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# Mozambique Economic Update
## Resilience on the path to improvement

November 2017

# Table of contents

# Executive summary

*Mozambique's primary concern this year has stemmed from the ongoing fallout relating to the external debt scandals that became known in early 2016.*

The government is in default and direct international budgetary support has all but disappeared, although donor aid is still flowing to the country for specific projects via non-governmental agencies.

Despite these concerns, there is an aura of optimism going into the tail-end of 2017 that Mozambique is on the road to improvement. Real GDP growth is recovering, inflationary pressures are receding, and the central bank has commenced a more accommodative monetary policy cycle.

The government is continuing talks with the International Monetary Fund (IMF), with an independent audit on the loans surrounding the external debt scandals an important first step to restoring confidence.

While Mozambique faces significant headwinds and challenges, the country still offers a relatively stable macroeconomic and investment environment over the medium to long term. Given its vast natural resources, fallout from the external debt crisis is expected to be a challenge only in the short term. Investor interest has proven to be resilient, with the natural gas sector in particular projected to assist in getting Mozambique over the debt hurdle.

# Pockets of political volatility

*Mozambique has enjoyed relative political stability since its extended civil war ended some two-and-a-half decades ago.*

The ruling Frente de Libertação de Moçambique (Frelimo) party has dominated the political environment.

However, tensions from Mozambique's volatile political past continue to raise their head on a sporadic basis. The official opposition party, the Resistência Nacional Moçambicana (Renamo), has threatened (and occasionally carried out) violence in an effort to force Frelimo to accede concessions that the opposition party cannot win democratically.

Renamo has the capacity to destabilise – partially at least – the central parts of Mozambique, which is a key region given its rich natural resources and linkages to the ports on the coast. As the opposition party's threats have the potential to deter foreign investment, Frelimo will likely acquiesce to demands made by Renamo.

Looking ahead, Frelimo is expected to win a majority in the 2019 general elections.[1] There is a possibility of increased volatility within the party as members vie for power heading into the elections. The political uncertainty that is being stoked by the main opposition party could be exacerbated by fiscal austerity measures that have been put in place after the 2016 exposed external debt scandals.

Nevertheless, Mozambique still enjoys a reputation of being relatively peaceful, with small outbreaks of violence unlikely to escalate into a serious rebellion.

# Economy starting to shake off debt crisis consequences

## Waning international budgetary support

Mozambique's budgetary aid has dried up following the emergence of the external debt scandals last year. The Group of 14 (G14) budget support donors withdrew their budgetary aid to Mozambique in May 2016.[2] This was a major blow to Mozambique, given that donor aid amounted to some 2% of GDP in 2015.[3]

Donor organisations such as the World Bank however continue to fund large projects. The World Bank also announced a new Country Partnership Framework with Mozambique on 30 March 2017, which includes access to US$1.7bn over the 2017-21 period for specific projects.[4]

In that vein, the World Bank released US$62m to the national statistics office in July 2017, and a further US$150m for the improvement of the country's power distribution in September 2017. The new agreement between the Mozambican government and the multilateral organisation is an important first step to recommencing much-needed international budgetary support.

Nevertheless, with the withdrawal of budgetary donor support exacerbating fiscal pressure, the Mozambican government has been unable to meet its obligations this year. In an update to the markets in August 2017, Moody's Investors Service noted its expectation that *"the ongoing default event will result in sizeable losses for private creditors"*.[5] The default event refers to missed coupon payments on Mozambique's so-called 'tuna-bond', which was restructured in early 2016.

In an effort to restore budgetary support, the government acquiesced to requests for an independent audit report, performed by international risk consultancy, Kroll. In June 2017, the government released a summary of the findings of Kroll's independent audit report concerning state-owned Ematum (Empresa Mocambicana de Atum), ProIndicus and MAM (Mozambique Asset Management). However, in a statement following a visit to Mozambique in July 2017, the IMF noted that *"critical information gaps remain unaddressed"* in the Kroll audit report. Specifically, some US$500m remains unaccounted.

Concern remains that the external audit by Kroll was not enough to lift the veil of opacity connected with Mozambique's external debt scandals. This will make it difficult for international agencies to resume budgetary support initiatives, with the economy likely to face pressure as a result.

## Real GDP growth and outlook

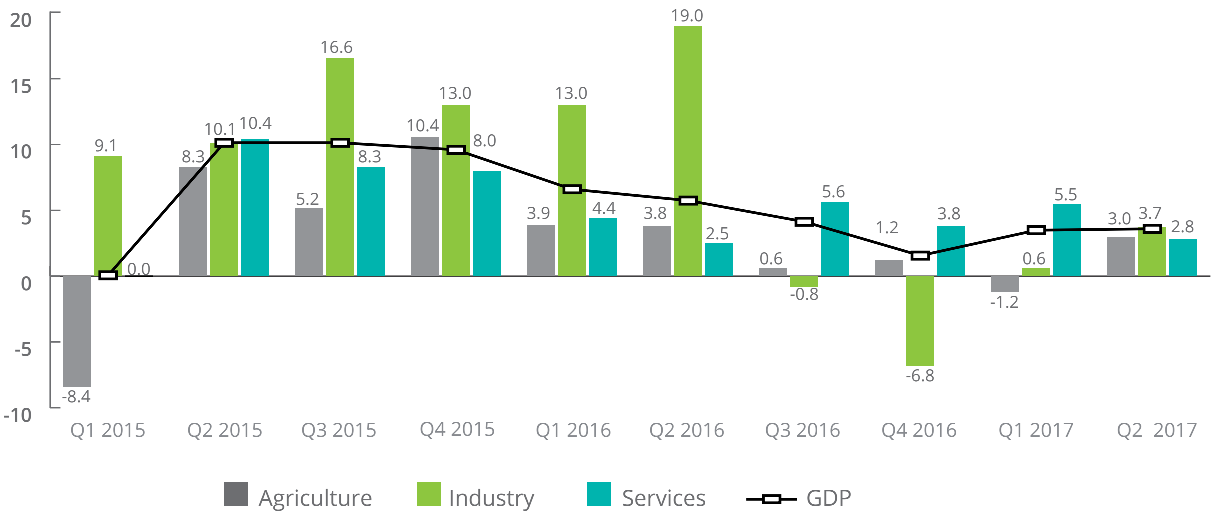
Mozambique's real GDP growth over the 2000 to 2015 period averaged 7.4% per annum.[6] This rapid growth has been the hallmark of the country's macroeconomic profile over the last two-and-a-half decades. As one of the fastest-growing economies on the continent, the southern African country outperformed both regional and global growth averages.

The external debt crisis, along with lacklustre international demand for Mozambique's commodity exports, saw real GDP growth slow to an estimated 3.8% last year. This was the second slowest annual expansion since the turn of the century, only behind Mozambique's 1.7% growth rate in 2000.

More recently, the Mozambican economy expanded by 3% y-o-y in Q2 2017, rising marginally from the 2.9% y-o-y growth recorded in Q1 2017.[7] The best performance in Q2 2017 was seen in the industrial sector, which accelerated from the weak 0.6% y-o-y recorded in Q1 to 3.7% y-o-y in Q2. The industrial sector's recovery over the April to June 2017 period was driven by the extractives sub-sector, which grew by a sharp 59.4% y-o-y. However, the industrial sector's expansion was impeded by the manufacturing and utility sub-sectors, which contracted by 9.3% y-o-y and 12.9% y-o-y, respectively, in Q2.

The agricultural sector recovered from a 1.2% y-o-y contraction in Q1, expanding by just over 3% y-o-y in Q2. The services sector slowed from a robust 5.5% y-o-y recorded in Q1 to 2.8% y-o-y in Q2 2017. The slowdown stems from weak performances in the financial services and hospitality sub-sectors, which contracted by 5.2% y-o-y and 3.7% y-o-y respectively. Regarding the former, pressure on the banking system from a combination of lower foreign exchange availability and increased central bank regulation translated to contraction in the financial services sector. The hospitality sector also suffered as a result of lower forex availability, with lesser business tourists and foreign donor activity exacerbating pressure on the sector.

**Figure 1. Real GDP growth (% change, y-o-y), Q1 2015 – Q2 2017**




***Source: INE, 2017***

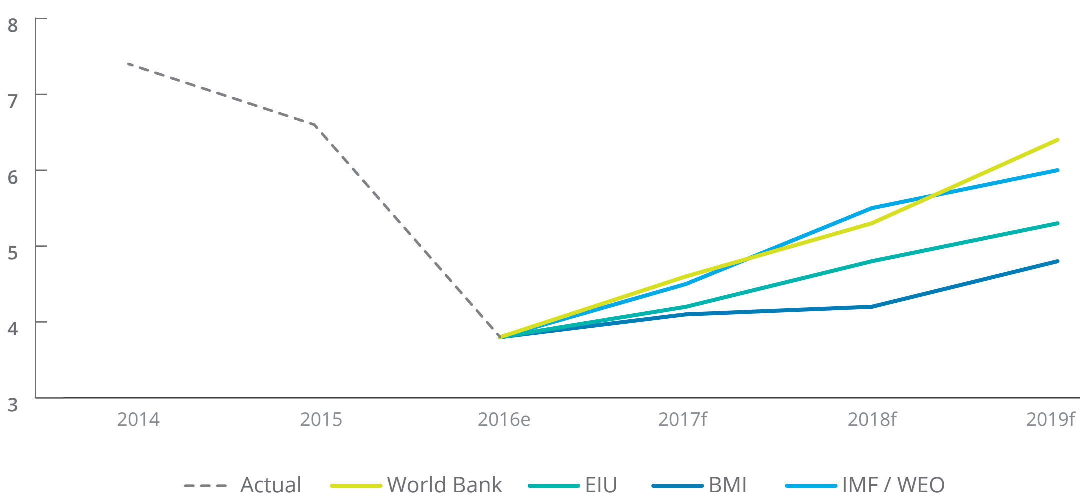
Recent data releases from the INE are in line with the World Bank's July 2017-released assessment that the country is *"showing some signs of recovery"*.[8] However, Mozambique still faces several potential headwinds. The country relies heavily on its commodity exports, and another international price slump could potentially have significant adverse consequences. Budgetary aid remains elusive, despite efforts to increase governmental transparency.

Nevertheless, the consensus among international agencies is that Mozambique's economic prospects are positive. Real GDP growth is projected to grow by over 4% this year, with the World Bank forecasting growth of up to 4.6% in 2017.

Mozambique's economic growth outlook for 2018-19 is also positive, although there are wider discrepancies between the different agencies as to how positive.

At the top end of the scale, the IMF sees real GDP growth averaging 5.8% over the next two years. On the more pessimistic end of the scale, Business Monitor International (BMI) expects the economy to expand by an average of 4.5% over the 2018-19 period. While fallout from the debt scandals is set to remain over the medium term, Mozambique's growth outlook is still relatively robust, albeit not quite at the same levels seen before 2016.

**Figure 2. Real GDP growth (%), 2014-19f**




***Sources: BMI, 2017; Economist Intelligence Unit N.A. Incorporated, 2017; IMF WEO, 2017; INE, 2017***

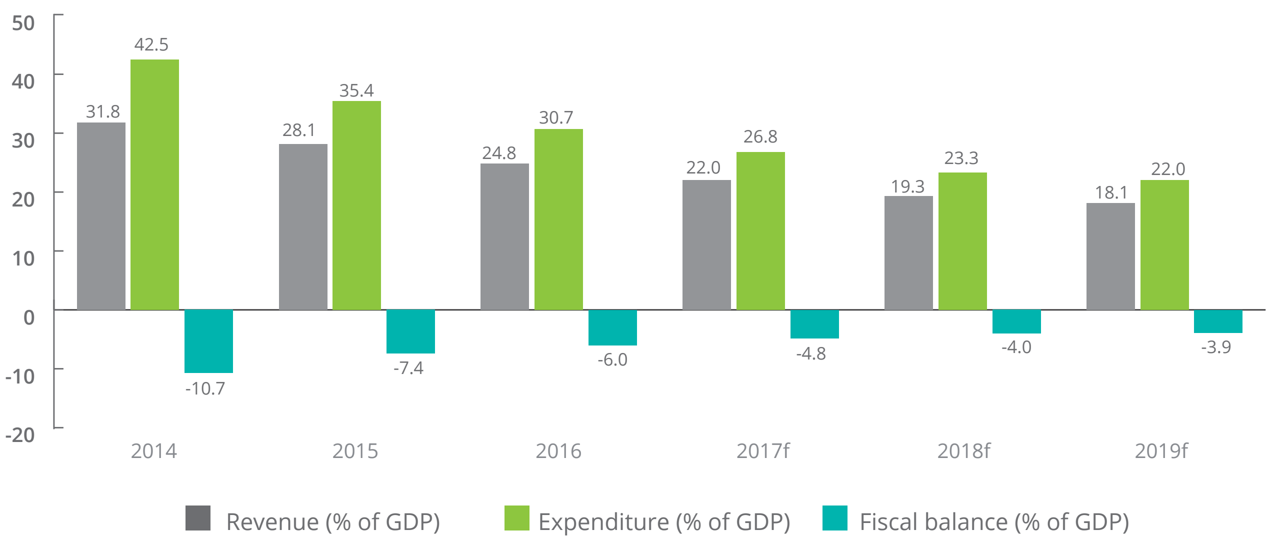
## Fiscal policy

Mozambique's government does not boast a strong track record of fiscal discipline. However, during the economic boom years over the 2000-15 period, the government could rely on donor support and windfall capital gains tax inflows. Poor discipline saw the fiscal deficit balloon to 10.7% of GDP in 2014, compared to an average deficit of only 4% during the previous five years.[9] As a result, the government implemented a fiscal consolidation drive in 2015, which saw the deficit narrow to 7.4% of GDP.

Although the withdrawal of budget support from the international community posed considerable difficulties for the government, it managed to narrow the fiscal deficit further via austerity measures to an estimated 6% of GDP in 2016. The 2017 fiscal budget aims for even greater tightening of the government's fiscal policy stance, which is projected to narrow the fiscal deficit to 4.8% of GDP. Notably, the Mozambican government has not incorporated a return of international budgetary support into its budget.

Over the short to medium term, Mozambique's fiscal environment is set to remain under pressure while donor aid continues to be elusive. However, the projected improvement in real GDP growth, as well as any capital gains tax inflows from further natural resources sales, will ease this pressure.

**Figure 3. Fiscal indicators (% of GDP), 2014-19f**




***Source: BMI, 2017***

## Inflation and monetary policy

As expected, fallout from the external debt scandals contributed heavily to pressure on Mozambique's inflation environment and, subsequently, monetary policy. The withdrawal of budgetary aid added to the country's weak export performance in 2015-16, which saw Mozambique's foreign reserves fall and the metical depreciate sharply.

The Mozambican local currency was one of the worst performing currencies in 2015, and weakened by another 39.2% y-o-y by end-2016 against the US dollar. Consequently, inflation spiked to over 26% y-o-y in Q3 2016 and the central bank tightened its monetary policy stance.

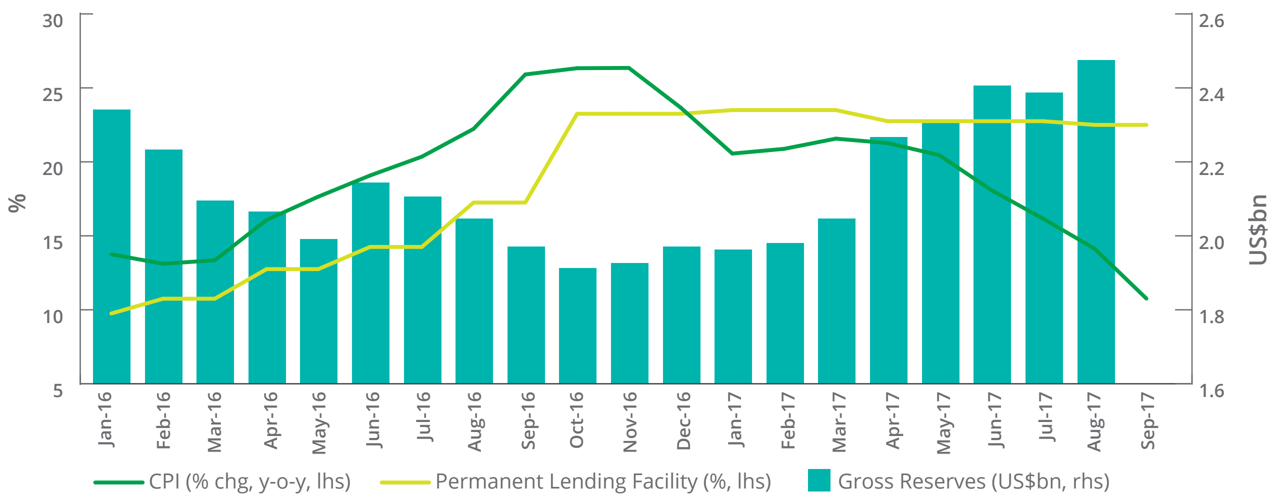
The most significant move made by the Banco de Moçambique (BdM, the central bank) was a 600 basis points (bps) hike in the permanent lending facility rate to 23.25% in September 2016 after Rogerio Zandamela was hired as the new BdM governor; and again by another 25 bps in January 2017.

More recently in 2017, the BdM introduced a monetary policy interest rate (at 21.75%) in an effort to consolidate interest rates and provide a tool for assisting in the management of interbank interest rates.[10] The new policy rate provides further evidence of the more sophisticated monetary policy toolbox. The central bank also introduced a minimum liquidity ratio of 25% as a percentage of short-term commitments invested in liquid assets. The new ratio is in line with the central bank's efforts to *"reinforce the soundness and resilience of credit institutions"*. The more sophisticated monetary policy mechanism by the central bank is a positive development and bodes well for the future of monetary policy in the country.

Mr Zandamela, who previously worked for the IMF, has achieved quick results, with the metical stabilising, inflation receding, and foreign reserves building. Headline inflation was most recently recorded at 10.8% y-o-y in September 2017, far from the 2016 peak of 26.4% y-o-y in November.[11]

Easing inflationary pressures have allowed the central bank to begin loosening its monetary policy stance. The permanent lending facility rate has been cut twice so far in 2017, by 75 bps in April and a further 25 bps in August. The policy rate now stands at 22.5%, with more cuts likely to be seen later in 2017 given that the BdM expects the current disinflationary trend to continue during the rest of the year.

**Figure 4. Inflation (% change, y-o-y), permanent lending facility rate (%) and foreign reserves (US$bn), Jan 2016 – Sep 2017**




***Sources: INE, 2017; BdM, 2017***

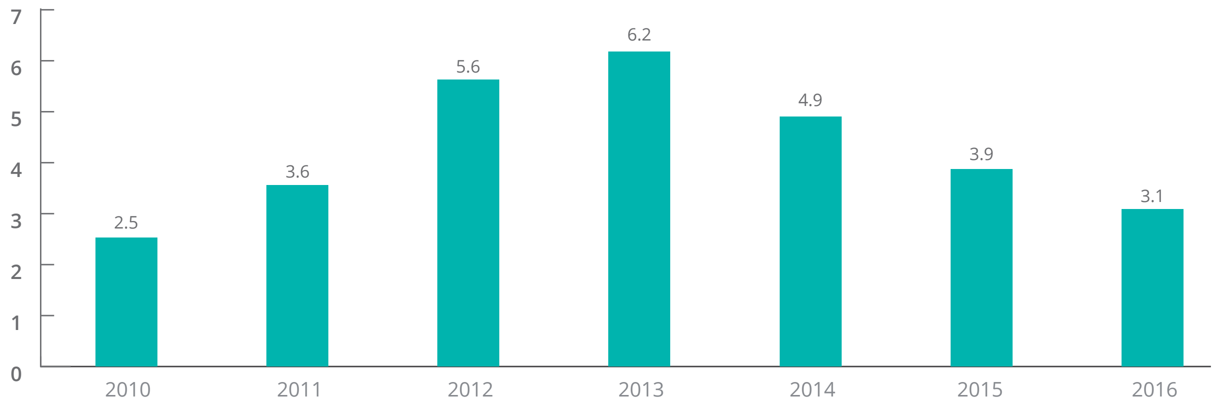
# Investment flows falling but set to recover

**Foreign direct investment (FDI)**

Although Mozambique's external balances, particularly the current account deficit, are under extreme pressure, the country enjoys significant inflows of foreign investment. Mozambique was among the top five recipients of FDI in Africa in each year over the 2012-15 period, averaging inflows of US$5.1bn per annum.[12]

Even in the aftermath of the external debt scandals and lacklustre global demand for Mozambique's commodities, the country still received FDI inflows totalling US$3.1bn in 2016 – the sixth largest in Africa.

**Figure 5. Foreign direct investment (US$bn), 2010-16**



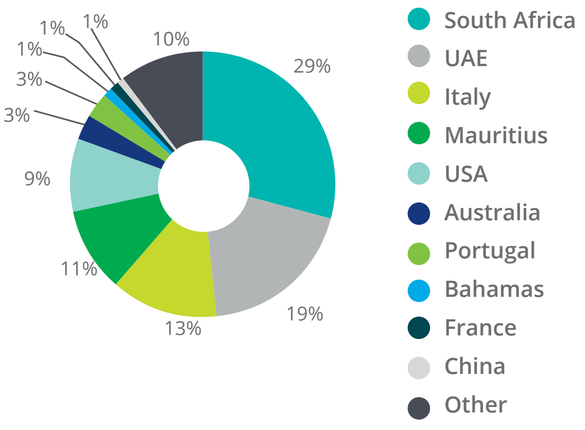

*Source: BdM, 2017*

In 2016, the largest inflows of FDI stemmed from South Africa (US$0.9bn), accounting for 29% of total foreign investment.[13] FDI from the United Arab Emirates (UAE) totalled US$0.6bn in 2016, accounting for 19% of total inflows, while another 13% of total inflows came from Italy.

Some US$0.3bn of FDI inflows originated from Mauritius, yet a large share of the flows likely originally stem from India. The two countries have a mutually beneficial tax agreement, which makes it financially more advantageous for India to invest in Mozambique via Mauritius.

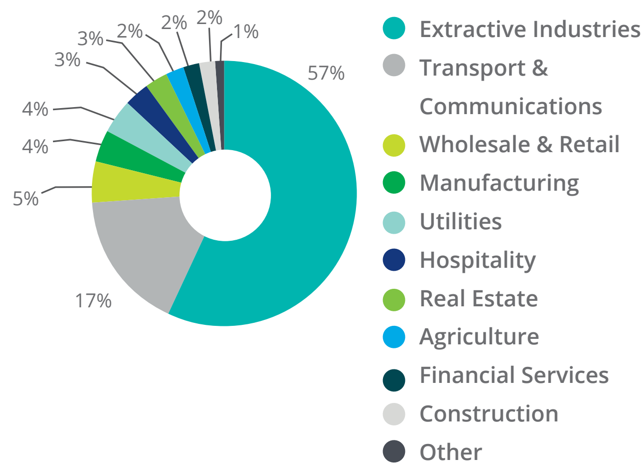
As expected, the sector attracting the most FDI in 2016 was extractive industries, which received FDI inflows of just over US$1.7bn in 2016, accounting for 57% of total FDI inflows. The transport and telecommunications sector also received a significant US$0.5bn last year, while the wholesale and retail sector attracted FDI amounting to US$0.14bn in 2016.

**Figure 6. FDI inflows by origin (% of total), 2016**




*Source: BdM, 2017*

**Figure 7. FDI inflows by sector (% of total), 2016**




*Source: BdM, 2017*

## Liquefied natural gas (LNG)

The LNG sector is projected to be the primary receiver of FDI inflows in Mozambique, as well as the major driver of the country's economic expansion prospects. The discovery of large natural gas reserves, amongst the largest in the world, in the Rovuma Basin has positioned Mozambique as an exciting investment opportunity. The projected boom of the LNG sector is set to have multiple positive externalities for the rest of the economy.

Looking at the latest developments in the Mozambican LNG sector, Italian multinational Eni has finalised the investment schedule of its LNG project, the so-called Coral South Development Plan.[14] The Plan was approved by the Mozambican government in February 2016, and Eni's board approved the first development phase of the project in November last year.

More recently, Bloomberg reported in June 2017 that Eni signed off on a US$7bn final investment decision (FID) to export natural gas from Mozambique.[15] BP, based in the United Kingdom (UK), signed a contract with Eni in October 2016 to purchase all output from the Coral South LNG project, with production set to start in 2022.

The finalisation of the investment deal is an important development for the Mozambican economy, signalling that the development of the LNG sector is still on track to revitalise the macroeconomic environment.

While US-based Anadarko has yet to finalise its investment schedule, the company is also expected to bring in investment amounting to a few billion US dollars. Indeed, Anadarko finalised an agreement with the Mozambican government in July 2017 in order to *"design, build and operate the marine facilities for its LNG project in northern Mozambique"*, an important step in the right direction to a final investment decision.[16]

# Risks and challenges

*While Mozambique appears to be turning the corner, due largely to more prudent monetary and fiscal policies, there are still significant risks and challenges ahead.*

Overall, the largest immediate hurdle, from an economic perspective, is the ongoing fallout from the external debt scandals.

Given that major donor agencies generally take the IMF's lead, recommencing financing and budgetary aid from the multilateral agency is paramount to the sustainable development of Mozambique's economy. Ongoing delays in securing this aid places the country's path to economic recovery in jeopardy.

From a fiscal financing perspective, there is considerable concern that the government will be unable to reach an agreement with its creditors, thereby remaining in default. The inability of the government to meet its financial obligations could potentially deter foreign investment and exacerbate difficulties in acquiring new lines of credit.

As the financial sector has faced increasing pressure in the wake of external debt scandals and the government entering default territory, non-performing loans are high, albeit highly variable within the different banks operating in the country.[17] The Mozambican central bank has already been forced to bail out Moza Banco by transferring an 80% stake in the bank to the central bank-owned pension fund.[18]

Similarly, the central bank ordered the closure of privately-owned Nosso Banco in November 2016.[19] There is a risk that more bank failures like Moza Banco and Nosso Banco will be seen due to higher capital requirements by the central bank, although it is unlikely that systemically-important banks that have international owners will fail.

Apart from the above-mentioned challenges, Mozambique also faces additional structural challenges. Inadequate infrastructure continues to constrain economic development, and a tighter fiscal stance makes it more difficult for the government to address these shortcomings.

Transport infrastructure constraints are especially important to address to export the country's vast natural resources to the international market. Similarly, a lack of infrastructure exacerbates the country's vulnerability to adverse weather conditions. Mozambique periodically faces both droughts and floods, with the vital agricultural sector taking extensive damage when these events occur.

The political environment also poses significant challenges. In order to promote a reputation of political stability in the country, it is vital that a lasting peace with Renamo is negotiated so that the main opposition party is demilitarised. Pockets of instability and violence in the country must be closely monitored, particularly in areas that could potentially adversely affect foreign investment sentiment.

The investment environment is already challenging. In the latest World Economic Forum (WEF) Global Competitiveness Report, released in October 2017, Mozambique was ranked a lowly 136th out of 137 countries.[20] That said, already-impressive FDI inflows to Mozambique should increase even further if the government manages to successfully implement positive reforms that improve the country's competitiveness.

# Endnotes

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