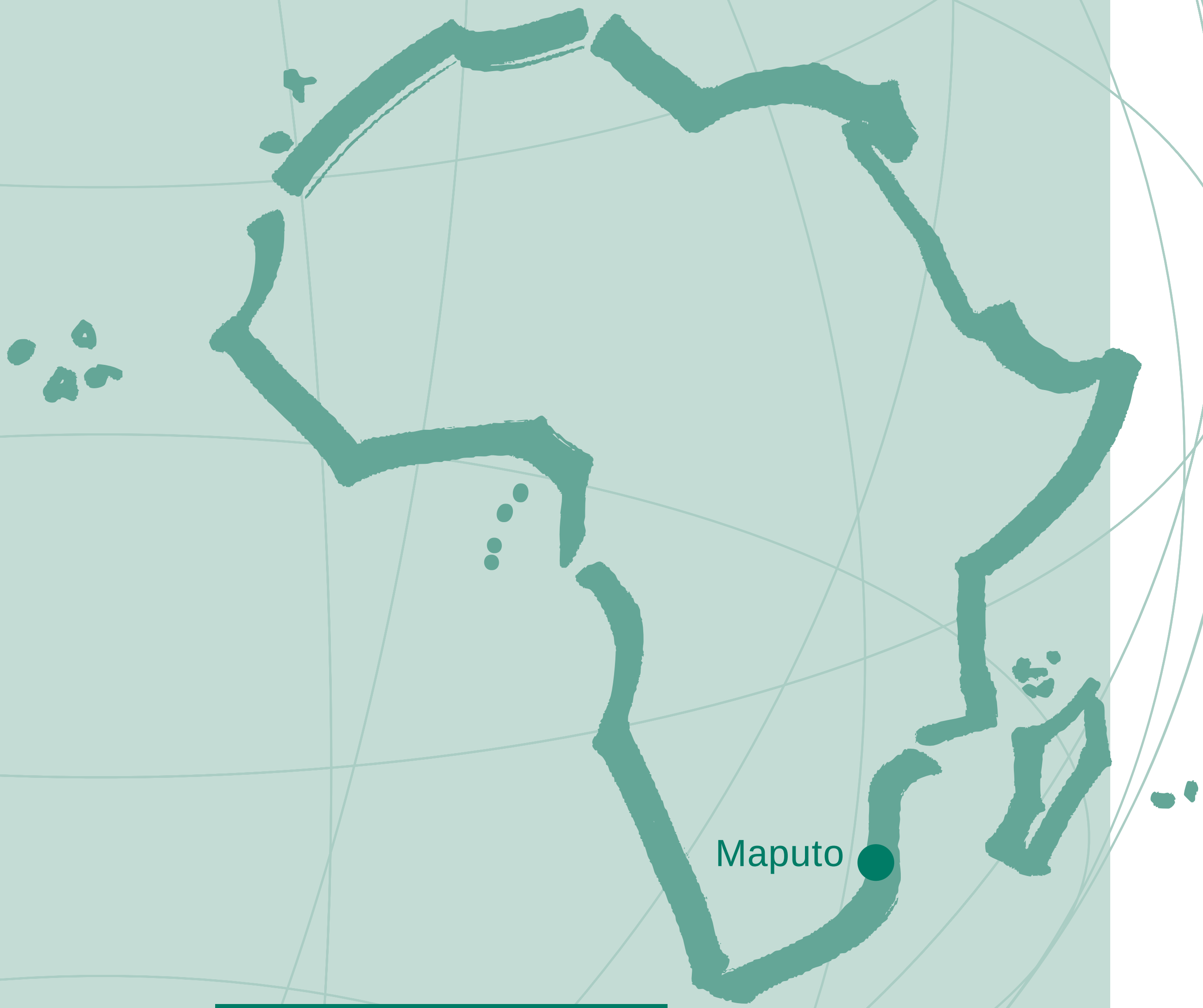
Mozambique



key figures

- Land area, thousands of km² 802
- Population, thousands (2004) 19 182
- GDP per capita, $ (2003) 229
- Life expectancy (2000-2005) 38.1
- Illiteracy rate (2004) 50.9

African Economic Outlook 2004/2005

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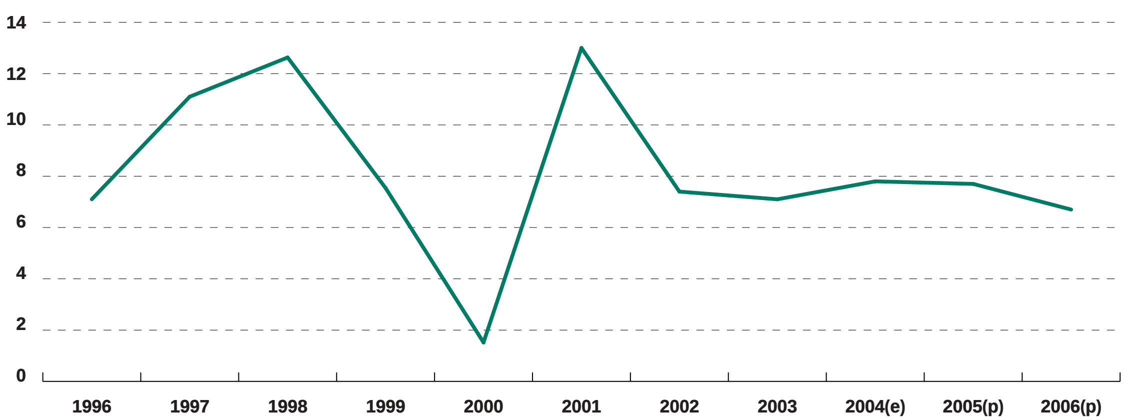
SINCE THE END OF A DEVASTATING WAR in 1992, Mozambique has recorded one of the world's highest growth rates, averaging 8.1 per cent from 1993 and continuing in 2003 and 2004. Owing to high population growth and the very low initial level in 1993, however, Mozambique's per capita income remains among the lowest in the world at $229 in 2003. Poverty has decreased sharply but more than 50 per cent of the population is still classified as poor, and income and wealth inequalities remain pervasive and may indeed have risen geographically. Much of Mozambique's growth comes from a few large foreign ventures (the "mega-projects"), while little has been done to create broader-based growth and competitive productive capacities. In addition, Mozambique must confront a serious and deteriorating problem of HIV-AIDS and a severe human resources deficit.

Real GDP growth reached 7.1 per cent in 2003 and is estimated to have increased to about 7.8 per cent in 2004, mainly as a result of the two foreign-owned mega-projects – the Sasol gas pipeline and Mozal II expansion of the aluminium smelter. If confirmed, this outcome is in line with the 8 per cent growth target under the Poverty Reduction Strategy Paper (PARPA) for 2001-05. GDP growth is projected to average 7.7 per cent in 2005 and to fall off slightly to 6.7 per cent in 2006. However, concerns remain regarding the sustainability of this

High economic growth is projected with the coming on stream of mega projects but redistribution and poverty reduction need to be tackled.

Figure 1 - Real GDP Growth



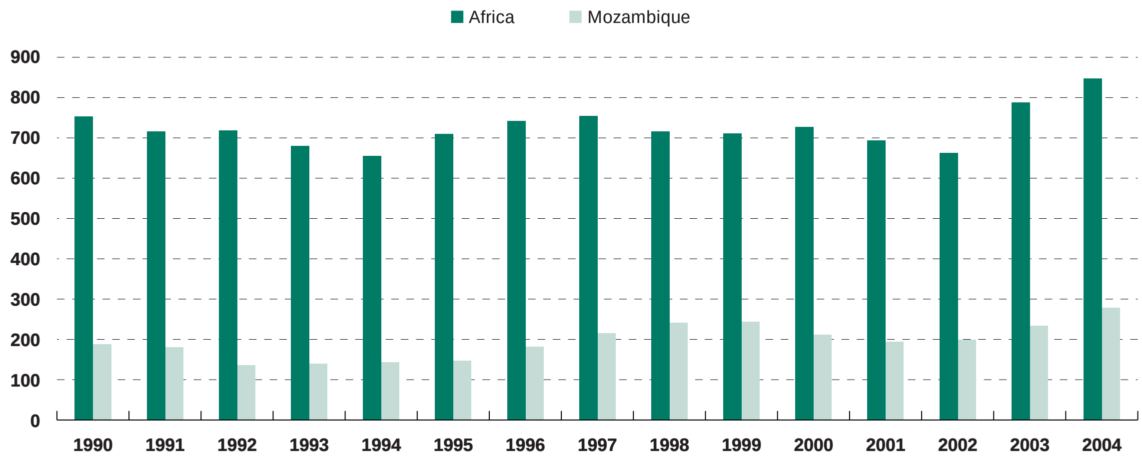
Source: IMF and National Institute of Statistics data; estimates (e) and projections (p) based on authors' calculations.

growth pattern, as well as the ability to turn the mega projects, which have limited spillover effects on the rest of the economy and benefit from substantial tax holidays, into sources of new jobs and fiscal revenues.

In December 2004, President Joaquim Chissano, in power since 1986 and winner of the previous two multiparty elections, was replaced by Armando Emílio Guebuza, a senior member of Frelimo for about four decades and a veteran of the liberation struggle against Portuguese colonialism. Despite some protests from the opposition, independent national and international observers were broadly satisfied with the election's fairness.

Multiple challenges await the new authorities. They need to improve governance, including judicial modernisation, take a tougher stance on corruption, and implement co-ordinated and coherent structural reforms to improve resource allocation and create new capacities. Such measures are of the uttermost

Figure 2 - GDP Per Capita in Mozambique and in Africa (current $)



Source: IMF.

importance in order to widen the development and growth base of the economy, accelerate job creation, fight poverty, and comply with development partners' conditions.

Recent Economic Developments

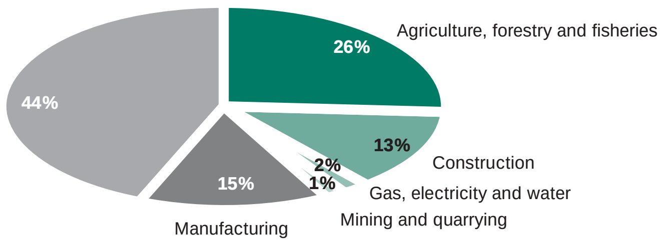
In 2003 and 2004, economic activity was mainly driven by the strong performance of the extractive and manufacturing industries, dominated by the two mega-projects. Good harvests for the main export crops and buoyant demand for transport and communication services also contributed to high growth.

While agriculture in Mozambique enjoys favourable soil conditions, it suffers from erratic rainfall patterns, particularly in the more arid south. In both 2003 and 2004, drought affected the country's south, while in the northern and central regions rainfall was abundant. Agriculture expanded by over 8 per cent in 2003 and 2004. On balance, production of both staples (beans, maize, and manioc) and cash crops (cashew nuts, cotton, sugar and tobacco) exceeded previous years' levels and, in many cases, reached all-time highs. Areas under cultivation increased markedly for most products and in all areas. In particular, the sugar and tobacco sectors experienced very fast growth, owing to respectively, the privatisation of many sugar plantations and preferential access to the European Union market, and the decline of production of tobacco in Zimbabwe. Productivity also rose on account of broader, albeit still far from sufficient, availability of fertilisers and high-yield varieties and, to a more limited extent, thanks to the Agricultural Sector Public Expenditure Program (PROAGRI II) in enhancing extension services.

The World Food Programme, in its Vulnerability Analysis report, indicates that food insecurity has declined significantly since the 2001-02 harvest season and that further improvements are likely to occur in the next harvest season. Agricultural production is expected to grow by 6.5 to 7 per cent annually from 2004 to 2007. Despite this overall progress, augmenting the sector's productivity calls for major efforts to improve access to credit, to stimulate the adoption of new technologies and to invest in rural infrastructure.

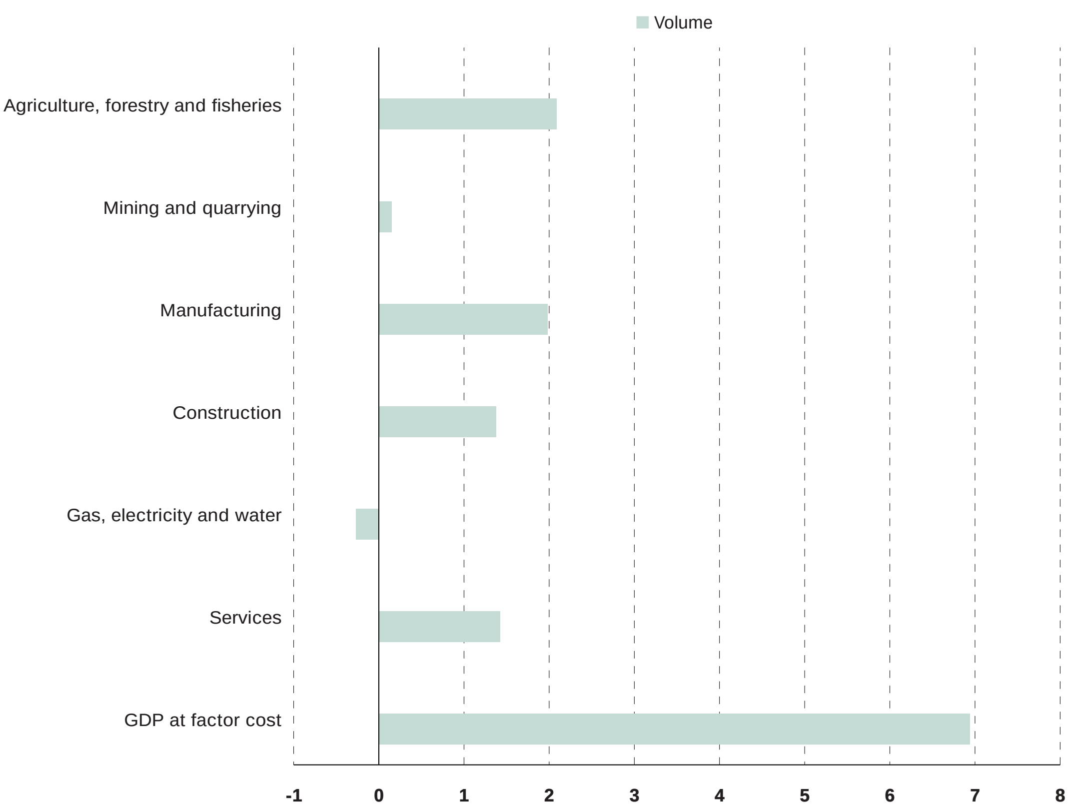
Over the past five years, the size of manufacturing in Mozambique has changed dramatically with the completion of a major aluminium smelter (Mozal) in Maputo province. With the expansion completed by end-2003 to an installed capacity of 512 000 tonnes, production grew by 82 per cent in the first half of 2004. Aluminium alone now accounts for about 50 per cent of total manufacturing output. Growth in other capital-intensive manufacturing branches, such as beverages and cement, was also strong, whereas agro-industries recorded a more muted performance. The

Figure 3 - GDP by Sector in 2003 (percentage)



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

Figure 4 - Sectoral Contribution to GDP Growth in 2003 (percentage)



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

crisis in the textile and clothing sector continued. Textile and clothing production has fallen from 20 per cent of manufacturing output, in the 1980s, to less than 3 per cent in 2003. Only two clothing factories are still in operation, and all of the four large textile plants are closed. The second mega-project concluded in 2004 is the pipeline to transport natural gas from Inhambane province to South Africa. The completion of the pipeline was followed by a surge of national gas production which grew by 130 per cent in the first half of 2004.

The construction sector, which is concentrated around the large projects, contracted by 10 per cent following the completion of the gas pipeline and of the Mozal extension programme. However, the sector is expected to rebound in 2005-06 with the start of a new $500 million titanium-bearing sands mine and smelter in Moma, the rehabilitation of the Ressano Garcia and Nacala Corridor railways, and of the Sena railway line from Tete to Beira.

In the service sector, transport and communications grew by 35 per cent in the first half of 2004, reflecting the expansion of existing port operations and increased air traffic, owing to the entry of a new private carrier, as well as the entry of a second mobile operator, Vodafone. Almost 80 per cent of investment in transport takes place around the three so-called corridors: Maputo to South Africa, Beira to Zimbabwe, and Nacala to Malawi. A concession to operate Maputo port was issued in 2003 and the $70 million investment in the first three years is expected to improve links between the Maputo corridor and the South African hinterland, in direct competition with the port of Durban.

Private investment remains on an upward trend, thanks notably to increased foreign investment in a few mega projects. After recording a steep rise in the early 2000s as a result of the exceptional reconstruction effort following the floods, public investment has levelled off. Government expenditures diminished in 2004 owing to a shortfall in external grant disbursements. External demand is estimated to have improved in 2004 on account of the rapid growth of aluminium exports and a fall in imports of capital equipment following the completion of Mozal II and of the Sasol gas pipeline.

Table 1 - Demand Composition (percentage of GDP)

	1996	2001	2002	2003	2004 (e)	2005 (p)	2006 (p)
Gross capital formation	**21.8**	**41.5**	**44.7**	**44.7**	**44.3**	**48.1**	**50.9**
Public	11.2	16.6	14.3	14.3	12.0	13.0	12.9
Private	10.6	24.9	30.4	30.4	32.3	35.1	38.1
Consumption	**101.8**	**72.9**	**68.0**	**68.0**	**63.1**	**60.2**	**59.1**
Public	8.0	13.9	14.3	14.3	13.8	13.6	13.4
Private	93.8	59.0	53.7	53.7	49.3	46.7	45.7
External sector	**-23.7**	**-14.4**	**-12.7**	**-12.7**	**-7.4**	**-8.4**	**-10.1**
Exports	12.2	29.2	33.0	33.0	35.1	34.1	31.5
Imports	-35.8	-43.6	-45.6	-45.6	-42.5	-42.5	-41.6

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

Macroeconomic Policies

Fiscal and Monetary Policy

The 2001-05 Poverty Reduction Strategy Paper (PARPA) presents the government's main economic policy objectives. Following an overall satisfactory evaluation of the implementation of the strategy over the past four years, in mid-2004 the government and the IMF agreed on a three-year Poverty Reduction Growth Facility. Notwithstanding the success of the government's efforts to consolidate macroeconomic stability, a series of weaknesses remain to be addressed, especially in terms of improving the efficiency of social spending and removing obstacles to private sector development.

Development partners have engaged in a dialogue with the Mozambican authorities on selected priority areas, including fiscal management, public sector and financial reforms, investment climate improvement, and the modernisation of justice. In 2003, in the context of the joint review of the government's programme, the PARPA goals were streamlined by developing a Performance Assessment Framework (PAF) matrix. The PAF provides a series of performance indicators to monitor progress in implementing the government's medium-term strategy, and to assist donors in making decisions about aid. Donors finance roughly half of the government expenditures.

The 2003 budget outcome was unsatisfactory, as the overall deficits (including bank restructuring costs) exceeded the official target of 3.9 per cent of GDP. Despite lower spending on goods and services, the

Table 2 - Public Finances (percentage of GDP)

	1996	2001	2002	2003	2004(e)	2005(p)	2006(p)
Total revenue and grants [a]	**17.6**	**28.1**	**25.9**	**24.9**	**21.8**	**20.9**	**20.6**
Tax revenue	9.8	11.8	12.5	13.3	12.8	12.5	12.6
Grants	7.0	14.8	11.8	10.6	8.0	7.4	6.9
Total expenditure and net lending [a]	**20.7**	**34.7**	**33.8**	**29.8**	**27.0**	**27.9**	**27.5**
Current expenditure	9.4	14.7	15.6	16.3	15.5	14.8	14.7
Excluding Interest	*8.0*	*14.0*	*14.1*	*15.0*	*14.4*	*14.0*	*13.9*
Wages and salaries	2.2	7.0	7.3	7.5	7.3	7.2	7.1
Interest	1.4	0.7	1.5	1.3	1.1	0.8	0.8
Capital expenditure	11.2	16.6	14.3	13.0	10.9	11.9	11.8
Primary balance	**-1.6**	**-5.9**	**-6.4**	**-3.7**	**-4.1**	**-6.2**	**-6.2**
Overall balance	**-3.1**	**-6.6**	**-7.9**	**-4.9**	**-5.2**	**-7.0**	**-7.0**

a. Only major items are reported.
Source: IMF and Ministry of Finance and Planning data; estimates (e) and projections (p) based on authors' calculations.

2004 overall deficit is estimated to have increased to 5.2 per cent of GDP from 4.9 per cent in 2003, reflecting significant grants and revenue shortfall. Delays by some companies in complying with payments under the new corporate income tax code, as well as the adverse impact of the appreciation of the *metical* on customs collections resulted in lower than programmed tax receipts. Only taxes on petroleum products performed well, as a result of the introduction of automatic adjustment[1] of fuel taxes on a quarterly basis in order to prevent the erosion of receipts by inflation.

In line with the PARPA prioritisation of public spending, the allocation of non-interest expenditures in priority sectors – education, health, agriculture, infrastructure, good governance and macroeconomic and financial management – increased from 55 per cent of total expenditures in 2003 to 63 per cent in the same period of 2004, slightly off the PARPA target of 66 per cent. Budget execution figures differed widely among sectors and provinces, with health and water exhibiting particularly low execution rates, leading to insufficient output, while others overspent. This reflects delays and unpredictability of donors' and line ministries' disbursements and irregularities in line ministries' planning and budgeting.

In order to improve efficiency and transparency in the use of public funds and allow for timely budget execution in key areas, priorities for 2005 include strengthening the monitoring and auditing of the budget process, as well as the state administration functions. Key measures include the adoption of a detailed system of classification by function, tighter controls on the wage bill and the introduction of an integrated budget, treasury management, accounting and internal control system. The government is also restructuring five major ministries. Moreover, districts have been recognised as budgetary units since 2003 and they can now access a donor-funded discretionary fund to finance small-scale infrastructure works on the basis of a participatory planning process. To provide clearer co-ordination mechanisms, align donors' programmes with government planning and implementation cycles, reduce the volatility of disbursement, and maximise the development impact of budget and balance-of-payment support, 15 donors signed a Memorandum of Understanding with national authorities in April 2004 that sets forth the details of direct budgetary support.

Budgetary spending is expected to increase over 2005-06, but at a slower rate than in recent years. PARPA-related expenditures are expected to reach 67.3 per cent of total expenditures in 2005, and will

1. In January 2004, the authorities issued a decree increasing the specific fuel taxes by an additional 2 per cent and adopting an automatic quarterly mechanism to prevent their erosion in real terms.

be mainly channelled towards education and transport infrastructure and hospital revitalisation programmes. The budget also projects new hiring of teachers and health personnel. This increase in current and capital outlays will be only partially offset by increased tax revenues, stemming from further improvements in tax administration as well as from the expiration of tax benefits applied to some projects. Budget deficits are expected to average 7 per cent in 2005 and 2006.

In 2004, the monetary policy targets included a reduction in money supply growth to 15 per cent (from 19 per cent in 2003) and a year-end inflation of 11.4 per cent. The Central Bank is progressively shifting towards indirect market-based instruments, such as weekly auctions for overnight and short-term paper. Another measure has been the mid-2004 broadening of the legal basis for calculating reserve requirements to include non-resident and escrow deposits. Moreover, the central bank has increased the use of foreign exchange sales to sterilise the monetary impact of government spending, following large placements of domestic debt instruments in the first half of 2004.

Although Mozambique's oil imports are denominated in US dollars, most other imports come from South Africa and the Euro zone. The *metical* depreciated against the rand by about 30 per cent in 2003 and 13.5 per cent in the first half of 2004. With food items, including sizeable imports from South Africa, accounting for more than two thirds of the CPI basket, the depreciation passed through to prices. Average CPI inflation in 2003 reached 13.4 per cent, in excess of the government target of 10.8 per cent.

Nevertheless, since May 2004, the local currency has been continuously strengthening in nominal terms against the US dollar and the South African rand. The appreciation *vis-à-vis* the US dollar, at about 18 per cent in 2004, reflects delays in donors' disbursements, which were heavily concentrated in the last four months of the year. The strengthening against the rand shadows the South African currency's depreciation following the interest-rate cut by South Africa's monetary authorities in August 2004. In turn, the strength of the currency impacted positively on inflation. Average annual inflation declined to 12.4 per cent in 2004, and ended the year at 9.1 per cent, below the target, following a slower rise in food prices that offset increases in oil prices. Against a background of a favourable 2005 harvest as well as expectations that the currency will retain some of its recent strength, inflation is projected to average 9.1 and 7.1 per cent in 2005 and 2006, respectively.

External Position

Mozambique participates in various regional preferential trade initiatives. As part of the South African Development Community (SADC) Trade Protocol, the country is committed to gradually lowering its tariffs with SADC member countries until achieving free trade. Implementation of tariff reduction will start in 2008 and free trade will be reached in 2012 with all countries except South Africa (complete elimination of tariffs is due in 2015).

Trade relations with the EU received a strong boost by the signing of the sugar protocol – that allows quota-free exports as well as uptake of unused quotas by other ACP countries. Finally, since 2003 AGOA eligibility has provided Mozambique preferential access to the US market for selected products, notably apparel. However, weak production facilities, particularly in manufacturing, have prevented firms from taking full advantage of such provisions. Indeed, Mozambique would benefit from an Economic Partnership Agreement (EPA) with the EU only with a strong development component that supports the development of institutional and productive capacities.

Mega-projects strongly shape the trade balance. In 2003, aluminium exports – which account for more than 50 per cent of Mozambique's total exports of goods – rose by 40 per cent, raising total exports to $880 million from less than $700 million in 2002. Mozambique which did not even produce any aluminium until 2000, is now the third largest exporter of aluminium to the EU.

Other products recording strong growth include sugar, timber and cotton, while prawns continued on a downhill trend. With Mozal II now completed and Sasol gas exports making their debut, preliminary estimates for 2004 point to a 60 per cent increase in exports from large projects.

South Africa's share of Mozambique's exports has risen to 18 per cent, although Belgium remains the largest market – a somewhat misleading statistic in view of the fact that aluminium is traded through an Antwerp-based trading company. South Africa also remains by far the single largest source of Mozambique's imports, at roughly 40 per cent. Food products are almost exclusively sourced from South Africa and electricity, equipment and machinery are also mainly imported from its powerful neighbour.

The trade deficit fell from 13 per cent of GDP in 2003 to an estimated 6.4 per cent in 2004, despite increased oil and electricity imports. Over the 2005-06 period, the expected increase in imports of capital goods, as a result of the construction of the Moma titanium smelter and the planned expansion of the gas pipeline will be partially offset by buoyant aluminium exports and the first full year of gas exports.

With the natural gas and titanium-bearing sand mine coming on stream, it is estimated that by the beginning of 2006, three products alone will account for roughly 80 per cent of exports. Although net exports are expected to increase substantially, concerns exist regarding the vulnerability to the vagaries of world raw commodity markets, as well as the ability to turn the mega projects, that benefit from substantial tax holidays and other incentives, into sources of new jobs and fiscal revenues.

Table 3 - Current Account[a] (percentage of GDP)

	1996	2001	2002	2003	2004(e)	2005(p)	2006(p)
Trade balance	-19.6	-10.5	-18.7	-13.1	-6.4	-5.8	-6.9
Exports of goods (f.o.b.)	8.0	20.5	18.9	20.4	25.0	25.7	23.8
Imports of goods (f.o.b.)	-27.5	-31.0	-37.5	-33.5	-31.4	-31.4	-30.7
Services	-3.2	-17.6	-5.7	-5.5			
Factor income[a]	...	...	...	...			
Current transfers[a]	7.9	13.7	11.7	12.4			
Current account balance	**-14.9**	**-14.5**	**-12.7**	**-6.2**			

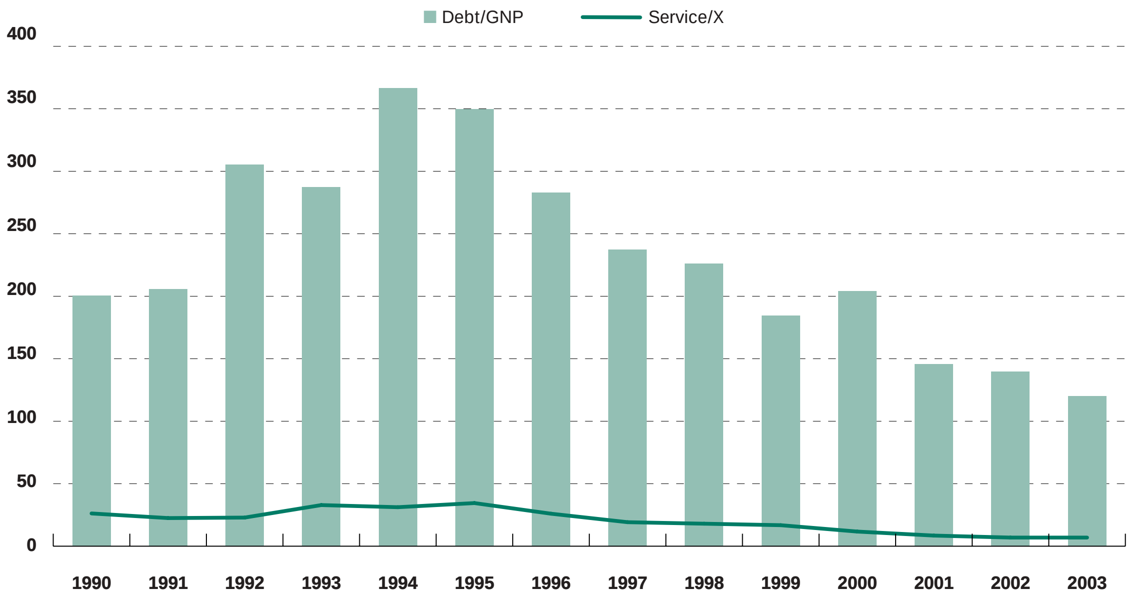
a. Factor income is included in services.
Source: IMF and Bank of Mozambique data; estimates (e) and projections (p) based on authors' calculations.

Two related phenomena – the mega-projects, which account for more than 90 per cent of cumulative FDI flows over the 1998-2004 period, and the interest of South African business in the Mozambican economy – have driven FDI activity over the past few years. Since 1985, the investment promotion centre has registered more than 262 South African projects by 182 companies and their accumulated investment value had reached $1.33 billion by end-2003 – making Mozambique the main regional location for South African FDI. In export-oriented sectors, South African investors (including companies that, while originally South African, now have their primary listing overseas) have been attracted by abundant natural resources, including gas reserves, low labour costs and subsidised electricity tariffs, as well as by extensive government incentives. BHP-Billiton has invested $2.2 billion in Mozal, while synthetic fuels group Sasol is the lead investor in the Pandé-Temane gasfield project, having put in more than $1 billion. State-owned Spoornet is rehabilitating the Ressano Garcia railway. As part of their regional expansion strategy, South African investors also control three of the four sugar estates, large cereal mills, all breweries and soft-drink bottling plants and most tourism facilities, especially outside of Maputo. A substantial number of smaller firms are also involved.

Despite their positive contribution to the country's GDP and exports, which almost tripled over the past five years, the mega-projects source most of their inputs from South Africa and risk crowding out domestic firms. The capital-intensive and knowledge-specific nature of much FDI limits the scope for linking up with local business. Although backward and forward linkages have started to increase – the International Finance Corporation launched a programme which successfully linked 12 Mozambican companies to $3 million worth contracts with Mozal – the integration between domestic and foreign business remains very limited.

In 2001, Mozambique became the third country (after Bolivia and Uganda) to reach the HIPC completion point for debt relief. Most Paris Club members have already given, or are soon expected to provide, debt relief, and a commercial debt buyback scheme is now operational. As a result, the external debt burden has stabilised at a sustainable level, with the net present value of debt-to-GDP forecast to decline gradually to 20 per cent by 2006. The government has undertaken measures to improve debt management. Dramatic progress in reducing the foreign debt to GDP ratio (although still very high relative to peers such as Ghana and Cameroon), as well as sustained high output and exports growth, have improved creditworthiness, leading Fitch to upgrade Mozambique to the B rating category.

Figure 5 - Stock of Total External Debt (percentage of GNP) and Debt Service (percentage of exports)



Source: World Bank.

Structural Issues

Although in the 1990s Mozambique carried out one of Africa's farthest-reaching privatisation programmes, results have been mixed and the expected additional contribution to investment, domestic product and employment creation have not materialised. During the process, many small and medium enterprises, which constituted the bulk of State Owned Enterprises (SOEs) acquired by Mozambican nationals encountered serious financial difficulties and went bankrupt. On the other hand, medium to large-sized enterprises bought by foreigners in sectors such as cement, beer, tobacco, and sugar were more successful, increasing sales and production levels.

By mid-2002, 20 large and 200 small SOEs remained to be privatised, mostly in the transport and communications sector. In recent years, no major privatisations have been concluded and little progress is in sight. Admittedly, in sectors such as energy, the global record of privatisation has been mixed. However, very little is known about employment levels, asset values, and financial and operational performance for most state-owned enterprises. In theory, the creation of a dedicated agency in early 2002 to manage state participations and prepare state-owned enterprises for divestiture was a major institutional breakthrough. In practice, IGEPE (Institute for the Management of State Shares) does not have any implementing autonomy. The government has so far failed to agree on a clear strategy regarding the choice of strategic sectors to be kept under state ownership and the long-term objectives of privatisation. While selected enterprises have been commercialised, others – including the ports and railway company, Companhia de Portos e Caminhos de Ferro de Moçambique (CFM), the post office, the airports, and Electricidade de Moçambique – are still subject to ministerial oversight. A consortium of CFM and Cornelder-Mozambique of the Netherlands, which is already co-managing the Beira container terminal, has been awarded the contract to run the port of Quelimane.

Some limited progress has been achieved in liberalisation of public services. In cellular telecommunications, in August 2002 a second GSM licence was granted to Vodacom International in association with local partners (Emotel, a consortium of local businesspeople, and the war veterans association). Vodacom Moçambique's services launch, however, was delayed by a year. When operations finally began in late 2003, Vodacom only covered limited portions of the country, and the price of pre-paid cards has basically remained unchanged despite the theoretically more competitive conditions. The repeal of the decree that granted state-owned LAM a monopoly on domestic routes allowed a new private airline, Air Corridor, to start operation, offering better services and cheaper non-peak fares. Additionally, although the Sasol pipeline is meant to be an open-access, government-regulated service provider, there is still some apprehension regarding Sasol's control of both the pipeline and the South African gas market, where it has an effective monopoly.

Donors are attaching increasing importance to governance issues in the broader sense and are ready to impose greater conditionality in the disbursement of budgetary support. The media, civil society, and business associations, although still in their infancy, are also increasingly vocal. Nonetheless, very little progress, if any, has been made in 2003-04 in legal and financial modernisation, in judicial reforms, and in fighting corruption. Lukewarm political will, coupled with limited budget and human resources, pose major challenges. The commercial, civil procedure, and procurement codes, areas in which revisions appear key, are far from ready for parliamentary discussion. Although Parliament recently passed a law for tribunal courts and the Council of Ministers approved the strategic plan for the sector, implementation of key elements, such as the appointment of new judges and prosecutors, the execution of budget approvals, and access to public defence remain weak. Finally, a more determined drive to fight high-level corruption is hampered by the standstill over the anti-corruption bill. This was passed by Parliament in late 2003, but certain articles were seen as breaching the Constitution and the law has not been ratified yet. An anti-corruption unit exists in the Attorney's General office, but it lacks autonomy and financial resources.

Mixed results from regulatory reform and limited progress in addressing the vulnerability of the financial system underline a general perception that the business environment in Mozambique is poor and does not provide the right incentives for investors to engage in risk-taking and job-creating activities. Investment climate surveys identify a series of constraints to private sector activity: inefficient bureaucracy leading to delays in company registration procedures, a weak legal system that jeopardises the enforcement of contracts, and widespread corruption. Labour regulation is rigid, constraining for instance the employment of expatriates, and the judicial backlog is long. Partly because the size of the economy is small, partly because no competition policy exists yet, abuses of market power and collusive behaviour add to the cost of doing business in Mozambique. Strikingly, political risk or political instability are seldom cited as problems – a substantial advance for a country that a decade ago was beset by a civil war.

Undoubtedly, these constraints affect Mozambican business differently, depending on the size and characteristics of the companies. Large foreign businesses are generally positive about the investment climate as

Donors' Credit Lines Based on Risk Sharing and Punctual Monitoring System

Several donors have directly supported the re-establishment of the economic base of small and medium Mozambican entrepreneurs which had been severely damaged by the floods that hit the country in 2000. A particular scheme is the one carried out by USAID. Under such a scheme the *metical* equivalent of $22 million has been channelled through the local banking system to flood-affected enterprises. A **Program Committee,** composed by representatives of USAID and of the Government of Mozambique, was established in order to allocate the funds provided by USAID. A local firm was contracted by the Program Committee to set up a **Project Management Unit (PMU)** to manage the loan fund. **PMU** was in charge of co-ordinating and executing the loan scheme and drafting an agreement with local banks in order to establish rules and procedures to manage the loans. The loan scheme has been carried out according to the following criteria:

- Loans to affected enterprises are provided at below market interest rates (8-10 per cent compared with the outside commercial rates of 34-36 per cent). Principals and interests are paid quarterly.
- The commercial risk is shared 50:50 between USAID and the banks.
- Beneficiaries of these loans are able to make repayments for up to five years with up to one year's grace period.
- The ceiling for the loans was originally established at $100 000 and successively increased to $250 000.
- The Program Committee has to pay the banks a commission fee of 2 per cent over the value of each credit disbursed and already reimbursed.

The banks are required to report monthly to the PMU about:

- The volume of credit disbursed.
- Amount of reimbursements received.

On the basis of these monthly reports, PMU carries out the auditing and monitoring activities of the credit operations.

The total number of loans extended with this programme was 274, with the largest loan amounting to $250 000 and the smallest $1 471. Thanks to a system of punctual monitoring carried out by PMU, loan repayments are on track. This typology of Guarantee funds has been replicated by other donor agencies and proved to be successful.

It should be noted, however, that in other similar schemes, some banks tend to take advantage of the guarantee funds and the risk-sharing agreement without reducing, for instance, the interest rate or the percentage of collateral required from their clients. In response to this concern and in order to increase competition between the local financial institutions, new procedures are under development. Risk-sharing will be made available to the local financial institutions that offer the best credit conditions to the final beneficiaries of the guarantee fund. The intention would be to share risk but also to push the financial institutions to soften their credit conditions (i.e. percentage of collateral, interest rates, repayment time).

they are granted preferential treatment by the government and are more insulated from the domestic economy. For instance, in order to speed up imports of inputs needed for the Pande-Temane pipeline, Sasol was allowed to establish its own customs terminal. Additionally, large foreign companies have access to finance, technology and markets through the companies they are affiliated to.

All these obstacles, on the other hand, have a very prominent impact on the indigenous formal private sector, which comprises 27 800 enterprises with a total turnover of 60 billion *meticais*, and which provides employment to 274 000 people. Moreover, a substantial share of economic activity is undertaken in the informal sector, mainly in trade or trade-related activities, although no reliable estimate exists of its weight. The majority of these firms are micro-enterprises employing ten or fewer staff concentrated in the Maputo area. Small firms are extremely weak and lag behind regional competitors in terms of modern management and manufacturing techniques and practises, offsetting the advantage of an abundant supply of low-cost labour.

More than 80 per cent of companies consider high costs of bank borrowing to be their major problem, while 75 per cent say that access to domestic and foreign credit is too limited. The large majority of Mozambican firms rely therefore on their own resources to meet investment and working capital needs. The agricultural and agro-industry sector has the least access to formal financial institutions. Overall, only 16 per cent of credit goes to agriculture – and mainly to large foreign-owned farms – while 35 per cent goes to industry and 49 per cent to trade and other services. However, the weight of credit to agriculture is expected to increase as a result of the new strategy of South African banks (Standard Bank and ABSA) to support medium and large commercial farmers, mainly Zimbabwean, in Manica.

A wide range of initiatives by government agencies, private sector associations and donor organisations have sought to promote SMEs financing. These schemes typically involve provision of concessional loans in tandem with technical, advisory and marketing services to SMEs. While governments' special funds for SMEs and support services have been implemented on a very small scale with little impact, some donor-funded initiatives proved to be more successful. Small, private and parastatal institutions operating on a much smaller scale include GAPI (Gabinete de Promoção para Pequena Industria), FFPI (Fundo de Fomento á Pequena Industria), and FCC (Fundo Comunitario de Credito) that support smallholder associations mainly in the agribusiness sector. However, they strongly depend on donors' funds, have limited outreach, and lack internal capacity and financial resources. In general, there is very limited information about other financial services, such as microfinance institutions, which are mainly concentrated in individual lending in urban areas, with loan amounts not exceeding $2 000.

Overall, support to SME financing appears fragmented. The lack of a coherent industrialisation strategy hinders co-ordination and impedes prioritisation. This reflects the lack of national private sector development policy and limited dialogue between authorities, donors and the private sector.

Political and Social Context

On 3-4 December 2004, the third consecutive multiparty presidential and parliamentary elections took place, a considerable achievement in a country that lived, after independence, through a 16-year long war until 1992. Participation was very low, as only about 36 per cent of people voted. Independent national and international observers alike viewed the election as mostly fair, despite detecting some irregularities. Armando Emílio Guebuza, the candidate of the Frelimo ruling party, had a 32-percentage points lead over the main opposition candidate. Frelimo had almost 33 percentage points of advantage over the main opposition party. Only two parties, Frelimo and the coalition Renamo-União Eleitoral achieved the 5 per cent barrier and had members of parliament elected (Renamo with a much reduced number of MPs). The election results demystified the idea that the country is politically divided along geographical lines, as Frelimo, apart from maintaining its strong hold in the South, won in all but two regions (Sofala and Zambézia).

President Guebuza has placed the fight against poverty, corruption and crime at the centre of his political manifesto. In his inaugural speech, on the 2 February 2005, he emphasised the need for co-ordinated policies and actions against corruption and collective responsibility in the council of ministers and the government as a whole. The new cabinet includes 26 ministers (including the prime minister) and

15 deputy ministers. Of these, eleven are women (seven ministers, including the prime minister and four deputy ministers). Only 13 members of the previous Cabinet (of 42) remain in place, including the Prime Minister, Luisa Diogo, while all the previous ten provincial governors have been appointed ministers or deputy ministers.

Prior to the December general elections, the Parliament elected in 1999 met in its last session to approve the new Constitution of the Republic, which introduces several important innovations. It reinforces the area of justice and legality, creates the State Council in which the leader of the second most voted Party has a seat, and makes other minor changes to the previous text. The new Constitution was approved by unanimity.

According to a recent household survey (Inquéritos aos Agregados Familiares 2002/03), the proportion of poor in Mozambique significantly declined from 70 per cent in 1996/97 to 54 per cent in 2002/03. However, this positive achievement masks significant regional variations. Incidence seems to have fallen dramatically in the centre, especially in the Tete and Sofala provinces, where poverty has fallen from above 80 per cent to 60 per cent and 36 per cent respectively. However, the poverty rate in the Southern province of Inhambane continues to exceed 80 per cent. Another recent survey carried out by the Ministry of Agriculture, which is based on income instead on expenditure, suggests a reduction of poverty by 4 per cent only.

Based on the IAF results, the authorities put Mozambique on track to achieve the PARPA goal of reducing the poverty rate to 50 per cent by 2010 and reach the first Millennium Development Goal (MDG) by 2015. Nonetheless, it is very unlikely that the country will achieve the other MDGs on gender equality, access to safe water in urban areas, maternal mortality and malaria. This reveals that despite the drop in poverty, income per capita, human capital and other human development indicators are still amongst the lowest in the world: Mozambique is ranked 171 out of 177 countries in the UN 2004 Human Development Index (HDI).

The PARPA evaluation highlighted progress in rehabilitating infrastructure, training health professionals and providing equipment to health centres. This translated into a reduction in infant mortality rates from 149 per thousand births in 1995 to 101 per thousand births in 2003. Other major improvements were recorded in child vaccination rates and in the percentage of attended births from 38 per cent in 1999 to 46 per cent in 2003. Despite these improvements, the health sector suffers from a series of weaknesses, including the lack of a comprehensive strategy in the area of maternal and paediatric care, low budget execution rates due to delays in disbursement from the government and donors and uneven access to health services between provinces. The PARPA objective of providing 80 per cent of households in two provinces with mosquito nets is far from being achieved. Moreover the salary and incentive policy does not promote productivity and/or motivate health professionals to work in remote areas. The capacity of health care workers is very low and the doctor/population rate is amongst the lowest in the world and is falling further.

HIV/AIDS remains one of the greatest threats to the development of the country, with life expectancy consequently falling from 47.1 years in 1997 to 37.9 years in 2004. The infection rate was 15 per cent of the population in 2004 and is increasing rapidly. Efforts in the last two years have concentrated on the creation of a policy and institutional framework for the implementation of the 2001-03 National Strategic Plan (NSP). A National Aids Council (NAC) was also established to ensure a multisectoral approach and greater partnership with civil society and other stakeholders. However, government's action to fight HIV/AIDS faces institutional and strategic difficulties. Evaluations of the NSP reveal significant problems of human and institutional capacity of the NAC to lead the national response effectively and absorb the resources allocated. Access to prevention, care and treatment is still very limited. Despite recent commitments by Brazil to build a factory in Mozambique to produce cheap generic anti-retroviral drugs, the cost of these drugs remains too expensive to be distributed in adequate quantities. Stigma hinders many actions and the awareness campaign is insufficient. The revised NSP, under preparation, will try to address these shortcomings, adopting a multisectoral approach to improve service delivery systems and financial management. More resources are currently being made available by the donors community, especially to provide anti-retrovirals and reduce mother-to-child transmission.

Although threatened by HIV/AIDS, Mozambique has made progress in education since the inception of PARPA. The gross enrolment for boys in lower primary education (EP1, the first five grades) has been over 100 per cent since 2001, and gross EP1 enrolment for girls has increased from 43 per cent in 2000 to 46 per cent in 2003, exceeding PARPA targets by wide margins. Accounting for more than 5 per cent of GDP, spending on education has led to substantial progress in teacher training and school construction. However such improvements have been uneven among provinces and the execution rate of investment is still low. Lack of monitoring and evaluation of external funds has also posed major problems in mid-2004, as misuse of the funds led the Ministry of Education to reimburse the donor. Moreover, repetition and dropout rates remain high (at about 22 per cent and 8 per cent, respectively, in lower primary education) and the supply of skilled teachers is low, owing partly to the impact of HIV/AIDS. A new strategic plan for education 2005-09 is under preparation and will focus on improving financial resource management and increasing the completion rate in primary education through the introduction of new curricula and the implementation of pre and in-service teacher education programmes.

