

WG: Growth and Macroeconomic Stability

Summary

At the mid-year review, prospects for continued rapid growth and single digit inflation looked good. Unfortunately end of year inflation went up to 11.2% and while growth rate was maintained to close to 8%, growth in the agricultural sector was affected by drought and floods and might not have been as strong. Growth in 2005 was driven by good performance in the transport and communication and construction sectors¹. These sectors are less labour intensive and their output more cyclical. Partly because of external shocks and partly because of internal policy decisions, there was significant volatility in the exchange rate in the course of the year that might have been counterproductive to building confidence of investors in the Mozambican economy and contributed to the inflation. Fiscal performance was close to expectations but with low level of execution of recurrent and, particularly investment expenditures, partly because of the delays in adopting the budget for 2005. Although targets in that area were met, we do not see significant improvement in the level of government revenues. An increase in FDI from non-mega-projects sources is observed but is far from being sufficient to compensate for the level of investments brought by mega-projects. On the external side, trade and current balances deteriorated during the year, partly as a result of the external shocks.

Overall, macroeconomic performance in 2005 was satisfactory, particularly when considering adverse external shocks (increased in oil price, drought and floods). This being said, while a fifth consecutive year of real growth was noticed in 2005, this growth might not have been as broad-based as earlier because of a drop in production of certain crops and underperformance in the agricultural sector upon which a very large proportion of households is dependant. This stress the need for, as indicated in the new PARPA, reducing the vulnerability of population to climatic changes and paying more attention to improving the conditions for reaching growth records that are potentially more sustainable and broad-based. To that effect, macroeconomic stability is key and more attention should be given to improving conditions for increased contribution of the traditional sectors (ie agriculture and fisheries) in the economy as well as for the emergence of new, labor-intensive, export oriented industries and services, in the agricultural as well as other sectors. Part of those conditions are linked with improvement in the business climate but also to increasing investments in rural infrastructure and in the formation of a skilled workforce and a reformed public administration.

Introduction

This note reviews the government's ("GoM's") performance in 2005 with respect to macroeconomic growth and stability. Important sub-sectors are treated separately followed by a summary of the main lessons learnt from 2005 and resulting priorities for 2006. GoM's macroeconomic and fiscal performance is assessed against the end-year targets set by the GoM in the PES and the OE 2005 as well as, when relevant against the targets agreed with the IMF in May 2005. A recurrent problem in analysing the performance of the economy is the very preliminary and incomplete nature of the data provided.

Real Sector

- *GDP growth*: estimates indicate that real GDP growth remained strong at 7.7% during 2005, against 7.5 % in 2004. High level of growth in the construction (+25.8%) and transports and communication (+19.5%) sectors explain the larger part of last year good performance. Growth in the construction sector was mainly driven by road rehabilitation

¹ The growth rate for the economy as a whole is coming from figures agreed with the IMF Mission of March 2006. Sectoral growth rates are taken from the Balanco do PES published in March 2006. Sectoral growth rates figures might be revised later in the year and the analysis of the real sector performance for 2005 might have to be revisited accordingly. Unfortunately more definitive figures could not be available in time for the production of this report. Data on Budget execution come from the Budget Execution Report produced in February 2005.

and bridges construction, in good part funded by external aid. In the transport and communication sector, performance was driven by the communication sub-sector.

- *Agricultural growth and poverty reduction:* Unfortunately, growth in the agricultural sector, which represents 25% of the economy, was of only 1.8% for the year. Poor performance resulted mainly from the floods in the Central region, resulting in a 7% lost of the planted area. With 80% of the economically active population employed in the agricultural, fishery and forestry sector, a poor performance in that sector is a bad omen for poverty reduction, despite overall growth. This is particularly worrisome as it has been showed that the agricultural sector has had the most significant contribution to poverty reduction in the last years. Furthermore, little progress in reducing the vulnerability of agricultural output to external factors has been made. Noticeable in the sector, is the significant increase in production (+30%) of cash crops driven by high increase in production of the following crops: cashew nut, tobacco and sugar cane.
- *Mega projects:* Now that the main construction period has terminated and production has reached its expected levels, the impact of the mega-projects on growth of the economy was not has significant in 2005 as in the previous years. Preliminary figures indicate that at around 12%, the contribution of current mega-projects to GDP might have peaked.

Fiscal Performance

- *Revenue collection:* domestic revenues increased by 24.4% compared to 2004 and reached 14.0% of GDP, thus meeting the PAF target of 13.9% for the year. This being said, revenue collection was lower then expected for all forms of taxes and overall represented only 94.2 % of the beginning of the year target. The IMF floor target for that indicator was slightly missed. Taxes on goods and services on internal operations represented only 80.2% of expectations, explaining a large part of the shortfall.
- *Expenditures:* as indicated in the table below, underperformance in revenue collection was somehow compensated by reductions in current and investment expenditures. Current expenditures reached 90.2% of the planned level, with expenditures for personnel reaching 93.8%, meeting the target set by the IMF for this budget line. With 67.2% of total expenditures going for priority expenditures, the PAF target of 65% for priority expenditure against poverty was also met. Total investment expenditures increased by only 8% (hence diminishing in real term) and reached only 66.3 % of the beginning of the year target. Internally funded investment performed better than externally funded investment (with 75.2% of amount budgeted disbursed for internal investments against 62.4% for external) and, in that latter category of expenditures, higher level of disbursements occurred for grants then for loans (62.4% against 51.7%). Lower then expected execution is linked with the late approval of the budget but maybe also due to problems of absorptive capacities.

Budget item	% of realization against budget law	In Millions of meticais	IMF target in millions of meticais
Internal revenue	94.2%	20,093	21,090 (floor)
Salaries	93.8%	10,358	11,045 (ceiling)
Primary deficit		- 4,240	- 4,481 (ceiling)

- *Fiscal deficit*: the domestic internal primary deficit² was below what had been planned, mainly because of the lower than expected level of recurrent expenditures, and was within the target set by the IMF. For the same reason, budgetary deficit was slightly lower than expected (91.4%). 75% of budgetary deficit was financed by external resources (66% grants and 33% loans) and 25% by domestic loans. Lower than expected grants were compensated by higher than expected borrowing on the local market (of 2,300 Billions of Meticiais or about US\$90 millions).

Monetary and Financial Sector Developments

- *Inflation and monetary policy*: At 11.2%, accumulated inflation substantially exceeded the target. This increase was largely due to a jump in late 2005. It reflects external shocks as well as the authorities' slow reaction to mitigate their effects. Factors outside the government's control included: natural shocks leading to low output of basic agricultural goods with large weights in the consumer price index; the effect of high fuel prices (due to high international oil prices) on distribution costs; and the effect of the large exchange-rate depreciation. But given the predictability of the effects of these shocks, policy reaction was slow: monetary authority interest rates did not start rising until November; fuel price adjustments should be managed more smoothly; concentrated public spending late in the year should be avoided. There was a significant expansion in broad money (currency and reserves, plus deposits), but the target for the expansion of base money (the only measure tightly controlled by the central bank) was met. Because monetary policy affects but does not control inflation, there is a need for clearer justification and articulation of central banks' actions.
- *Exchange rates*: Since late 2004 the currency has been highly volatile. After appreciating in 2004, it lost 30% of its value (to the US dollar) during 2005. Although the value of the currency is naturally affected by factors outside government control, and some level of volatility is natural in a floating regime, exchange rate policy has been particularly uncertain and opaque.
- *Credit market conditions*: Overall conditions improved. Average interest rates on domestic currency loans fell to circa 20% by late 2005. Given the increase in inflation, this represented a substantial decrease in real interest rates on fixed-rate loans. The ratio of non-performing loans in the banking system fell to a (post-liberalisation) record low of less than 4%. This combination of factors contributed to a significant expansion in domestic credit to the economy. In nominal terms, credit to the economy increased by 54% (15% in dollar terms). Threats to these positive developments to watch over 2006 include the effect of renewed double-digit inflation on bank rates, and the consequences of recent regulatory restrictions on foreign currency lending.

External Sector

- *Trade balance*: as the mega-projects have reached their "cruising speed", exports grew less significantly in 2005 than in the previous years. Variation from 2004 was of +16%, with exportations from mega-projects increasing by 20% in value terms due to high aluminium prices and by non-mega projects by only 6%. Share of mega-projects exports increased in relation to total exports from 70% to 72%. This deterioration took place despite a 30% increase in export crops production (that might have an impact on the trade balance only in 2006) and might indicate increased dependency toward mega-project exports. With an increase in imports of 21% (or by 31% excluding mega-projects), trade balance deficit increased by 44% (-26% excluding mega-projects) and current account deficit by 25% after grants. Only part of the increased in imports can be linked with increase in oil prices and imports of food. On the positive side, importations of capital goods increased by 13% for the period into consideration and continue to represent around 13% of total imports.

² Taken for Mapa VIII – REO. Should be checked against primary deficit agreed with IMF Mission.

- *Capital inflows:* diminishing investments by mega-project translated into a continued reduction of overall foreign direct investments from US\$245 millions to US\$108 millions between 2004 and 2005 (ie, a decrease of 56%). Interestingly, FDI for non-mega projects increased by 46% over the period (from US\$67 millions to US\$98 millions) and represented 90% of all FDI. *It is suggested that this section be completed after the IMF mission. Amount in “errors and omissions” in the currently available balance of payment is still very large and figures available indicate large negative fluctuations from 2004 of capital inflows toward the government, these might stand to be corrected.*

Key lessons and perspectives for the future

Assessment of 2005:

Macroeconomic performance in 2005 is considered satisfactory, particularly when considering adverse external shocks (increased in oil price, drought and floods). This being said, while a fifth consecutive year of real growth was noticed in 2005, this growth might not have been as broad-based as earlier because of underperformance by the agricultural sector upon which a very large proportion of households is dependant. On the fiscal side, the PAF and IMF performance indicators were met or almost met but there are still rooms for improvement in terms of increasing tax collection. On the less positive side, inflation for the period was relatively high at 14% and exchange rate volatility might have created uncertainties among investors. The increased in trade deficit is worrisome.

Perspectives for the future: notwithstanding the positive developments witnessed in 2005, a number of areas should be highlighted for GoM’s consideration during 2006. These include:

- regardless of the generally good performance of the economy, macro-economic stability cannot be taken for granted as Mozambique is still and will continue to be vulnerable to external shocks. This call for continuous fine tuning of macroeconomic policies and development of policies and program targeted at reducing vulnerability;
- monetary policy should be more transparent and stable and better anticipate or react to developments in order to deal more effectively with external shocks while reducing exchange rate volatility;
- increased efforts should be made to widening and strengthening the tax base in an effort to reduce dependency towards external aid. Increasing revenue collection on imported goods as well as increasing tax intake from non-revenue sources (including concessions) should receive particular attention;
- Increased macro-economic stability and increased likelihood of attaining the PARPA II poverty reduction objectives will continue to require tight co-ordination and collaboration between different government institutions and more careful economic analysis supporting policy interventions. The intention of MPD (DNEAP and DNP) and MF (DNO) to provide strengthened analytical support to the sectors as well as advice and support in the program and budget planning area should also contribute to attainment of poverty reduction objectives. These efforts should be translated in a PES, and when relevant in sectoral work plans, that put more emphasis on specific and verifiable measures towards boosting economic growth and poverty reduction;
- External partners should consider pooling resources together to support better coordinated strengthening of analytical and planning capacities. In addition, strengthened dialogue between GoM and bilateral and multilateral institutions in the course of the year on macro-economic and poverty issues should be encouraged;
- Government and donors should continue to work closely together to achieve more predictability in aid flows;
- As it was stated last year, greater attention to better management of natural resources in a growth and poverty reduction context and in the context of increasing domestic revenue generation is still needed;
- The ongoing labour force survey should be a valuable instrument to increase knowledge about employment movements and make appropriate policy decisions with a view to increasing household welfare;

- the macro and micro-economic impact of HIV-AIDS should be better assessed, including in the PES and Balanço do PES, as a way to ensure that adequate financial and human resources are allocated to the pandemic. Better understanding and integration in sectorial policies and programs of the micro effect of public health and education on labour productivity would also contribute to achieving increased outcomes of poverty reduction efforts.

It should be noted that discrepancies between the various sources of information on the performance of the economy and the lack of more detailed and reliable information shortly after the end of the period under consideration render analysis difficult and subject to different interpretations.