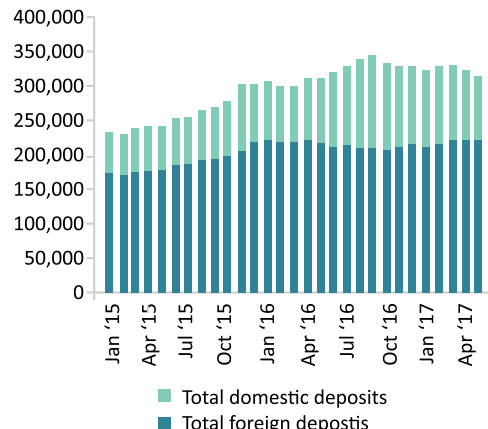
Decomposition of nominal credit growth, 2015-17
(MZN million)



Source: BdM

Figure 15: Deposit levels have remained stable

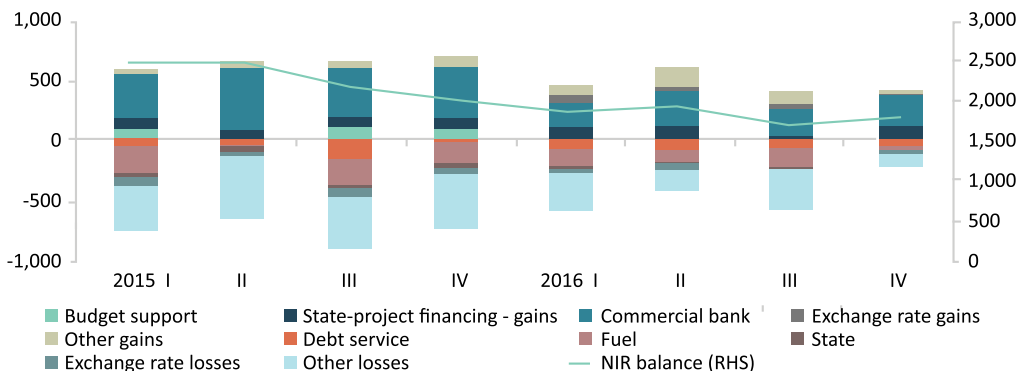
Commercial Bank deposits (MZN million) and metical/dollar nominal exchange rate, 2015-17



Source: BdM

Figure 16: Replenishment by commercial banks has softened the drawdown on reserves for debt service and fuel payments...

Quarterly reserve usage and replenishment, 2015-16 (USD millions)



Source: BdM

Fiscal Policy

Accumulating arrears and growing domestic financing are slowing the fiscal adjustment.

While the fiscal deficit narrowed substantially in 2016 on a cash basis,¹⁷ the accumulation of payment arrears suggests that fiscal consolidation efforts are under pressure. The fiscal deficit is estimated to have narrowed to 4.5 percent of GDP from 6.4 in 2015, on a cash basis, due to an 11 percent increase in revenues¹⁸ and a sharp contraction in capital spending in favor of the recurrent budget (Figure 17). Total investment spending was 39 percent lower than foreseen in the budget whilst recurrent spending overshot by 4 percent due to higher wage, pension and subsidies costs.¹⁹ At the same time, the government's limited payment capacity ramped up the pace of accumulation of arrears. Amounts accrued to private creditors and fuel suppliers alone in 2016 and 2017 so far are estimated at around USD 660 million,²⁰ almost 6 percent of GDP.²¹ These pending payments to suppliers, including fuel distribution companies, and to private creditors reduce overall spending on a cash basis but represent sizable government obligations that lead to a wider deficit if estimated on a commitment basis.²²

Domestic financing played a more prominent role in financing the 2016 budget (Figure 18). Development partners' support to the budget, which has historically²³ represented 6.5 percent

of total expenditure and roughly 2.1 percent of GDP, continues to be suspended following the revelation of previously undisclosed borrowing. This, coupled with reduced access to external borrowing, has resulted in higher levels of domestic financing, with the central bank gaining more prominence as a source of financing through short-term loans.²⁴ Central bank credit to government increased by almost 600 percent in 2016. Most of this increase was realized in the last quarter. This trend continued in early 2017 as central bank credit increased further by 43 percent in the first quarter of the year. The share of financing through treasury bonds fell as demand declined with the government's deepening financial difficulties. Treasury bond rates averaged 28.3 percent at the most recent auction,²⁵ which was nevertheless undersubscribed by 45 percent.

A changing budgetary composition: less investment, fewer subsidies, and a growing wage bill.

The wage bill continues to be a significant source of pressure on the budget. Difficulties in containing new admissions led to overspending on civil service salaries. Despite cuts to the *décimo terceiro*²⁶ salary, higher than planned recruitment in education, health, agriculture and policing²⁷ caused the wage bill to reach 111 percent of the budgeted amount for 2016. If not countered, continued acceleration in the public-sector wage bill risks worsening the composition of the budget by reducing growth enhancing

¹⁷ Cash-based accounting only recognizes income when it is received and spending when it is paid, and does not report commitments (or liabilities) to pay for goods and services already received.

¹⁸ Currency depreciation also supported revenues as tax on imported goods was higher.

¹⁹ Spending on subsidies was 214 percent of the revised budget following the authorities' decision to reengage in subsidies to wheat and transporters to mitigate effects of deteriorating economic conditions on the lives of Mozambicans.

²⁰ Amount includes arrears on EMATAUM, MAM and Proindicus loans, as well as fuel supply arrears from June 2016 onwards. Arrears to private creditors include principal and interest payments. Interest payments arrears (roughly 2 percent of GDP) contribute to widening the fiscal deficit.

²¹ Supplier arrears are not routinely reported in official fiscal reports.

²² Mozambique's fiscal accounts are presented on a cash basis. Traditionally, several governments recorded their government accounts on a cash basis only, however, the IMF's Government Finance Statistic Manual (GFSM) proposes that governments should also record accrual accounts to get an indication of the full spectrum of governments fiscal position. In the latter, commitments such as government debt servicing or employee pension obligations would be included in the fiscal accounts.

²³ Historical data refer to period 2010 – 2015.

²⁴ The current legal framework allows the government to draw an amount up to 10 percent of the penultimate year's revenues on a short-term basis.

²⁵ <http://www.bvm.co.mz/index.php/pt/mercado/comunicados/362-apuramento-dos-resultados-sessao-especial-de-bolsa-obrigacoes-do-tesouro-2017-3-serie-2>.

²⁶ The annual Christmas bonus paid to public servants, also known as the thirteenth salary, was cut but half in 2016. The bonus was not paid to people in managerial positions including Ministers, Deputy Ministers and Heads of SOEs.

²⁷ As per the January to December 2016 Budget Execution Report, page 29.

and social expenditures whilst propping up the high costs of the public sector.

Cuts in the investment budget and low disbursement rates constrained spending on the social and economic sectors in 2016.²⁸

Having averaged roughly 19 percent of GDP between 2010 and 2015, spending on the social and economic sectors declined to 14 percent of GDP by 2016.²⁹ A significant drop occurred in 2016 (almost 3 percent of GDP) with sizable cuts in the investment budgets of these key sectors being a major factor. Spending was particularly constrained for infrastructure investments in roads and public works, and in the agriculture budget. Water was the exception amongst the infrastructure sectors as it benefited from an increase in external financing³⁰ which helped to boost its expenditure during the year (Table 3). The education and health budgets fared somewhat better than other social and economic sectors. These two sectors, which accounted for over half of total spending since 2010 on average, saw 12 and 10 percent increases in spending respectively during 2016. Much of this increase is linked to growth in these sectors' wage bills. Nevertheless, these sectors also faced difficulties in executing non-salary spending, including the funding of transfers to provincial education directorates and the costs of medical supplies.

Subsidy reforms have progressed and will ease fiscal pressures, but they transfer the burden to the population, which makes safety net mechanisms a priority. Historically, the public sector subsidized basic goods and services such as bread, electricity, transport and fuel. The ongoing economic downturn intensified the strain these outlays place on the government budget. The authorities have started tackling these costs head-on to reduce their fiscal burden. Subsidies to bread and salt producers were removed in March and April, respectively, and fuel price subsidies were eliminated by May,

allowing prices at the pump to fluctuate with global prices (see Box 2). Similarly, electricity and water prices were revised upwards to increase the cost recovery and improve the financial position of utility providers. The challenge for the government, however, will be to reform subsidies whilst encouraging entities to operate under efficient conditions in order to avoid the pass-through of inefficiencies to consumers. Mitigating the impact on poor households will require a transition to targeted subsidy programs and strengthening of social safety nets, making these policy priorities. Moreover, as previously mentioned, progress in wage bill control will help to balance the fiscal reforms and prevent the over-dependence on subsidy removal as the main lever for adjustment.

Fiscal risks are materializing and may compromise fiscal recovery efforts if not managed proactively.

Fiscal consolidation efforts must address materializing fiscal risks from SOEs. The operational weaknesses of Mozambique's state owned enterprises have been aggravated by the economic downturn. Growing foreign currency loan portfolios, some large inefficient investments, and reliance on central government support placed these companies on a weak footing when the currency depreciated sharply in 2016 and demand slowed. Consequently, the SOE portfolio's performance is deteriorating and a number of key SOEs are struggling to meet debt service obligations. Business interlinkages between non-performing public entities are common and are a source of concern as delays in payments between SOEs may further accelerate financial distress to often already poorly performing entities. A proactive plan to resolve the difficulties of strategic companies under distress and structural reforms to limit the fiscal risks from other companies are more urgent than ever.

²⁸ This includes education, health, infrastructure, agriculture and rural development, the judicial system and social welfare and work.

²⁹ Spending on the social and economic sectors reached 60 percent of total expenditure in 2013 but declined progressively thereafter to 48 percent by 2016.

³⁰ Overall spending in the sector increased 142 percent to MZN 6.2 billion, or 0.9 percent of GDP. Much of this is attributed to a five-fold increase in externally financed investment spending by FIPAG.

Mozambique’s debt position remains untenable.

Debt levels had been on a rising trajectory prior to the undisclosed borrowing, and were magnified further by currency depreciation in 2016. The debt revelations pushed external debt up from 66 to 76 percent of GDP in 2015. The sharp depreciation of the currency in 2016 (32 percent) accounted for the majority of the increase in the stock of external debt to 111 percent of GDP by end 2016. Domestic borrowing pressures also increased in 2016 as the fiscal situation deteriorated at a time when external financing was reduced. Total debt stock at the end of 2016 is estimated at 120 percent of GDP, placing the country in an unsustainable position.

Debt restructuring remains key to restoring fiscal buffers and macroeconomic stability.

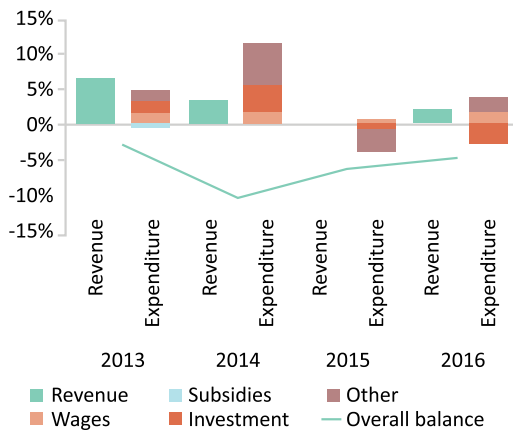
Mozambique is currently unable to service all its debt obligations. It’s default on the sovereign bond was the first for African countries since Ivory Coast defaulted on its government bonds in 2011. Arrears to private creditors have continued to accumulate in 2016 and 2017 and stand at approximately USD 590 million³¹ by July 2017. Hence, the country is likely to remain in debt distress in the medium-term unless the authorities can agree with creditors on a restructuring of a portion of its debt. Measures to strengthen domestic debt management throughout the public sector, not only central government, are also a key ingredient for restoring stability.

Although progress had been made, the pace of reforms to bring public finances back to a sustainable position needs to be accelerated.

Despite the recent measures to contain the cost of subsidies and investment spending, Mozambique’s fiscal position continues to be unsustainable. Progress with the debt restructuring negotiations is critical for reestablishing fiscal stability and halting the accumulation of arrears to creditors. Reforms to control the wage bill and strengthen revenue administration would also help to ease pressures on the budget and limit the build-up of arrears to suppliers. Equally important for restoring sustainability would be a commitment from the authorities to pursue policies that help Mozambique build fiscal buffers and ingrain prudence in the management of public finances in the long-term. Such a policy stance would involve pursuing targets for shifting to a primary surplus and a sustainable debt profile in the medium-term. It would also involve reforms to strengthen the legal frameworks for managing debt and fiscal risks from SOEs and other public sector entities. Lastly, without clear measurement and reporting of the fiscal deficit and government arrears, assessing the fiscal situation and taking the appropriate actions is difficult. Hence, updating the presentation of Mozambique’s fiscal reporting framework to be more consistent with Government Finance Statistics standards would be a key to the success of such a reform program.

Figure 17: Consolidation efforts have been limited...

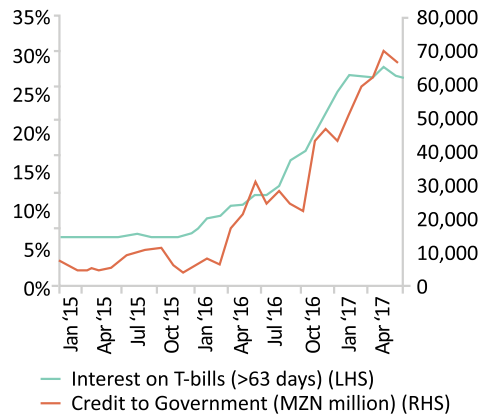
Annual change in revenue and expenditure, 2013-16 (% of GDP)



Source: MEF and World Bank staff estimates

Figure 18: ...with domestic financing playing a significant role in covering expenditures

T-bills auction (average interest on term > 63 days), Central Bank credit to government, 2015-17



Source: BdM

³¹ This figure represents interest and principal arrears.

Table 2: Central Government Finances

(percent of GDP)	2014 Actual	2015 Actual	2016 Estimates
Total Revenue	27.5	25.2	24.0
Tax Revenues	23.5	20.8	20.1
Non-Tax Revenue	4.0	4.4	3.9
Grants	4.3	3.2	2.4
Total Expenditure	39.1	34.3	30.0
Current Expenditure	24.0	21.1	21.5
<i>Of which:</i>			
Compensation to employees	11.3	10.9	11.3
Interest on public debt	1.1	1.3	2.4
Capital Expenditure	15.1	13.0	8.5
Domestically financed	8.3	7.2	3.4
Externally financed	6.8	5.8	5.1
Net Lending	3.0	0.4	0.9
Overall Balance (cash basis)	-10.3	-6.4	-4.5
Primary Balance (cash basis)	-6.2	-5.1	-2.1
GDP (nominal, MZN billions)	532	592	689

Source: MEF and World Bank staff estimates

Table 3: Spending on Social and Economic Sectors

(MZN billions)	2015 Actual	2016 Estimates	% Δ
Education	41,815	46,732	11.8
Health	18,399	20,265	10.1
Infrastructure	21,592	16,903	-21.7
<i>Roads</i>	15,044	8,103	-46.1
<i>Water</i>	2,560	6,202	142.3
<i>Public works</i>	2,022	1,149	-43.2
<i>Mineral Resources</i>	1,967	1,449	-26.3
Agriculture and Rural Development	11,366	8,831	-22.3
Judicial system	4,238	4,050	-4.4
Social action and Labor	5,901	4,692	-20.5
Total	103,311	101,473	-1.8
<i>percentage of GDP</i>	17.5	14.7	...

Source: MEF

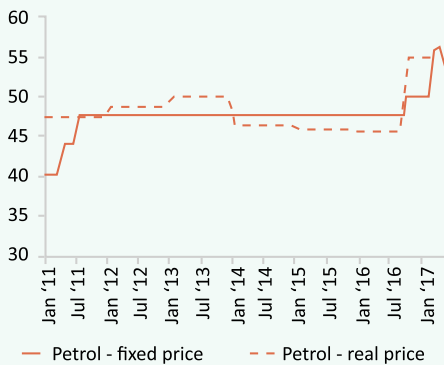
Box 2: The fuel subsidy reforms

Ongoing reforms to Mozambique’s fuel subsidy system are estimated to bring annual savings of up to 2 percent of GDP over the next five years. Mozambique kept fuel prices unchanged between July 2011 and October 2016. The difference between the government set prices and actual costs resulted in a subsidy averaging almost 1 percent of GDP between 2010 and 2014, and over 3 percent of revenue during the

same period. Diesel, which represents 70 percent of total fuel consumption, was the most heavily subsidized product. As part of its reforms to consolidate the budget and reduce exposure to external shocks, the government of Mozambique implemented a series of retail price increases starting September 2016. By May 2017, diesel and petrol prices at the pump were unsubsidized.

Figure 19: Subsidies on petrol have been marginal as fixed prices have been near actual prices...

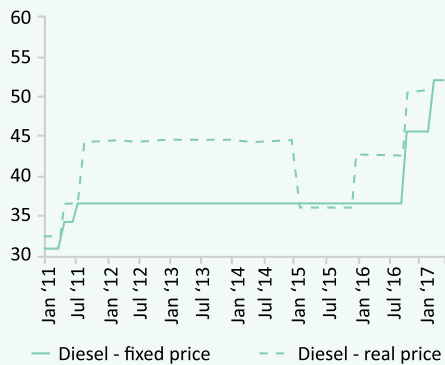
Fixed and real petrol price, 2011-17 (MZN per liter)



Source: MIREME and World Bank staff estimates

Figure 20: ...whilst diesel subsidies have been sizable as the authorities look to dampen public transport costs

Fixed and real diesel price, 2011-17 (MZN per liter)

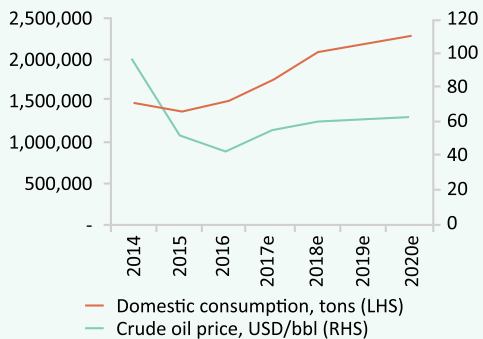


Source: MIREME and World Bank staff estimates

This reform comes in time to mitigate the fiscal impact of rising fuel prices and growing domestic consumption. Fuel imports, excluding LPG, registered at USD 192 million in the first quarter of 2017, up 57 percent on the same quarter last year and highlighting the effects of oil price recovery. Average crude oil price in 2017 is estimated at an average of USD 55 per barrel, up from USD 43 per barrel in 2016. This trajectory is expected to continue in the near-term although growth may be contained by the rebounding U.S. shale oil industry. Rising domestic demand for fuel products linked to population and economic growth pose further pressures. Total fuel consumption increased an average of 17 percent annually between 2012 and 2016, with a notable 70

Figure 21: Oil price recovery and increased fuel demand will place pressures on domestic prices...

Evolution of domestic consumption and average crude oil prices, 2014-20



Source: BdM and World Bank staff estimates

percent increase in 2013 following a surge in FDI and megaproject activity.

Looking ahead, steadfast implementation and investments in expanding robust safety nets are key to the sustainability of the reform. Mozambique's fiscal constraints and the inefficiency of general subsidy

regimes make a clear case for reform. Careful attention should be paid, as part of this policy package, to mitigate impacts on the poor. The authorities will need to invest in robust safety nets, such as cash transfer programs and selected targeting to shelter vulnerable populations.

Outlook

A more favorable external environment is expected in 2017 as commodity prices gradually recover and growth picks up in advanced and emerging economies.

The pickup in trade and favorable financing conditions are contributing to projections of stronger global growth. Growth is predicted to recover modestly in emerging market and developing economies, including sub-Saharan Africa, as obstacles to growth in commodity exporters diminish, while activity in commodity importers continues to be robust. Growth in one of Mozambique's major trading partners, South Africa, is forecast to recover slowly albeit within a context of policy uncertainty.³²

A recovery of commodity prices could bolster Mozambique's growth outlook, at least in the short-term. The recovery in commodity prices, evident in the first quarter of 2017, is set to continue at least in the short-run and could support further gains from Mozambique's key exports: coal, aluminum and gas. Coal prices are projected to rise by 6.2 percent in 2017. There is, however, a risk that they could contract again in the following years as global supply increases. Coking coal prices, which peaked at a record USD 309 in November last year, are forecast to follow a downward trend in the coming years albeit remaining above USD 100 until the end of the decade. If price increases can be sustained and additional production capacity from the recently opened Nacala coal terminal is capitalized, coal's contribution to growth in the Mozambican economy could remain significant.

Growth in agriculture and extractives, along with progress in the peace talks, could steer growth towards 7 percent by the end of the decade.

Growth is projected to follow an upward trajectory over the coming years, with some risks to the outlook. Recoveries in commodity prices and in the agricultural sector, post el-Niño, are the main pillars of the World Bank's 4.6 percent growth outlook for 2017. Moreover, after a sharp slump in confidence in 2016, the approval of the final investment decision by the ENI led consortium to begin developing the Rovuma Basin Area 4 gas fields is expected to contribute to improving investor sentiment in 2017. In the medium-term, further progress in developing Mozambique's Rovuma basin gas projects, developments in the coal sector, and stabilizing macroeconomic conditions are expected to ease inflationary pressures as well as improve both investor and consumer sentiment. Peace in central Mozambique would add a further boost to the outlook if the ongoing peace talks result in lasting stability. The outlook is positive but it is subject to downside risks. The likelihood of this positive outlook is contingent on an economic recovery program that balances fiscal and monetary policy and that provides breathing space to Mozambique's nascent small and medium enterprise sector. Moreover, with much of the outlook hinging on developments in the extractives sector, trends in commodity prices and global demand for resources will continue to pose large risks to growth. Furthermore, whilst spillover effects

³² World Bank Global Economic Prospects, June 2017.

from FDI and large extractives investments into the economy can be expected, more is needed to strengthen growth and job creation in the non-megaproject economy.

The fiscal outlook is strained with consolidation remaining a key priority, and significant fiscal risks ahead.

Mozambique's fiscal outlook continues to be challenging, and will depend on the pace of fiscal recovery reforms. Consolidation reforms remain a priority. Having made progress in reforming subsidies, additional measures to check growth in the wage bill and limit inefficient investments will help to place the economy in a more stable position. The resolution of the ongoing debt restructuring process would represent a boost to the fiscal outlook and an important shift towards reestablishing macroeconomic sustainability.

Fiscal risks from state-owned enterprises are heightened and pose a significant risk to the

outlook. A comprehensive plan to reform the state's enterprise sector, including restructuring and exit strategies where necessary, are key to mitigating these risks and their potential impact on Mozambique's economic recovery.

External pressures may ease further as growth and investment pick up.

The current account deficit is expected to contract to roughly 30 percent of GDP in 2017 before expanding to almost 60 percent of GDP by 2019 to accommodate LNG infrastructure development. Preliminary data for 2017 point to a further contraction in the current account balance, largely driven by growing coal exports and reduced import levels. This trend should help to stabilize the metical and bolster reserves. A sharp increase in gas investments is expected to widen the deficit in the medium-term, largely supported by an accompanying increase in FDI.

Table 4: Outlook

	2016	2017p	2018p	2019p
External Scenario				
Real GDP (% Δ)				
Euro Area	1.8	1.7	1.5	1.5
China	6.7	6.5	6.3	6.3
Sub-Saharan Africa	1.3	2.6	3.2	3.5
South Africa	0.3	0.6	1.1	2.0
Nominal Commodity Price				
Aluminum USD/mt	1,604	1,800	1,828	1,856
Coal, Australia USD/mt	66	70	60	55
Coking coal, Australia USD/t	146	194	132	115
Natural gas, Europe USD/mbtu	4.6	5.0	5.2	5.4
Tobacco USD/mt	4,806	5,000	4,960	4,920
Domestic Scenario				
Real GDP and Current Account Deficit				
Real GDP, % Δ	3.8	4.6	5.3	6.4
Current Account Deficit, % of GDP	-38.1	-29.5	-36.0	-57.1

Source: World Bank, Bloomberg;
p = Projection



Part Two: Mozambique's Private Sector – A tale of two speeds

This section explores the profile of Mozambique's formal private sector and the impact of the ongoing economic downturn on its performance. The recently released firm census, *Censo de Empresas (CEMPRE)*, which covers Mozambique's formal private sector, suggests that Mozambique's resource-driven growth acceleration has been accompanied by an expansion in the non-extractive private sector. The overall number of firms doubled since 2002 and these businesses now employ twice as many workers as in 2002. In spite of this, dynamics in the firms' landscape have been lopsided. The private sector remains highly concentrated with a small number of large firms dominating output on one end of the spectrum, and a large number of less productive micro firms on the other end. There is also a persistent pull wielded by Maputo, which continues to attract the largest share of new economic activity.

There have been some positive signs. The share of small and medium enterprises in the formal private sector is growing, a phenomenon that bodes well for overall productivity growth. However, the ongoing economic downturn is likely to have a disproportionately negative impact on these emerging micro, small and medium enterprises. A review of the emerging

evidence indicates that while megaprojects and large industries are showing some resilience, the rest of the private sector, the green shoots, are facing reduced demand, higher costs and more difficult access to credit. Given Mozambique's openness and its exposure to the commodity cycle, reforms to improve the business environment, strengthen competition, as well as improve education and skills are essential.

Mozambique's Firm Landscape prior to the crisis

Between 2002 and 2015, formal employment and the total number of firms in Mozambique doubled;³³ Maputo amplified its position as the country's center of economic activity.

Mozambique experienced robust growth in the number of firms over the past 15 years and significant growth in the services sectors.³⁴ According to the latest firm census, the number of firms that are formally registered in Mozambique grew by 4 percent per annum between 2002 and 2015.³⁵ Data shows that growth was particularly robust in construction

³³ Based on data from the recently completed business census: 2014/2015 *Censo de Empresas (CEMPRE)*. The census covers formally registered businesses only.

³⁴ Data shows a decline in the number of firms for manufacturing and agriculture between the two census periods (2002 and 2015).

³⁵ According to the latest business census CEMPRE, the number of registered formal firms increased from 28,314 in 2002 to 43,010 in 2015.

and services such as real estate, financial services, transport and logistics. The number of firms in the manufacturing sector remained unchanged, while that of agriculture and fishery, and tourism declined.

Almost two thirds of firm growth in the past decade happened in Maputo City and the Greater Maputo area. The Maputo area, which contains approximately 10 percent of Mozambique's population captured 62 percent of the expansion in the number of firms. Maputo City and greater Maputo also registered the highest rates of employment growth, followed by the provinces of Sofala and Nampula.

New jobs were created particularly by firms in poorer regions. In 2002, 28,000 firms reported employing 255,000 people. By 2015, both the number of firms and employment had doubled. Employment growth between 2002 and 2015 was widespread, with significant job growth in central and northern provinces including Tete, Sofala, Nampula and Zambezia, where poverty levels are accentuated. Outside of the extractives sector, the highest employment growth was registered in the real estate sector.

The bad news: Informality remained high and value added in the formal sector continued to be concentrated in a few large firms.

Much of the private sector in Mozambique remains informal. Approximately 40 percent of Mozambique's GDP is currently produced in the informal private sector, one of the highest shares in Sub-Saharan Africa.³⁶ According to the latest household survey, between 70 to 80 percent of the Mozambican labor force works in the informal sector. Those working in the informal sector lack access to legal protection, social security and pension benefits. Because of the informal nature of their business they also have no access to formal finance and might find it difficult to recruit skilled labor; two factors that will limit their ability to grow their activity and contribute to economic growth.

The formal private sector continued to be dominated by a handful of firms, with 70 percent of employment, revenues, and value added in Mozambique being generated by just seven percent of all registered firms.

This concentration constituted only a slight improvement in comparison with 2002, when 70 percent of revenues and employment were generated by only five percent of all firms. The role played by Mozambique's highly capital intensive megaprojects was a key driver of the concentration in value added amongst the large firms. It presents a stark contrast with Mozambique's micro firms. In 2015, three fourths of firms in Mozambique's formal sector were micro businesses that employed fewer than five employees. These were typically involved in low productivity endeavors, and all together accounted for just 16 percent of revenue and 13 percent of employment.

Since 2002, the productivity of the average firm in the extractives sector by far outpaced that of firms in other sectors. With an annual increase of 22 percent, labor productivity of the average firm in the extractives sector grew more than seven times as fast as in the agricultural sector, the only other sector which registered significant positive productivity growth between 2002 and 2015. Also, while still small in terms of its overall contribution to GDP, firms in the extractives sector were also already punching above their weight in terms of each firm's contribution to value added. Similarly, exports from the extractives sector have been increasing steadily, accounting for on average 25 percent of all exports between 2011 and 2016. And more than half of total FDI flows have gone to the sector since 2009.

The good news: A greater share of small and medium enterprises and signs of increasing competition within sectors signal some budding dynamism in Mozambique's private sector outside of the extractives sector.

There have been some signs of a growing "middle" in Mozambique's firm landscape, a

³⁶ IMF Regional Economic Outlook 2017.

development that bodes well for productivity growth.³⁷ While Mozambique's firm landscape continued to be dominated by very small (so called micro) firms,³⁸ there were some signs of a slowly growing "middle", i.e. the share of small and medium sized firms was increasing. Since 2002, the share of small and medium sized firms, defined as firms with 5 to 19 (small) and 20 to 100 (medium) employees, grew from 19 to 25 percent. Moreover, the share of these "middle" firms among the group of high performing firms increased from 21 to 36 percent (Figure 26).

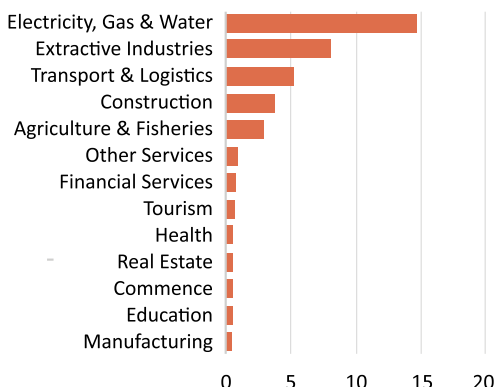
There were also signs that some sectors are slowly becoming more competitive. One

symptom of efficient allocation of resources across sectors is that productive firms drive the less productive ones out of business. As a result, productivity dispersions tend to be smaller in more competitive sectors. In 2015, productivity dispersions of firms in Mozambique still tended to be high within sectors with the exception of the financial sector. However, when compared to 2002 these within sector productivity dispersions have been on the decline across the board, suggesting a tendency towards more efficient resource allocation (Figure 28). Within sector productivity dispersion has declined the most amongst agricultural firms, as well as in the education sector and financial services.



Figure 22: Utilities and extractive industries punch above their weight in terms of value added...

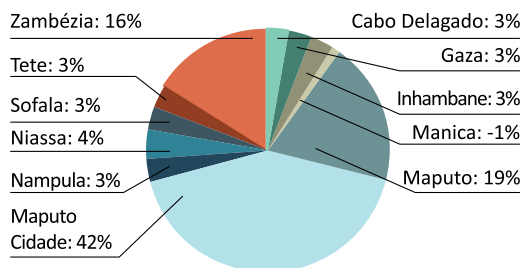
Concentration of value added per sector,³⁹ 2015



Source: INE, Censo de Empresas (CEMPRE)

Figure 23: ... and Maputo has captured a large share of firm growth

Share of firm growth by province, 2002-15



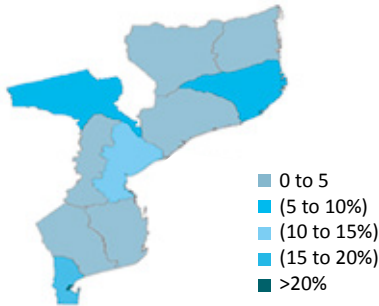
Source: INE, Censo de Empresas (CEMPRE)

³⁷ The firm landscape in many developing countries tends to be marked by a "missing middle", a dearth of small and medium size firms, as firms choose to stay informal or very small to avoid excessive government regulation. This phenomenon is problematic for economic growth as it has been shown to be associated with weak overall productivity growth as informal and very small firms tend to lack access to resources like capital and skilled labor (La Porta and Shleifer, 2008).

³⁸ Three quarters of firms in Mozambique employ fewer than five employees.

³⁹ Concentration is measured by dividing the sector's share of total value added by its share of total firms. For example, electricity and gas contribute 2.3 percent to total value added but since this is generated by only 0.4 percent of total firms, it is a sector with a high concentration of value added.

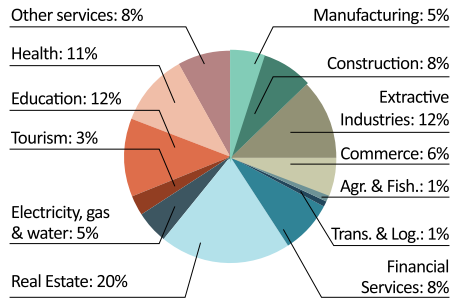
Figure 24: Maputo has also accounted for the largest share of employment created ...
Share of new jobs created by province, 2002-15⁴⁰



Source: INE, Censo de Empresas (CEMPRE)

Figure 25: ... and employment growth has been diversified

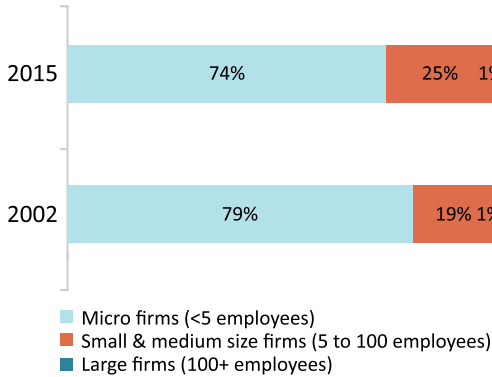
Formal private sector employment by sector, 2002-15



Source: INE, Censo de Empresas (CEMPRE)

Figure 26: The share of small and medium firms has been growing...

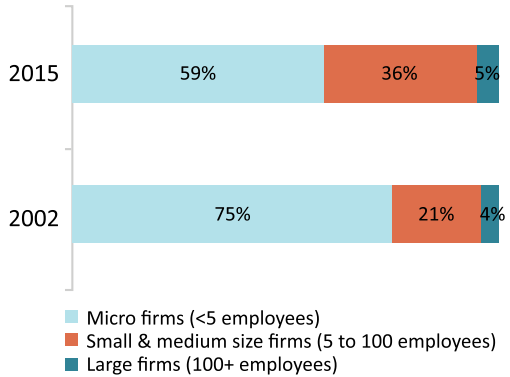
% of total number of firms by firm size



Source: INE, Censo de Empresas (CEMPRE)

Figure 27: ...as well as in productivity

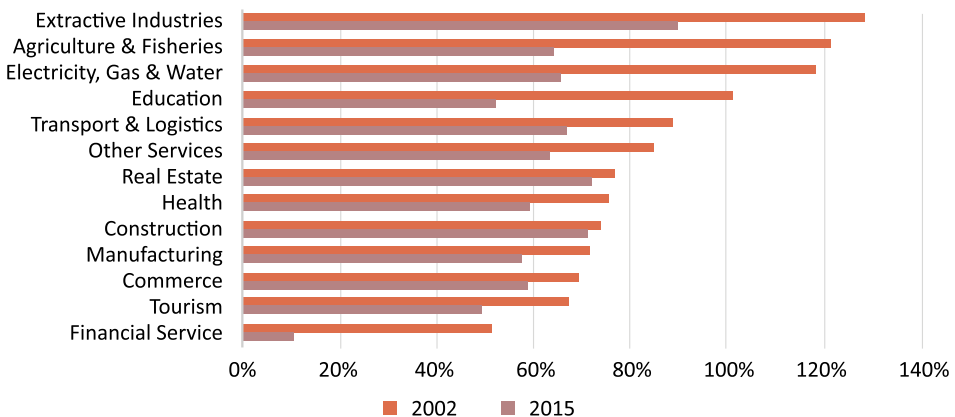
% of firms in the top productivity quartile by size



Source: INE, Censo de Empresas (CEMPRE)

Figure 28: Productivity dispersion within sectors has declined suggesting increased competition

Percentage difference between labor productivity for 90th percentile productive firms and 10th percentile productive firms, 2002 / 2015



Source: INE, Censo de Empresas (CEMPRE)

⁴⁰ The map presents the share accounted by each province in total job creation between 2002 and 2015, by taking the level change in jobs per province over total additional jobs in the country.

Impact of the Economic Downturn

Private sector confidence, a key indicator for growth, had already been on the decline before the debt crisis.

The private sector's outlook started deteriorating in mid-2015 and plunged further after the debt crisis. The private sector's demand and employment prospects and their overall confidence in the economy started weakening in 2015 when low commodity prices and tapering gas exploration became headwinds to growth. The debt revelations in April 2016 triggered a deeper crisis in confidence that was eventually reflected in a decline of business confidence indicators and translated into a sharp reduction in growth.

A divergence appears between megaproject firms and the rest of the private sector when assessing the impact of the economic crisis.

Recent trends indicate that the non-extractives private sector is hit hard by the current downturn. Export trends in 2016 demonstrate this divergence; extractives exports increased⁴¹ by 43 percent whereas non-extractive exports declined by 19 percent in 2016 (Figure 32). A commencing recovery in commodity prices by the end of the year, especially for coal,⁴² and

positive FDI flows helped support growth in extractives exports.⁴³ The rest of the exporting private sector however suffered a decline. Constraints in access to credit and slowing investment are likely to have played a key role in this trend, along with the impact of the El Niño drought on agricultural exports.

Industrial production indicators further confirm a lower level of resilience in the non-extractives economy. Whilst extractive industries experienced modest growth in production levels since the onset of the downturn, all other industrial sectors experienced a significant contraction in 2016. Extractives and minerals recorded 14 percent growth in production. Meanwhile, industries such as food processing and other small industries registered 5 and 33 percent declines in production respectively (Figure 33).

Commerce and services, core pillars of the domestic economy, have been particularly affected by the economic downturn. Commerce and services, which have been indirect beneficiaries of the extractives boom, saw their turnover decline by 14 and 13 percent respectively in 2016 (Figure 31).⁴⁴

Box 3: Listening to the private sector - what business confidence tells us about growth

"Soft data" such as business confidence indicators can be informative of short-term economic prospects and the likely direction of "hard data" such as GDP growth. In the case of Mozambique, the relationship between these two indicators is informative. When statistically tested, the business demand indicator is found to have a causal correlation with GDP at a one quarter lag. Based on this,

a retrospective forecast of GDP in 2015 and 2016, using business demand and a seasonal component as explanatory variables, shows the convergence between the soft and the hard data. The forecast is close to the actual in most quarters but seasonal peaks seem to be underestimated suggesting a certain measure of conservatism in private sector expectations.

⁴¹ Extractives refer to precious stones, heavy sands, coal and natural gas.

⁴² Coal exports increased by 91 percent.

⁴³ Despite the recovery observed in 2016, megaproject exports are still 1 percent below their 2014 level in USD terms.

⁴⁴ Commerce includes wholesalers, retailers and car sales. Services include transport, tourism, real estate, social sectors and other services.

Figure 29: GDP forecasts based on business demand indicators

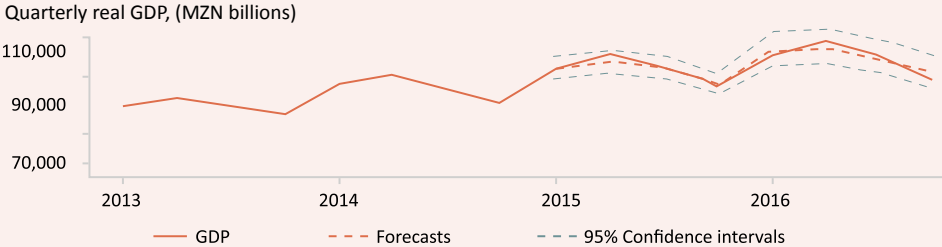


Figure 30: Declining private sector confidence is reflected in slower growth...

Trend in economic confidence indicators, currency depreciation/appreciation against USD since Jan 2015, 2015-17 (2004 =100 for indicators)

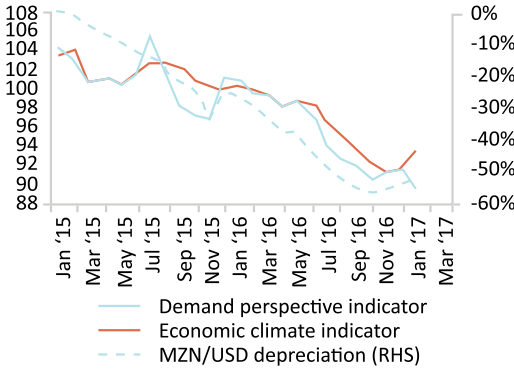


Figure 31: ...turnover indices show sharp downturns in commerce and services

Average Year-on-Year Variation (Constant Prices)

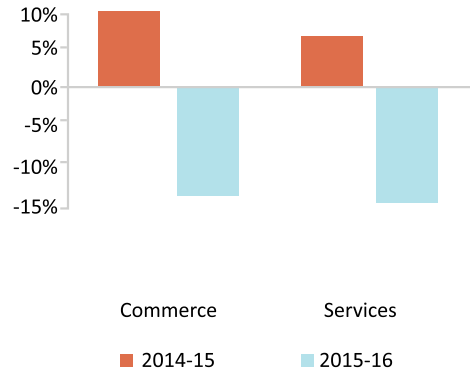


Figure 32: Exports show a divergence between extractives and the rest of the of exporting private sector...

Annual Exports, 2013-16 (USD Millions)

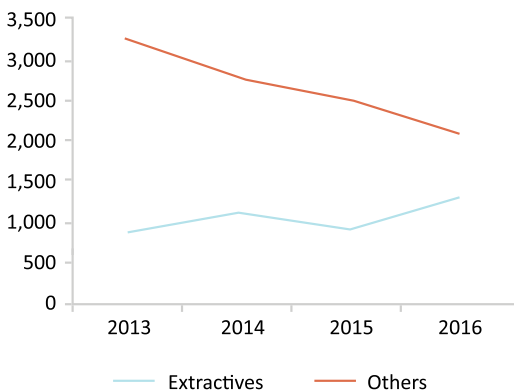
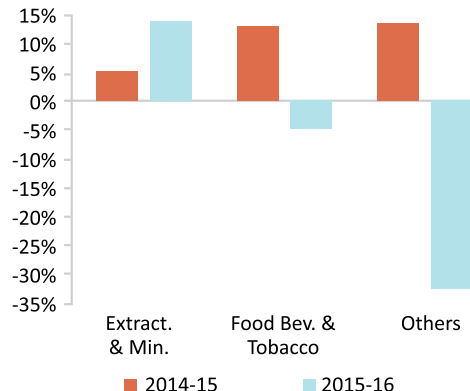


Figure 33: ...and industrial production indicators confirm this trend.

Industrial Production Index Year-on-Year Variation



Demand, investment, credit and costs are key transmission channels.

The ongoing economic downturn and macroeconomic environment is affecting Mozambique’s small and medium enterprises through falling demand and investment, and higher costs, including in credit markets. We review these issues in turn:

- **Falling investment in the non-extractives economy.** Total investment in the economy declined by 30 percent in real terms in 2016. At the same time, FDI inflows fell by 20 percent, driven by lower external investment in the non-extractives economy (down 27 percent). Among non-exporting sectors, real estate and construction were particularly affected, with FDI down from 40 to 75 percent.
- **Capital, input, and labor cost pressures.** Higher costs driven by a weakened metical and high inflation are raising the cost of intermediate and capital goods imports, and placing pressure on the cost of labor. As shown in Figure 34, intermediate and capital goods imports decreased by 17 percent in 2016. The trend is more pronounced for the non-extractive sectors, where the value of these imports declined by 41 percent in

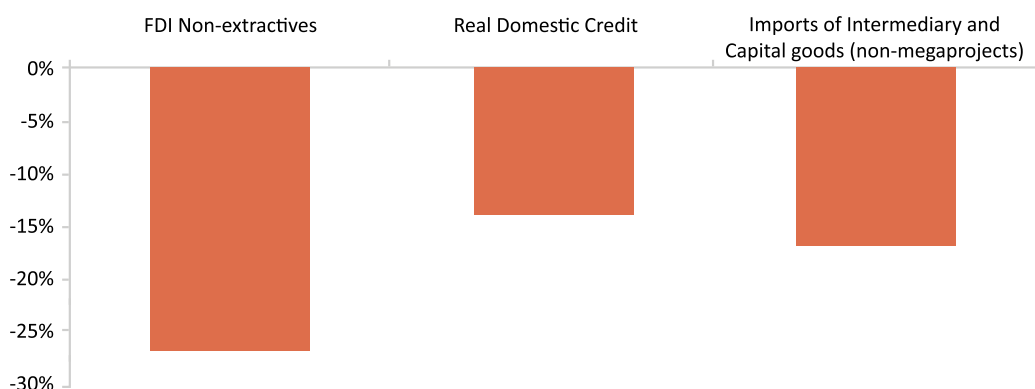
2016. The private sector is likely to face further upward pressures on the cost of labor as employees may seek to maintain their purchasing power in real terms under a high inflation context.

- **High cost of accessing credit domestically.** Access to finance has become very difficult for exporters and non-exporters. Lending by domestic banks has slowed from already low levels. Real credit to the private sector decreased by roughly 14 percent⁴⁵ in the 12 months to December 2016, as real interest rates remained largely positive throughout the year. Exporting firms have also found it difficult to access credit in foreign currency, an important prerequisite for their trading activities, as foreign currency liquidity tightened in the second half of 2016. As such, the stock of domestic credit in foreign currency declined by 30 percent between January 2015 and December 2016.
- **A drop in demand growth.** Growth in consumption fell to 5 percent in 2016, having averaged 7 percent since 2010 as a spike in inflation eroded purchasing power and as the government’s budget came under pressure. The fall in demand had a direct impact on sectors serving domestic markets such as services and local food processing.



Figure 34: Economic crisis transmission channels to the private sector

% change, 2015-16



Source: INE, BdM

⁴⁵ Variation of credit to private sector in domestic currency.

Box 4: Tourism – slowing even before the economic crisis

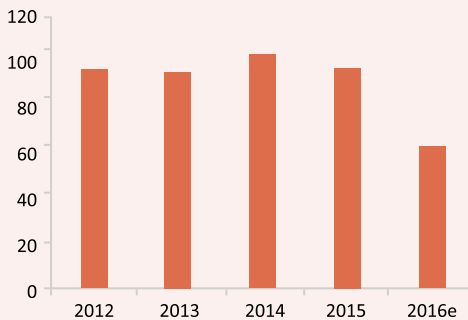
Despite the huge potential of the tourism sector, it has been struggling since at least 2012. Hotel revenues were 34 percent lower in 2016 than in 2012. In the same period of time, tourist and business international arrivals decreased by 24 percent. The volume of overnight stays and the average duration of stay has also fallen mildly.

The decline of this sector throughout the last five years suggests that tourism could be suffering from structural constraints which go beyond the current crisis. International arrivals may have been compromised by the high cost of domestic and international flights to Mozambique, an underperforming national carrier, and the image of instability caused by the armed

conflict in the center of the country are affecting the performance of the sector. A study by USAID-SPEED – *Economic Cost of Conflict in Mozambique (2014)* – found that the conflict between late 2013 and the first quarter of 2014 resulted in an estimated decrease in spending on tourism of 26 percent (equivalent to approximately USD 3.25 million). Additionally, obtaining a business or tourism visa for Mozambique remains burdensome in comparison with its neighboring countries despite some recent facilitation in granting access to visas at the border. These trends indicate that tourism is a sector that needs to be bolstered for it to meet its potential., especially now that progress is being made in securing peace in central Mozambique.

Figure 35: The economic crisis has further aggravated the declining trend in tourism earnings...

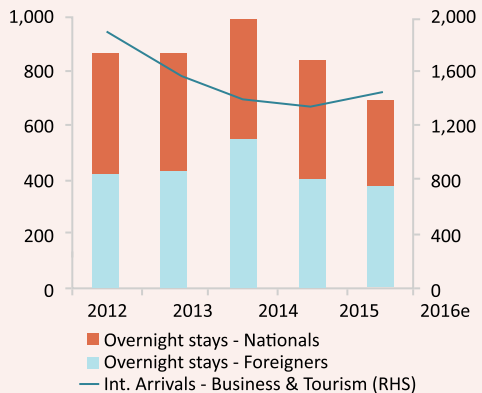
Hotel revenues, 2012-16 (USD millions)



Source: INE

Figure 36: ...in part due to lower overnight stays and international arrivals

Overnight stays and international arrivals, 2012-16 (Thousands)



Source: INE

Supporting small and medium enterprises through the crisis and beyond

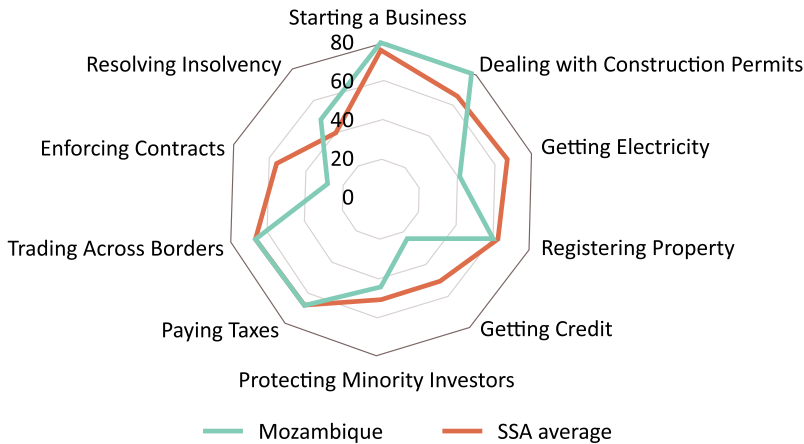
In the short-term, reestablishing macroeconomic stability through a balanced mix of fiscal and monetary policy is critical. An uncertain and weakened macroeconomic context is one of the major causes of disruption to private sector activity. The onset of Mozambique's current economic downturn has been met with a policy response to support the recovery of the economy. The response has been more heavily anchored in monetary policy, which has been important for stabilizing

the depreciating metical. The fiscal adjustment program is also commencing, but it comes at a relatively modest pace. In the meantime, the private sector has been operating under tight monetary policy conditions and a high interest environment. Looking ahead, a rebalancing towards a credible fiscal adjustment program would help the monetary policy tightening cycle to be unwound as the currency stabilizes and inflation decelerates in the second of half of 2017, which help ease the pressure on Mozambique's small and medium enterprises. In addition, placing debt on sustainable path and introducing structural reforms to public finances will improve the risk profile of the Mozambican economy and attract more foreign capital to support private sector investment.



Figure 37: Mozambique scores poorly in several Doing Business indicators when compared to the region's average...

Doing Business indicators – Mozambique vs Sub-Saharan Africa, 2017 (Distance to Frontier)



Source: World Bank

In the medium-term, overcoming the structural factors that constrain the competitiveness of the private sector and its resilience to shocks is a priority. As extractive industries play an increasingly important role Mozambique's economy will continue to be exposed to the commodity cycle and external shocks. There are also risks that the non-extractives sector gets stifled by the heavy economic weight of the extractives sector. Reforms to make the private sector more resilient and competitive will help Mozambican firms to weather future crises and to realize the potential for a dynamic and diversified economy. Some of the key policy areas include:

- Infrastructure and skills:** According to the 2016 World Economic Forum's Global Competitiveness Index, Mozambique scores low on the provision of infrastructure, higher education and training, innovation and business sophistication. Compared to other low-income countries in the region, Mozambique falls particularly behind on human capital relevant factors such as the quality of the health and education system. These factors limit the ability of Mozambican firms to compete in the world. In addition, Mozambique's labor law imposes high costs on taking a chance on those who might still

require training on the job: The Mozambican labor law forbids firms the use of short-term -contracts for permanent tasks and imposes on them one of the highest costs of dismissal in Sub-Saharan Africa.⁴⁶

- Access to credit:** Mozambican firms have limited ability to access finance in exchange for collateral with scarce credit information and a weak collateral framework for non-moveable assets being key constraints. In addition, the absence of a legal framework that would allow for the collateralization of movable assets such as farm inventories and jewelry limits those who could pledge other possessions.⁴⁷ Further, building “*reputational collateral*” instead of “*physical collateral*” is difficult in Mozambique. The absence of a comprehensive credit reporting system compromises banks’ ability to distinguish good from poor performers and makes them reluctant to lend in the absence of collateral.⁴⁸ Similarly, equity finance is constrained by a corporate governance regime that provides few incentives for firms to make financial information and audited reports of their activities available. As a result, investors are hesitant to invest because they cannot assess the viability of firms seeking finance.⁴⁹
 - Contract enforcement:** It takes 950 days to enforce a simple contract in Mozambique, 50 percent longer than in other Sub-Saharan African countries, and the costs associated with going to court are nearly three times as high as in the rest of the continent. When it
- takes that long to get justice many contracts and economic activities never take place. Weak contract enforcement has been found to keep firms from formalizing⁵⁰ and credit to be rationed as banks fear that they cannot enforce collateral.⁵¹ Similarly, weak court systems discourage firm’s from developing and exporting products that are contract-intensive (usually, the higher value added products)⁵² and foreign investors’ from setting up shop in a foreign country.⁵³
- Insolvency and firm resolution:** Economic crises can result in firms having to go out of business. In such cases, it is important that an insolvency regime is in place that supports firm resolution in a way that guarantees a high recovery of assets so that they can be quickly re-deployed into the economy. In Mozambique, investors can currently hope to recover 34 cents to the dollar of the assets invested in company. This is a higher rate than in other Sub-Saharan African countries, but only half of what can be recovered through insolvency proceedings in high-income countries.
 - Leveling the playing field:** As the economy rebounds from the crisis, it will also be important that new firms find it easy to enter the market and get a fair chance to compete. This requires business registration procedures that are simple and competition policies that ensure a level playing field for all firms. Firm entry regulations in Mozambique have been eased over the years,⁵⁴ but there remains room for streamlining the procedural

⁴⁶ World Bank (2016b).

⁴⁷ A draft Secured Transactions law has been prepared and is in the final stages of approval. The implementation of this law will be an important achievement for Mozambique and will help expand the range of collateral available to borrowers.

⁴⁸ As of the latest Doing Business Report, the public credit registry at the Central Bank contains information for only 5 percent of the country’s population and there are limitations to what type of data is collected for this 5 percent. A private credit bureau does not exist. In addition, the legal framework for the collateralization of movable assets is very limited. Both factors resulted in a score of only 25 out of 100 points on the distance to frontier measure of the “Getting Credit Indicator” in the latest publication.

⁴⁹ As of the latest Doing Business report, Mozambique scores only 43 out of 100 points on the distance to the frontier measure for “Protecting Minority Investors”, the indicator capturing the quality of a country’s corporate governance regime.

⁵⁰ Dabla-Norris and Inchauste (2007).

⁵¹ Economies with a more efficient judiciary, in which courts can effectively enforce contractual obligations, have been found to have more developed credit markets and a higher level of development overall. See, for example, Mehnaz Safavian and Siddharth Sharma (2007).

⁵² Nunn (2007) found that countries with weak contract enforcement are less likely to export goods that require relationship-specific investments. According to his estimates, contract enforcement explains more of the patterns of trade than physical capital and skilled labor combined.

⁵³ See, for example, Esposito et al. (2014).

⁵⁴ According to Doing Business, the time to start a business was reduced from 174 to 19 days and the number of procedures reduced from 15 to 10 between 2006 and 2016. However, other countries reformed more aggressively at the same time, which explains why Mozambique still ranks relatively low on this indicator.

complexity imposed on the private sector. Worldwide, Mozambique still ranks 137 out of 190 economies in this regard. Competition policy in Mozambique is still taking its first steps.⁵⁵ While the legal framework has been in place since 2013⁵⁶ and a competition authority was constituted in 2014, it has yet to take up operations.⁵⁷

- **Supportive government institutions:** For firms to focus on their productive activities, they require the support of their governments.

Governments that resort to excessive regulation or make it cumbersome for firms to comply with regulatory obligations, such as complicated procedures for tax payments,⁵⁸ represent an unnecessary cost to firm activity and create incentives for firms to stay informal. Unfortunately governance indicators for Mozambique reflect a gradual decline of government effectiveness, control of corruption, the rule of law, voice and accountability over the past several years.

⁵⁵ Competition policy is generally seen as the fourth pillar for government's economic policy, along with monetary, fiscal and trade policies. Competition policy is defined as the policy specifically directed to prevent anticompetitive business practices by firms and unnecessary government intervention in the marketplace and is usually carried out by a competition agency as defined by a competition law. (UNTAD (2011)).

⁵⁶ The Competition law is Law 10/2013 of 11 April 2013. Further steps towards the implementation of the competition law in Mozambique were taken with the publication of the Statute of the Authority and of the Competition Law Regulation on 1 August and 31 December 2014, respectively.

⁵⁷ World Bank (2016a).

⁵⁸ According to Doing Business, the total statutory tax rate for Mozambican firms is low compared to other countries in the region and even compared to rich countries, but Mozambican firms deal with more than twice as many payments as their peers in richer countries, tax audits are frequent and a VAT refunds take a long time.

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