

Pulling in non-extractive industry investments

The extractive industry has been the beneficiary of substantial investments in recent years. The massive investments in the Moatize coal basin in the Tete province by the Brazilian mining company, Companhia Vale do Rio Doce (CVRD), and the Moma titanium project by the Irish mining and exploration company, Kenmare Resources, are testimony to the growth of this industry. Over 80% of the USD1.8 billion investment projects that were approved by the Mozambican authorities in the first half of 2007 represented CVRD's investment alone. Once production is at full steam at the Moma titanium mines, they are expected to contribute a significant 2.4% per annum to national output. Over the medium term, further investments are expected in the first open-pit gold mine and if oil reserves in the Rovuma basin prove viable, Mozambique could probably become an oil producer.



Africa has traditionally been a net exporter of extracted commodities. As such, the aforementioned investments were expected once political and economic stability was restored in Mozambique and allowed for investors to access the country's natural resources. What is remarkable is the growing interest of investors in non-mining sectors, implying that foreign direct investment (FDI) headed to Mozambique is diversifying into other sectors. This typically signals a response to macroeconomic stability, an improvement in infrastructure and, most importantly, that the 'anchor' investments, such as Mozal, have demonstrated that Mozambique with all its challenges can provide attractive returns to investors. This may explain the tenfold surge in investment projects in 2007 to 192, compared to 2006, and that a fair share of these proposals were for sectors that have not historically attracted large FDI inflows, including agriculture, agroindustry and tourism. Furthermore, a sizeable share of these investments are intended for formally investment poor regions in central and northern Mozambique. This is promising for significant investments are finally being attracted into sectors that are greater generators of employment and the spread north of FDI will support efforts to reduce the regional disparities in development.

Political developments

The upcoming first provincial assembly elections are a reminder that presidential and legislative elections are due within two years. In a move by the government to decentralise power and increase participation at grass-roots level in the democratic process, 10 new provincial assemblies were created. These assemblies will have a supervisory function with the powers to reject budget proposals and plans for provincial governors appointed by the president.

For most of 2007, the December 2007 date for the provincial elections was a bone of contention because of concerns about the electoral commission not having sufficient time to prepare for the elections as well as the fact that the elections date fell in the rainy season. However, the constitution mandated that provincial elections take place within three years of the constitution coming into effect, which implied a 2007 or January 2008 election. In July 2007, the then director-general of the National Electoral Commission (CNE) expressed his doubts about completing the electoral census by December 2007. The CNE director-general stated that if the electoral commission was rushed to meet the end-year deadline 'ghost voters' on the voters roll because of disorganisation or fraud will not be comprehensively removed, the cost of resolving all the glitches is likely to double to USD54 million and the timing of the provincial elections in the middle of the rainy season would serve to reduce voter turnout. In addition to the timing of the provincial elections, the scheduling of the party candidature registration on 18 October 2007, the day following the completion of the voter registration process left very little time to organise party lists for the number of seats is determined by the voter registration.



An appeal from the local Muslim community that was concerned about the election date coinciding with one of its significant religious events, Eid-ul-Adha finally compelled President Guebeza in July 2007, to move the provincial elections from 20 December 2007 to 16 January 2008. However, this postponement did not address the rainy season element, the administrative nightmare of cleaning up the voters' roll and the late arrival of equipment critical to the execution of the registration process. As at 30 October 2007 only 2.4 million of the Electoral Administration Technical Secretariat's target of 10.5 million had been registered. Thus, following consultation with other political parties, the government amended the constitution in November 2007 so that a new deadline for voter registration could be set. The new date for completion of the registration process was announced as 15 March 2008. Registration was suspended during the rainy season, from 16 December 2007 to 14 January 2008, when non-all-weather roads are often impassable and make transportation difficult. The provincial elections are yet to be rescheduled.

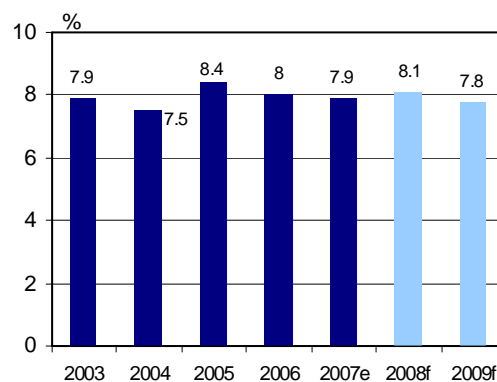
The upcoming provincial elections brought to the fore the simmering tensions between the ruling party, Front for the Liberalisation of Mozambique (Frelimo), and the main opposition, Mozambique National Resistance (Renamo). A series of unexplained arson attacks in the coastal province of Sofala in the third quarter of 2007, led to people being displaced from their torched homes and the creation of a wave of fear. Renamo was accused of instigating several of the attacks. This was fervently denied by the party's general secretary, who argued that the attacks were being executed by assault groups created by Frelimo to terrorise the opposition party's supporters. Although in between elections, relations have been broadly stable between the two political parties, around election times the rivalry that characterises their relationship comes to the fore and is a stark reminder that the hostilities stemming from the civil war are simply latent.

Economic structure and growth

Mozambique has been afflicted with one devastating cyclone and severe floods twice in the space of 12 months, however, this flood prone country has still managed to grow at one of the fastest economic growth rates on the continent, particularly for a non-oil exporter. This implies that although it has expanded at stellar real GDP growth rates in excess of 7% per annum since the beginning of this decade, the economy has the potential to grow even faster. These recurrent floods have been regressive for they impose a huge cost on the economy through their impact on infrastructure, human capital and production. Last year's Cyclone Flavio cost the government an estimated USD71 million to repair damaged infrastructure and redress people that had been displaced by the floods. Aside from the damage to schools, hospitals, electricity supply and tourist facilities, agriculture production was also impacted because of the submersion of crops and the displacement of small holder farmers.

The economy is estimated to have expanded at 10% y/y in the first half of 2007, compared to the corresponding period of 2006. The drivers of this growth were the electricity and water sector, which expanded at a whopping 39.9% y/y; the buoyant commerce sector that grew by 15.2% y/y; strong performance from agriculture, in spite of floods early in the year, which increased production by a remarkable 12.7% y/y; solid expansion in the construction industry of 11.8% y/y; and 9.8% y/y growth in the transport and communication sector. The small extractive industries and mining sector also registered strong growth of 7.1%, which reflects burgeoning investment in the sector in recent years. The stellar growth rates of the aforementioned sectors failed to rub off on the manufacturing and fishing sectors, which contracted by 2.3% y/y and 13.5% y/y respectively. The poor performance of the manufacturing industry reflects the country's focus on exporting raw materials and of manufacturing facilities that

Real GDP growth



Source: IMF, Standard Bank est.



do exist, although several are not in operation. The dramatic decline of the fishing industry is on account of the looting of Mozambique's marine resources by illegal fishing vessels, which has been especially detrimental to exports, for this industry is a significant generator of export revenue.

The rapid growth of the utilities (electricity and water) sector reflects the massive investment that is being directed at it. In the mid-2007 the Mozambican finance minister stated that an investment of USD382 million will be made in the country's electricity sector that would connect more than one million people to the national grid. New power projects include a 750 megawatt (MW) gas-fired power station in the Inhambane province, a 2 000MW coal-fired power station at a Moatize in Tete and a new hydroelectric plant that will be located 70km west of the Cahora Bassa at Mpenda Nkua that will be able to generate 1 200MW and is expected to cost USD2.3 billion. This strong expansion of the power sector not only reflects the government's desire to support industrialisation and attract FDI, as it did the Mozal Aluminium Smelter through the carrot of cheap electricity, but also the fast regional growth in demand for electricity, estimated at 1 000 MW per annum, that implies a ready export market for new supplies of electricity.

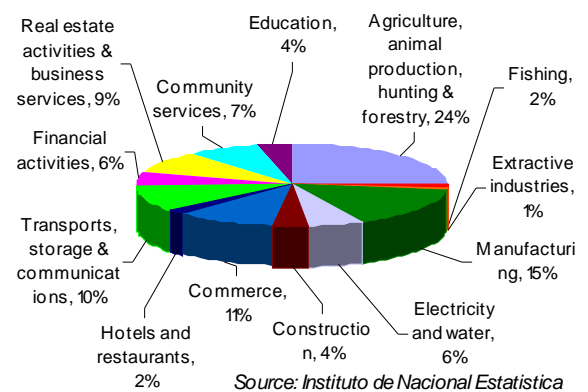
The size of the commerce and transport, storage and communications sectors indicates the importance of Mozambique to the region, particularly its neighbouring interior countries, as a significant transport conduit for the movement of tradable goods and services. These sectors are hence more interdependent than others as the performance of the one determines that of the other. Mozambique's coastal position implies that its ports are major conduits for the region's trade. The country's strategic position in the region's transport corridor explains the growing investment in its transport infrastructure. The government seeks to attract foreign investment of about USD1 billion to repair its dilapidated road infrastructure and build new roads. Towards this end, the World Bank has approved a credit facility of USD100 million to support the second phase of Mozambique's Roads and Bridges Management and Maintenance project.

An improved and more extensive road network will not only link Mozambique to its neighbours but also reduce the isolation of northern Mozambique by linking it to the south of the country. This will in turn boost agriculture, trade between the provinces and tourism. In previous years, when the south of Mozambique was afflicted by drought, it was difficult to transport food from northern parts of the country due to impassable non-all-weather roads. Better roads would connect food surplus areas to deficit areas and beyond to export markets; allow for Mozambique's tourism potential to be fully tapped into; and continue supporting the rapid growth of the commerce industry for smoother transportation of goods that will increase the traffic and reduce the transportation cost component on prices of tradable goods.

The strong performance of the agriculture, livestock, hunting and forestry sector largely reflects an increase in livestock production. The cyclone and floods that afflicted Mozambique in early 2007 affected the production of food and commercial crops that support the balance of payments. Nevertheless, the performance of the sector was still solid and together with the improvement in livestock production boosted the sector's output for that period.

The small extractive industry and mining sector is growing rapidly off a very low base following the discovery of several resources alongside a global commodity boom and hence attracted large FDI inflows and is expected to become a significant contributor to national output in the years to come. CVRD's mega coal-producing Moatize project in the Tete province is the largest extractive industry project in the country. Of the USD1.8 billion in investment projects that were approved in the first half of 2007, over 80% represented CVRD's

Contribution to GDP (2006)





investment in the coal basin of Moatize. Titanium is being mined by Irish company, Kenmare Resources, under Mozambique Titanium Minerals Project (Moma). Once production at Moma is at full steam, it is expected to contribute about 2.4% per annum to Mozambique's GDP, thereby raising the country's growth potential.

The massive investments in the rehabilitation of energy and transport infrastructure as well as the expansion of the once negligible mining industry explain the sound growth in the construction industry. In 2008 construction is expected to begin at Mozambique's first open-pit gold mine in the Manica province, which is estimated to have 1.5 million ounces. The USD68 million project is expected to employ 300 people and will initially produce just under 90 000 ounces per annum before rising to the projected long-term production level of 500 000 ounces. Hydrocarbon exploration companies have revealed that Mozambique has significant oil and gas potential on the north-east coast around the Rovuma basin. The potential of oil and gas production in the medium to long term coupled with plans to build an oil refinery in the northern province of Nampula will substantially reduce the import bill and hence the pressure of importing expensive refined oil has on economic growth.

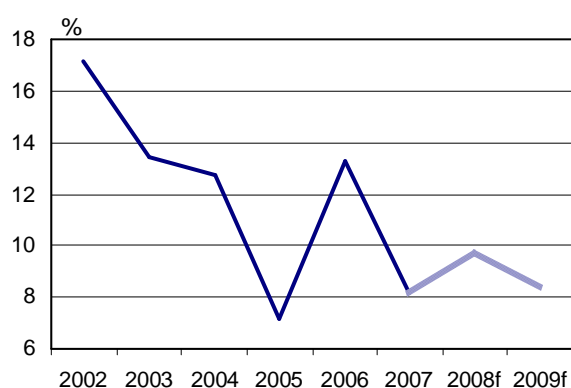
The growth in agricultural production in 2008 is not expected to be as strong as it was in 2007 because of the protracted heavy rainfall and flooding that has damaged an estimated 15% of food crops. Nevertheless, the economy is expected to continue its growth momentum spurred by large FDI inflows, generous donor support for the public infrastructure, education and health sectors, and sizeable export revenue as commodities and minerals from new mines begin to come on stream. The risk to a favourable growth outlook is constraints in energy supply given the regional deficit. As electricity is a prerequisite for any potential investors, ensuring the availability and reliability of energy supply is crucial to attracting FDI. According to the authorities, 192 projects worth USD8 billion were approved in 2007, which is a remarkable tenfold increase compared to 2006. Unsurprisingly, mineral resources and industry attracted a significant share of investment proposals but so did other sectors that have historically attracted investment, including agriculture, agro-industry and tourism. Aside from investment becoming broader based, a sizeable share is also spreading northwards to far flung provinces implying that the regional disparity of investment is progressively being reduced.

Inflation

Inflationary pressures in 2007, particularly in the first half of the year, stemmed from the escalation in international oil prices that fed into higher prices for the rent, utilities and fuel index. In the year to January 2008, the prices of petrol and diesel surged by 46% and 90% respectively. These massive price increases feed into the rent, utilities and fuel index, which has the second largest weight in the consumer price index (CPI), after food and non-alcoholic drinks. The annual average inflation rate for this index increased to 14.1% in 2007 from 12% in 2006, and hence had a marked effect on overall inflation, particularly in the first half of 2007. The softening of food prices in the first half of the year, when harvests seasonally go to market, and the dampening of energy prices in the second half of the year, allowed for a decline in overall inflation in 2007 to an annual average rate of 8.2% compared to 13.3% in 2006. This despite the rise in food prices during the end-year lean season that pushed inflation beyond the 10% mark in December 2007, to 10.3% y/y.

Core inflation (excluding food and energy) has been contained in the 5% to 7% band. This measure of inflation is immune to exogenous factors and instead is influenced by domestic liquidity pressures. Currently, the Bank of Mozambique imposes a ceiling on base money growth to control inflation. In 2008, the

Inflation – annual average



Source: Instituto de Nacional Estatística, Standard Bank est.



authorities plan to limit the growth rate of the monetary aggregate to 14% to meet its overall inflation target of 5% to 6%.

In 2008, overall inflation is expected to remain on the upside because of unusually heavy rains and the damage of recent floods on food production. According to the Ministry of Agriculture, over 150 000 hectares of crops, which constitute about 15% of the total cropped area, has been damaged by the adverse weather conditions. We hence expect food shortages this year to push prices up. As the 'boiling' oil prices are not expected to give any relief in the short term, energy prices are expected to be elevated. Following local protests in January 2008 in response to the increases in transport fares after the fuel price hikes, the authorities have capped fares indefinitely implying that the impact of higher oil prices may only show through in utilities and fuel prices, and not transport, in the short term.

As Mozambique is an importer of petroleum and food production is dependent on volatile weather patterns, overall inflation will continue to be vulnerable to high international oil prices and natural disasters that affect food production in the medium term. The ongoing exploration of oil reserves in the Rovuma basin as well as plans to construct an oil refinery in Nampula are expected to ease the oil import bill in the long term and hence dampen inflationary pressures stemming from energy prices. In the medium term, the impact of food prices on inflation will moderate as the food weight declines in accordance with projections of higher disposable income. Over the long term, as the technology used in agriculture becomes more sophisticated and irrigation schemes become more prolific, food production is expected to increase and stabilise, and as such food inflation is expected to be contained at low levels.

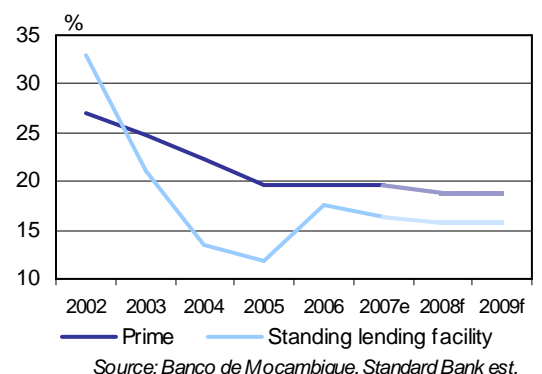
The Bank of Mozambique plans to graduate to an inflation-targeting framework. For this framework to be effective there has to be a solid transmission mechanism between the real economy and domestic financial market, such that a hypothetical increase in the presumed monetary policy tool, the policy interest rate, to curb inflation has the desired effect of slowing consumption. However, the cash-based nature of the economy with limited credit facilities implies that an interest rate as the monetary policy tool employed to rein in inflation may be a blunt instrument. Although significant developments have occurred in the local financial market in recent years, more substantial financial deepening needs to take place over the medium to long term to reduce the current disconnect between the real economy and the financial market.

Interest rates

While the annual average standing lending facility rate, the policy interest rate, eased to 16.3% in 2007 from 17.6% in 2006, the prime lending interest rate actually edged up to 19.7% in 2007 from 19.6% the previous year. The decline in the policy rate reflects a policy decision by the Monetary Policy Committee (MPC) to cut the interest rate by two percentage points to 15.5% in June 2007. The reasoning behind this decision to relax monetary policy was a lower inflation environment compared to that in the previous year, a stable exchange rate and an improvement in the balance of payments position.

The policy rate remained stable for the remainder of 2007, despite the escalation in inflation in the second quarter of the year. The next policy move occurred in January 2008, when the policy rate was cut again, this time by one percentage point, to 14.5%. The MPC defended its decision to cut rates based on a favourable inflation outlook. We are of the view that inflation will remain on the upside in the short term and do not expect further relaxation of monetary policy in this period. The central bank's decision to increasingly drain liquidity with foreign exchange sales as opposed to Treasury bill issuances as well as its plans to redeem Treasury bills in 2008 suggests that short-term interest rates will ease in 2008. We believe the projected impact of the redemption of short-term

Interest rates – annual average





government paper on interest rates is the reason behind the MPC's decision to cut the policy interest rate.

Although the prime lending rate edged up on an annual basis, it declined during the course of 2007 from 20.3% in January to 18.9% in December. The slide of the downwardly sticky lending rate occurred particularly in the second half of 2007, following the cut in the policy rate in June. The reduction in the Bank of Mozambique's statutory reserves requirement ratio to 10.15% in April from 11.51% previously, increased loanable funds on the credit market, which lowered the cost of credit and contributed to the moderate decline in the lending rate to record lows. The extent of the lending rate's decrease was likely restrained by the concomitant increase in domestic borrowing by the government to cover the shortfall from delayed disbursements of grants, which reduced loanable funds in the market. Nevertheless, the modest decline in lending rates is likely to be looked on as favourable by Mozambican business associations that find the cost of credit high and a significant constraint to the expansion of the private sector.

Given our upside inflation projections, we expect interest rates to remain broadly stable in the short to medium term and only downwardly adjust if there is a substantial slowdown in inflation that inflates real interest rates. Any significant decrease in the lending rate is only likely to follow a major structural reform in the financial sector, such as the establishment of a credit reference bureau that reduces the cost of asymmetric information on lenders. In the long term, greater inroads in financial deepening are expected to improve the transmission policy between financial markets and the real economy that will allow for inflation rates to become more responsive to interest rate changes, and result in the two parameters moving more closely together.

Exchange rate

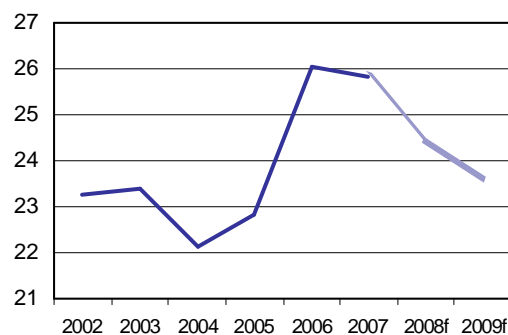
After depreciating for two years, the metical appreciated by 5.1% in 2007 to an annual average rate of MZN25.82 per US dollar. The strengthening of the metical reflects strong inflows of foreign exchange due to a combination of buoyant donor inflows and an increase in FDIs. This surge in foreign exchange explains the acceleration in the growth rate of commercial banks' foreign deposits in 2007 from 15.4% y/y in January to 36.5% y/y in November.

According to the Bank of Mozambique's balance of payments, at the end of the third quarter of 2007 the country's net foreign reserve assets position had fallen to negative USD151.1 million, from USD75.2 million a year earlier. This implies that in the 12-month period to September 2007, the commercial banks' net foreign assets had risen by USD226.3 million on account of a substantial increase in inflows of foreign exchange. This surge in hard currency deposits in the banking system explains the gain in value of the metical in 2007.

Aside from strengthening, the metical has also stabilised over the past two years with the support of a temporary band that was placed on the interbank foreign exchange market. The exchange rate regime was centred on the previous day's exchange rate to reduce the volatility stemming from large inflows of foreign currency in an otherwise thin foreign exchange market. This band was removed in June 2007 thereby restoring flexibility to the market. The foreign exchange market was largely unruffled by the removal of the band, and the spread between the interbank rates and those quoted by commercial banks narrowed to less than 1%.

In 2008, strong inflows of foreign exchange owing to FDI related to ongoing mining projects and exploration of new resources, including oil and gold, donor financing of the budget deficit and projects as well as export revenue due to favourable commodity prices are expected to support the currency. Although the current account balance is expected to come under strain from imports of

Meticais per US dollar, annual average



Source: Bloomberg, Standard Bank est.



petroleum and capital equipment, we expect the sizeable inflows of foreign exchange to prop up the currency.

In the medium term, as the titanium mines and the Moatize coal project become fully operational, the additional exports of natural resources are projected to boost export earnings. The growth rate of donor funds may be projected to decelerate over the medium term, however, in absolute terms they remain large for such a small economy. If oil reserves are found to be economically viable and the authorities succeed in their endeavours to attract FDI into agriculture, the metical is likely to gain in value over the medium term. The risk to this outlook is an unprecedented surge in oil prices that impacts the trade account or a sharp fall off in the price of export commodities.

Balance of payments

The trade deficit for the first three quarters of 2007 narrowed by 5.5% to USD463.2 million, compared to the corresponding period of 2006, because of a 5.6% increase in exports revenue to USD1 843.6 million while the import bill expanded by a relatively slower 4.5% to USD2 040.5 million, and a decrease in the services account deficit. The best performing exports were energy, electricity and natural gas. Of the 42.5% surge in electricity sales, four out of every five units of electricity from the Cahora Bassa Dam was exported to South Africa and the remainder to Zimbabwe.

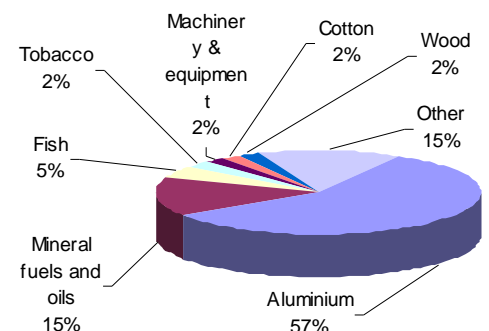
Non-traditional exports did not fare as well as traditional exports, particularly because of a downturn in the prawn industry due to Mozambique's marine resources being looted by illegal foreign fishing vessels and lower cashew nut prices that countered the increase in production in the first half of the year. Re-exports of fuel to interior countries dropped by one-third in the first half of 2007, compared to the corresponding period of 2006, adding to the poor performance of non-traditional export revenue. Cotton export revenues were better than expected as were earnings from sugar exports. The modest 3.7% improvement in the services account's deficit to USD266.3 million reflects the narrowing in the negative net income balances for the following services; transportation, travel, communications and construction.

Unlike the trade balance, the income account deficit deteriorated in the first nine months of 2007 by a substantial 63% to USD311.8 million, compared to a similar period of 2006. The widening of the income deficit reflects an increase in repatriated income from FDI projects and the growth in interest payments on public debt. Conversely, the current transfers account recorded an increase of 16% to USD484.1 million due to generous inflows of donor funds intended for the government.

On the whole, the current account deficit widened by 12% to USD290.9 million in the first three-quarters of 2007 compared to the corresponding period in 2006. This deterioration reflects the swell in the income account deficit, which highlights the impact of the repatriation of income generated by the foreign owned megaprojects and other FDI that is equivalent to the hole in the current account.

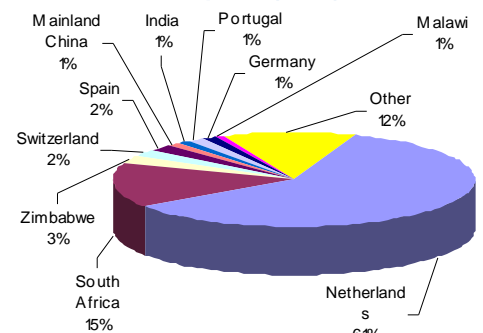
The capital and financial account reported a modest 3% decrease in its balance to USD165.7 million in the period under analysis, because of an increase in Mozambicans' acquisition of foreign assets and a dramatic decrease in the net foreign exchange reserve assets position. The capital account, in particular, reported a decrease in investment grants and transfers. Conversely, the financial account revealed a threefold increase in net direct investment to USD227.7 million. This positive performance was countered by the swell of the negative net portfolio investment balance by 41% to USD188.9 million implying that portfolio outflows exceeded inflows. This is unsurprising given Mozambique's illiquid stock exchange and limited government debt market. The country's ownership of foreign assets increased by 42.2% to

Composition of exports (2005)



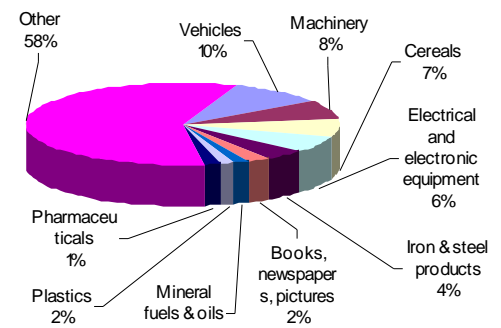
Source: International Trade Centre

Destination of exports (2006)



Source: Department of Trade Statistics, Yearbook 2007

Composition of imports (2005)



Source: International Trade Centre

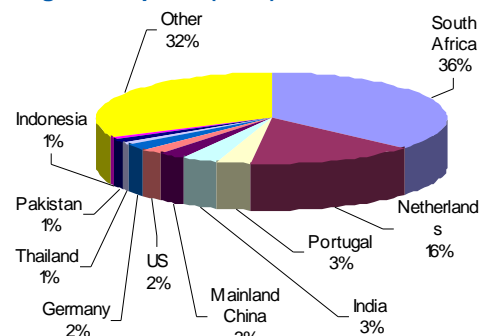
USD481.9 million largely on account of an increase in foreign currency and deposits held by Mozambicans abroad. Foreign ownership of domestic assets also increased but not enough to offset the increase in domestic ownership of foreign assets. This growth was mainly due to an increase in loans implying that Mozambique has taken on new external debt following debt relief in 2006.

When omissions and errors are disregarded, the balance of payments balance came in at a negative USD125.2 million for the first three-quarters of 2007. This is a 41.1% increase in the balance of payments deficit from the corresponding period of 2006, owing to the deterioration in the current account deficit and moderate decrease in the capital and financial account's surplus.

Mozambique's free trade agreement with the Southern Africa Development Community (SADC) became effective on 1 January 2008. The agreement implies that 85% of goods produced in SADC countries can now enter Mozambique duty free, which means trade activity is likely to pick up in the short term, particularly inflows of imports. The country's export base does not hold much appeal for regional neighbours as they produce similar products. The current account is expected to hence come under pressure in the short term from an increase in tariff-free imports and the projected increase in capital equipment for new investment projects, including the open-pit gold mine in Manica, the proposed oil refinery, power plants as well as construction of roads. However, in the medium to long term as production begins at the mines and the new electricity supply becomes available for export, revenue is expected to increase.

The improvement in transport infrastructure is expected to boost regional trade. The services account deficit is also expected to increase as transportation services subsequently increase, and travel services are also projected to rise as the accessibility of far flung tourist sites improve. As the business environment improves, FDI into non-mining sectors is expected to increase complementing ongoing mining investments, and add to inflows in the capital and financial account. According to the authorities, 192 projects worth USD8 billion were approved in 2007, which is a remarkable tenfold increase compared to 2006. Unsurprisingly, the mineral resources and industry attracted a significant share of investment proposals but so did other sectors that have historically not attracted significant investment, including agriculture, agro-industry and tourism. This is expected to diversify the export base in the medium to long term, thereby reducing the dependence on commodity price cycles.

Origin of imports (2006)



Source: Department of Trade Statistics, Yearbook 2007



Government finances

The execution of the 2007 budget was hindered by delays in disbursements of external funds. According to the Bank of Mozambique, in the first three quarters of 2007, donor grants increased by a meagre 0.9%, compared to the corresponding period of 2006, to MZN14 592 million. When grants are disaggregated, that set aside for budget support actually contracted by 14.3% in the period under analysis, to MZN5 057 million, while aid channelled to specific projects doubled to MZN1 700 million. As a result of the poor performance of budget support, government was compelled to finance some priority expenditure items domestically. With regard to domestic borrowing, the government is a net creditor. As government was compelled to borrow domestically to cover the shortfall due to delayed external grants, its net credit position, with regard to domestic financing, declined by a substantial 37% in the first three quarters of 2007, compared to the corresponding period of 2006, to MZN3 083 million.

Better than expected government tax revenue compensated for the lower than projected donor grants. Tax revenue increased by 14.4% in the first three quarters of 2007, compared to a similar period in 2006, to MZN20 070 million. This strong performance was mainly due to a 21.6% surge in tax revenue from income and profits, which constitutes just over one-quarter of total tax revenue. The improvement in income and profits' tax revenue reflects the broadening of the tax base, improved compliance, higher revenue from privatisation, mining concessions and dividends. As is typical in most developing countries, tax revenue from tradable goods and services is the largest contributor to total tax revenue. In Mozambique, it constitutes about one-half of tax revenue. In the first three quarters of 2007, this source of tax revenue expanded by 12.6%, compared to the corresponding period of 2006. The growth rate of goods and services taxes was not as strong as that of income and profits taxes largely because of the impact of the phasing down of customs duties, in accordance with SADC's Free Trade Protocol.

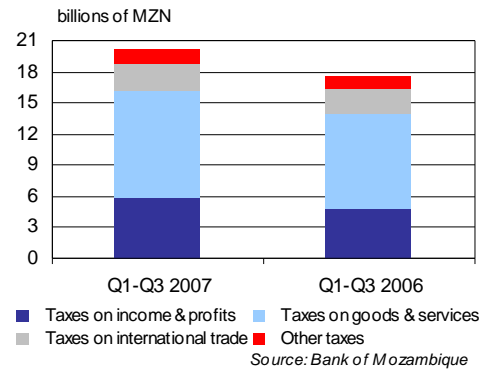
The 18.9% expansion in total expenditure in the first three quarters of 2007 to MZN38 911 million was largely due to the 25.5% increase in current expenditure to MZN23 433 million. As current expenditure is predominantly financed domestically, this part of the budget was largely executed. The swell in current expenditure reflects a 26.2% increase in the wage bill to MZN11 936 million and a 28.6% rise in transfer payments to MZN4 489 million for the business sector's development projects, particularly in telecommunications, energy, harbours and railways.

Capital expenditure, which is largely financed by external funds, increased by 17.6% in the period under analysis. The failure of capital expenditure growth to meet the performance of current expenditure is regressive for a country seeking to upscale investment expenditure with an end of improving dilapidated infrastructure. For capital expenditure to expand by a respectable rate, despite delays in disbursements of external grants, the government sought domestic financing to execute some capital projects. As such, local financing of capital expenditure surged by 38% in the first three quarters of 2007, compared to the previous period.

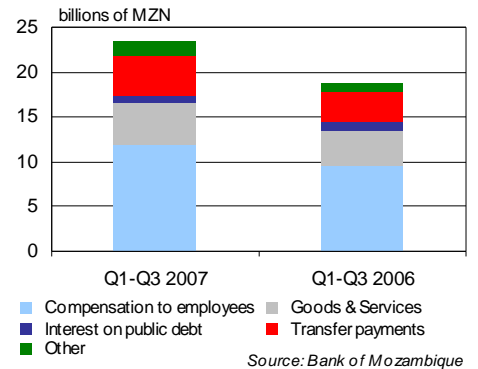
As a result of higher than projected government revenue, the budget deficit, before grants, only expanded by 9.4% in the analysis period to MZN15 842 million. However, the budget deficit, including grants increased 20-fold, from MZN20 million in the first three quarters of 2006 to MZN1 261 million in the corresponding period of 2007. This illustrated the poor performance of external grants in 2007.

Grants are projected to increase in absolute terms in the medium term but at a slower rate, implying that as a share of GDP, they will decline. Direct budget

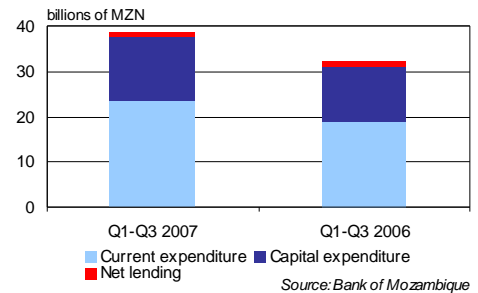
Sources of tax revenue



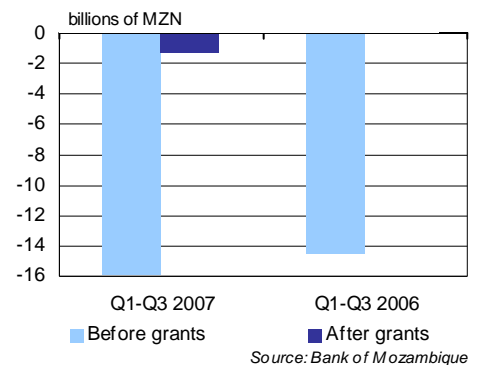
Constituents of current expenditures



Composition of total expenditure



Overall budget balance



NB: Budget balance after grants in Q1-Q3 2006 was MZN200 million.



support under the Programme Aid Partners (PAP) initiative, comprising 19 donors and funding agencies, is expected to increase to USD385.8 million in 2008 from a spending commitment of USD369 million in 2007. The PAP chose to maintain the same level of support in 2008, as for 2007 because of its concerns with the lack of legal reform, productivity in agriculture, the provision of public services and the fight against corruption. The PAP also pledged USD241 million for development projects in 2008, up from USD223 million in 2007.

In 2008 and beyond, tax revenue from goods and services as a share of total tax revenue is expected to shrink because of the free trade agreement with SADC that became effective on 1 January, 2008, which essentially implies that 85% of all imports from the SADC region will now be duty free. This is expected to be countered by an increase in income and profits tax stemming from businesses and employment that will emerge from the scores of investment proposals that the local investment authority approved in 2007 and future proposals. Tax measures that were introduced in late 2007, including the removal of exemptions on interest earned on Treasury bonds, and the imposition of a 10% tax on deposit accounts and securities on the local bourse for the first time should mobilise additional revenue.

This year's introduction of a subsidy on diesel used by urban transport operators will put pressure on the budget. This will be compounded by the projected increase in election-related expenditure over the next two years owing to the first provincial assembly elections in 2008 and general elections in 2009. The National Elections Commission estimates that the provincial elections will cost government USD34 million. The European Union, the largest financier of the elections, is expected to finance a fair share of this cost. Nevertheless, the budget deficit is expected to widen in 2008. Unless donors finance a sizeable chunk of this deficit, domestic borrowing will increase thereby crowding out the private sector and the sustainability of external debt will be compromised.

External debt

The external debt stock was estimated at MZN5.2 billion in July 2007, which is a 22.4% drop from MZN6.7 billion 12 months earlier. The sharp reduction in external debt was due to debt forgiveness in 2006 under the World Bank and International Monetary Fund's (IMF) Highly Indebted Poor Country (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). Under the MDRI, all debt owed to the IMF, the African Development Bank (AfDB) and the World Bank up to 31 December 2005, which amounted to USD154 million, USD500 million and USD1.3 billion respectively would be cancelled. However, where as the IMF and AfDB cancelled all the debt owing to them, the World Bank will be cancelling debt owed to it by the Mozambican government on a year-to-year basis. So, in 2006 only USD255 million of the debt Mozambique owed to the World Bank was cancelled. Thus the debt burden will only be alleviated in a phased manner, however, as new external debt is being concurrently contracted, this is likely to counter the impact of debt forgiveness.

Following the 2006 cancellations of external public debt, debt repayments fell by one-fifth in the first half of 2007, compared to the same period in 2006, to USD310.5 million. Half of the debt service payments, USD157.3 million, were for public debt. Only 12% of the public debt service payments were funded by the national budget and the remainder constituted debt cancellation by the Romanian government under the HIPC initiative. Private debt service repayments were valued at USD153.2 million and this was primarily financed by large companies with direct investments in Mozambique.



Outlook

A milestone in Mozambique's political sphere will be achieved this year when the country holds its first provincial assembly elections. The holding of these elections demonstrates the government's efforts to decentralise power and boost participation of people at grass-roots level in the democratic process. However, the tensions that emerged in the provinces between supporters of the ruling party, Frelimo, and the largest opposition party, Renamo, highlighted the latent hostility that exists between the two political entities, and raises a red flag about the circumstances that could surround the political environment in the run-up to the 2009 general elections.

The existence and discovery of new natural resources will continue to attract large investments and support the strong growth momentum, as long as commodity prices remain strong. Ongoing investments in energy and transport infrastructure are expected to make the local environment more conducive to business. The challenge for the authorities is to attract FDI into non-extractive industries, and sectors such as agriculture, tourism and manufacturing. Over the medium term, economic growth is expected to be driven by buoyant activity in the commerce sector, greater construction activity due to significant public investment in infrastructure construction, and an expanding transport and communication sector. Mozambique is expected to realise growth rates of between 7% and 8% over the medium term.

Inflationary pressures will continue stem from oil and food prices. We expect inflation to be on the upside in 2008 because of the significant damage to food crops by floods earlier this year. For as long as Mozambique remains an importer of petroleum and prices elevated, energy prices and transport fares will be under pressure to rise. Following January 2008's fuel price hike, the authorities have chosen to cap fares for urban transport operators through a subsidy on fuel, however, eventually the authorities will have to recover this cost through the consumer. Mozambique's vulnerability to floods implies that agriculture production will continue to be volatile over the medium term as long as farming technology does not improve significantly.

Short-term interest rates are projected to be stable in 2008 given that the policy rate was shaved by one percentage point in January 2008, to 14.5%, and as inflationary pressures are projected. The prime lending rate is not expected to have a much desired downward adjustment in 2008. It is hence projected to be stable throughout 2008.

Aluminium will continue to dominate exports in 2008 and as commodity prices are not expected to drop off sharply, export revenue from this commodity will continue to be strong. The coming on stream of additional supplies of minerals and natural resources in the medium term will boost export earnings, however, large imports of machinery and capital equipment for the new mining projects are likely to put pressure on the current account. Inflows of FDI related to the new wave of investment projects is expected to enter the capital and financial account and provide financing for the hole in the current account.

The metical is expected to be stable in 2008. Although oil and capital equipment imports will put pressure on the local currency, pledged FDI and generous donor financing are expected to prop up the currency.

The 2008 and 2009 fiscal budgets are expected to come under pressure from election-related spending. The introduction of a subsidy on fuel used by urban transport operators will create an added expense to the budget. As the execution of budgets is highly dependent on donor aid, the government's relationship with donors is critical. To ensure budget support continues and donor financing is not redirected to projects, the government must appease donors' concerns by intensifying efforts towards legal reform, increasing



productivity in agriculture, improving the coverage and quality of public service delivery, and reducing corruption.

Given Mozambique's limited options for financing, contracting new external debt is an unavoidable option. Nevertheless, debt sustainability can still be maintained by ensuring that only concessional debt is taken up and that it is directed towards productive ventures.

Summary forecasts

	2007e	2008f	2009f	2010f	2011f
National income					
Real GDP growth (%)	7.9	8.1	7.8	8.3	7.9
Inflation (% annual average)	8.2	9.8	8.4	9.4	7.1
Standing lending facility (policy interest rate)	16.3	15.8	15.8	15.4	15.5
Exchange rate (MZN per US dollar, annual average)	25.8	24.5	23.6	22.7	21.7
External sector					
Current account-to-GDP ratio (%)	-10.7	-8.6	-7.0	-5.6	-4.3

Source: Instituto de Nacionale Estatistica, Bloomberg, Bank of Mozambique, Standard Bank est.



Selected socio-economic information

General facts

People:

Population: 20.1 million (2006 est.)
Population growth rate: 1.8% (2006 est.)
Life expectancy at birth: 41.8 years (2005 est.)

Government:

Government type: Republic
Capital city: Maputo
Chief of state: President Armando Emilio Guebuza (since 2/02/05)
Elections: President elected by popular vote for a five-year term.
Election last held 1 and 2 December 2004. Next elections to be held in December 2009.

Geography:

Natural resources: Coal, titanium, natural gas, hydropower, tantalum, graphite.

Health:

Adults (age 15-49): 16.1% (2005 est.)

Source: World Bank, UNAIDS, National sources

Restrictions on capital flows

A law passed in 1993 and amended in 1995 guarantees profit repatriation. Foreign exchange rules, which were passed in 1996, are applied simultaneously to residents and non-residents. They restrict the remittance of funds overseas, but the investment law guarantees that foreign investors will be able to remit loan payments, dividends and invested capital although amounts exceeding USD5 000 will require pre-registration with the Investment Promotions Agency (CPI) and the Bank of Mozambique.

Source: Global Insight

Taxation

Corporate tax	32%
Corporate capital gains tax rate	32%
Branch tax rate	32%
Withholding tax dividends	20%
Withholding tax interest	20%
Withholding tax royalties	20%
Net operating losses –carry back	0 yrs
Net operating losses – carry forward	5 yrs
Personal income tax – top rate	20%
Personal capital gains tax – top rate	18%
Withholding tax on personal income – top rate	20%
Value-added tax	17%

Source: Global Insight

Sovereign credit rating

Standard & Poor's:

Outlook: Stable
"Stable" implies the outlook is unlikely to change: the economy is vulnerable to adverse business, financial and economic conditions, but currently has the capacity to meet debt obligations.

Local currency long term debt: B+

Foreign currency long term debt: B+

Local currency short term debt: B

Foreign currency short term debt: B

Moody's Investor Service:

Not rated

Fitch ratings:

Outlook: Stable

"B" rating denotes higher level of credit risk: speculative grade

Local currency long term debt: B

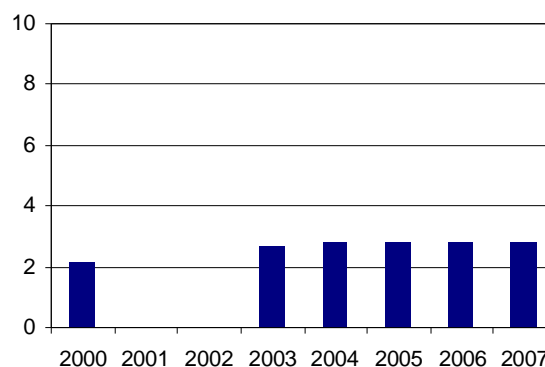
Foreign currency long term debt: B

Local currency short term debt: B

Foreign currency short term debt: B

Source: Bloomberg

Corruption perceptions index (2007)



Score: 2.8

(where 10 is "highly clean" and 0 is "highly corrupt").

Place: 111

179 countries surveyed, 1 = least corrupt, 179 = most corrupt.

(The surveys reflect the perceptions of business people, academics and country analysts. The surveys were undertaken over the past three years and no country has been included in the index without results from a minimum of three surveys).

Source: Transparency International

Human development

HDI rank 2006

172 out of 177 countries

(1=most developed, 177= least developed)

Iceland	1
Seychelles	50
Mauritius	65
Egypt	112
South Africa	121
Botswana	124
Namibia	125
Ghana	135
Lesotho	138
Swaziland	141
Madagascar	143
Cameroon	144
Kenya	148
Zimbabwe	151
Uganda	154
Nigeria	158
Tanzania (United Republic of)	159
Angola	162
Malawi	164
Zambia	165
Ivory Coast	166
Congo (Democratic Republic of the)	168
Mozambique	172
Sierra Leone	177

The Human Development Index (HDI) measures a country's achievements in three aspects of human development: longevity, knowledge and a decent standard of living. Longevity is measured by life expectancy at birth; knowledge is measured by a combination of the adult literacy rate and the combined gross primary, secondary, and tertiary enrolment ratio; and standard of living, as measured by GDP per capita

Source: UNDP Human Development Report 2007/8



Group Economics

Goolam Ballim – Group Economist

+27-11-636-2910 goolam.ballim@standardbank.co.za

South Africa

Johan Botha
+27-11-636-2463

Johan.botha2@standardbank.co.za

Shireen Darmalingam
+27-11-636-2905

Shireen.darmalingam@standardbank.co.za

Sizwe Nxedlana
+27-11-631-2018

Sizwe.Nxedlana@standardbank.co.za

Jeremy Stevens
+27-11-631-7855

Jeremy.Stevens@standardbank.co.za

Danelee van Dyk
+27-11-636-6242

Danelee.vanDyk@standardbank.co.za

Rest of Africa

Jan Duvenage
+27-11-636-4557

Jan.duvenage@standardbank.co.za

[Botswana](#)

[Lesotho](#)

[Namibia](#)

[Swaziland](#)

Anita Last
+27-11-631-5990

Anita.last@standardbank.co.za

[Angola](#)

[Ghana](#)

[Malawi](#)

[Mauritius](#)

Yvonne Mhango
+27-11-631-2190

Yvonne.Mhango@standardbank.co.za

[Kenya](#)

[Mozambique](#)

[Uganda](#)

[Zambia](#)

Victor Munyama
+27 11-631-1279

Victor.Munyama@standardbank.co.za

[DRC](#)

[Nigeria](#)

[Tanzania](#)

[Zimbabwe](#)

Kindly email brenda.landsberg@standardbank.co.za should you wish to be included on our research distribution list. Do visit our web site <http://www.standardbank.co.za> and select "Research" to view our publications.

Analyst certification

The authors certify that: 1) all recommendations and views detailed in this document reflect his/her personal opinion of the financial instrument or market class discussed; and 2) no part of his/her compensation was, is, nor will be, directly (nor indirectly) related to opinion(s) or recommendation(s) expressed in this document

Disclaimer

This document does not constitute an offer, or the solicitation of an offer for the sale or purchase of any investment or security. This is a commercial communication. If you are in any doubt about the contents of this document or the investment to which this document relates you should consult a person who specialises in advising on the acquisition of such securities. Whilst every care has been taken in preparing this document, no representation, warranty or undertaking (express or implied) is given and no responsibility or liability is accepted by the Standard Bank Group Limited, its subsidiaries, holding companies or affiliates as to the accuracy or completeness of the information contained herein. All opinions and estimates contained in this report may be changed after publication at any time without notice. Members of the Standard Bank Group Limited, their directors, officers and employees may have a long or short position in currencies or securities mentioned in this report or related investments, and may add to, dispose of or effect transactions in such currencies, securities or investments for their own account and may perform or seek to perform advisory or banking services in relation thereto. No liability is accepted whatsoever for any direct or consequential loss arising from the use of this document. This document is not intended for the use of private customers. This document must not be acted on or relied on by persons who are private customers. Any investment or investment activity to which this document relates is only available to persons other than private customers and will be engaged in only with such persons. In European Union countries this document has been issued to persons who are investment professionals (or equivalent) in their home jurisdictions. Neither this document nor any copy of it nor any statement herein may be taken or transmitted into the United States or distributed, directly or indirectly, in the United States or to any U.S. person except where those U.S. persons are, or are believed to be, qualified institutions acting in their capacity as holders of fiduciary accounts for the benefit or account of non U.S. persons; The distribution of this document and the offering, sale and delivery of securities in certain jurisdictions may be restricted by law. Persons into whose possession this document comes are required by the Standard Bank Group Limited to inform themselves about and to observe any such restrictions. You are to rely on your own independent appraisal of and investigations into (a) the condition, creditworthiness, affairs, status and nature of any issuer or obligor referred to and (b) all other matters and things contemplated by this document. This document has been sent to you for your information and may not be reproduced or redistributed to any other person. By accepting this document, you agree to be bound by the foregoing limitations. Unauthorised use or disclosure of this document is strictly prohibited. Copyright 2004 Standard Bank Group. All rights reserved.