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MOZAMBIQUE ECONOMIC UPDATE

SHAPING THE FUTURE
Why Services Matter for Growth and Jobs

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Acknowledgements

The Mozambique Economic Update is a World Bank report series that assesses economic trends, prospects, and policies in Mozambique. Each edition includes a section on recent economic developments and outlook, followed by a focus section analyzing issues of particular importance. The thematic section in the present edition explores growth opportunities in the services sector and offers reform options to unleash the potential of services for inclusive growth and jobs.

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Acronyms

BM	Bank of Mozambique (*Banco de Moçambique*)
CAD	Current account deficit
COVID-19	Coronavirus disease
CPI	Consumer Price Index
CSE	Consumer support estimate
DSA	Debt sustainability analysis
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GoM	Government of Mozambique
GSSE	General services support estimate
ICT	Information and communication technology
IMF	International Monetary Fund
INE	National Institute of Statistics of Mozambique
LNG	Liquefied natural gas
MSME	Micro, small, and medium enterprise
MT	Metric ton
MZN	Metical
NPL	Non-performing loan
PAE	Package of Economic Acceleration Measures (*Pacote de Medidas de Aceleração Económica*)
PMI	Purchasing Manager Index
pp	Percentage point
SOE	State-owned enterprise
SME	Small and medium-sized enterprise
SSA	Sub-Saharan Africa
TSE	Total support estimate
USD	United States dollar
WB	World Bank
WDI	World Development Indicators
WTO	World Trade Organization
y-o-y	Year on year

Overview

Mozambique's economy is gaining momentum in a challenging global context

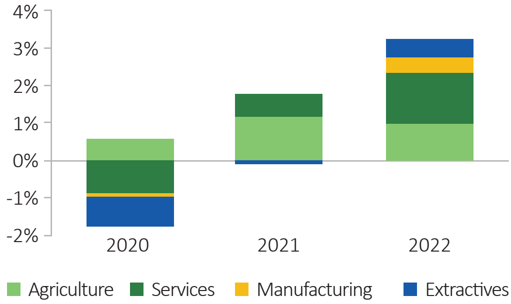
Economic recovery has gathered pace, with growth reaching 4.1 percent in 2022, despite the worsening global economy. Agriculture and services saw good performance, thanks to higher farm productivity and the full resumption of mobility. Increased external demand and prices for Mozambique's key export commodities—notably coal and aluminum—have supported the recovery further. The broader macroeconomic impact of Russian invasion of Ukraine was mitigated by Mozambique's weak trade and investment links with Ukraine and Russia, and higher prices for the country's key export products.

Inflation hit a five-year high as global fuel and food prices surged, and adverse weather reduced domestic food production. Headline inflation reached 9.8 percent in 2022, driven by food inflation. The Central Bank of Mozambique (BM) has responded to the inflation hike by consistently raising policy interest rates. The monetary tightening has constrained credit growth and put Mozambique's real interest rates among the highest in the region. High real interest rates also reflect the country's shallow financial sector; low savings and institutional investors' market power; and rising government domestic borrowing.

The ongoing wage bill reform, debt service, and fuel subsidies put pressure on fiscal balances. The impact was moderated by strong revenue collection, under-execution of capital spending, and budget support. The overall fiscal deficit is estimated to have reached 5.9 percent of GDP in 2022, from 4.8 percent in 2021. Upfront costs of the wage bill reform and implicit fuel subsidies have put pressure on the budget. Public sector employee compensation and debt service alone absorb around 90 percent of tax revenues.

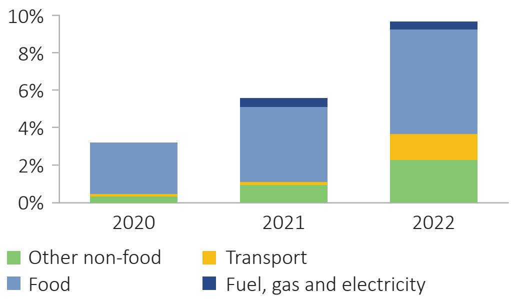
The growth recovery has been driven by the services and agriculture sectors...

Sectoral contributions to GDP Growth



Source: INE data, various years; World Bank staff estimates.

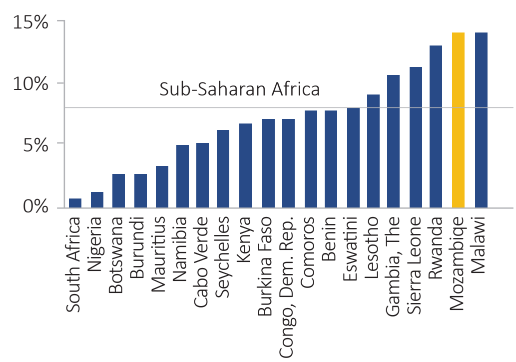
Inflation surged as global fuel and food prices rose



Source: BM; World Bank estimates.

Mozambique has one of the highest real interest rates in sub-Saharan Africa

Real interest rate (2021)



Source: Data from BM; WB estimates.

The medium-term outlook is positive but subject to substantial downside risks. Growth is expected to accelerate in the medium term, reaching 6 percent over 2023-2025, driven by continued recovery in services, increased LNG production, and high commodity prices. The growth acceleration partly reflects recovery from the consecutive shocks in recent years. The offshore floating LNG project is set to reach full capacity in the next two years, boosting GDP growth to 8 percent in 2024. Assuming favorable weather conditions, agriculture should maintain its positive performance, supported by investments in inputs. An ambitious and growth-friendly fiscal consolidation is expected to strengthen the fiscal position. However, substantial downside risks could lower medium-term GDP growth to 4.5 percent. Key risks stem from climatic disasters and security risks in northern Mozambique that may further delay the resumption of the TotalEnergies-led LNG project. Persistent pressures on food and fuel prices from a protracted war on Ukraine could lead to further monetary tightening, slowing the economic recovery. Further, setbacks in the implementation of the wage bill reform would exacerbate fiscal pressures.

Why Mozambique needs to rethink its current growth model

Mozambique needs to forge a new development paradigm based on diversified sources of growth, productivity, and jobs, with over half a million people projected to enter the labor force each year. The strong growth performance in recent decades has helped reduce poverty, but at an uneven pace and in tandem with a rise in inequality. Growth mostly benefited those at the top of the income distribution, with the Gini coefficient rising from 47 to 56 percent between 2002 and 2015. This pattern is partly due to heavy reliance on the extractive industry, with limited linkages to the broader economy, and low productivity in the agricultural sector—the main source of livelihood for the poor. Mozambique's current growth strategy has particularly been limited in its capacity to generate productive jobs. Agriculture's share of employment fell from 83 percent in 1997 to 70 percent in 2020, with most of the labor moving into services. However, although services provided a wider pathway to non-agriculture jobs, the sector is dominated by informal activities. Looking ahead, sustained, broad-based and inclusive growth will not occur by focusing only on extractives and low productivity agriculture. It will require raising productivity in services and stimulating the formalization of informal firms, while strengthening linkages between sectors.

Services can drive growth and job creation

Under the right conditions, services could be an avenue toward inclusive growth and accelerated job creation. Currently, although the services sector is the largest (in terms of output share) and relatively the most productive, it is oriented towards less complex activities such as retail. Mozambique's commercial services exports are dominated by traditional services (travel and transport). Services need to upgrade into more sophisticated and tradable activities—such as ICT, finance, and professional and business services—to become an engine of inclusive growth and employment creation. Services offer many opportunities, but the sector's productivity growth is declining at a faster pace than any other sector due to several constraints. Although policies targeted at the services sector are generally open and non-discriminatory, they are hampered by weak governance and regulatory bottlenecks, particularly in the backbone services, such as telecoms and IT services, and transport.

Opportunities in the services sector

- **Services firms have been the largest source of job growth.** While in 2006, more workers were employed in manufacturing than in services, by 2018 services firms had more than twice as workers. Services also provide a larger share of jobs to female workers than manufacturing. In 2018, almost 30 percent of workers in the services sector were women, compared to 22 percent in manufacturing.

- **Services have higher productivity levels than other sectors.** The services industry has experienced the fastest productivity growth since the mid-2000s. Productivity levels in service activities compare well with manufacturing. Within services, productivity levels in some subsectors are higher than or comparable to capital-intensive manufacturing sub-sectors.

- **Services feature strong forward and backward linkages with the broader economy.** While manufacturing is usually emphasized as a driver of economic growth and transformation because of the scalable and tradeable nature of manufacturing output, services also possess similar features thanks to the ICT revolution that enabled market exchange without physical proximity. In Mozambique, the sector has the highest employment multipliers than does manufacturing, notably in urban areas.

- **Trade in services represents an alternative path toward higher export earnings, economic diversification, and productivity growth.** The share of Mozambique's services trade surged from 11.6 percent of GDP in 2006 to almost 35 percent in 2018, but they are dominated by traditional services.

How to unleash the potential of services for inclusive growth and jobs

Mozambique needs to transition into more complex services to boost productivity growth and job creation. Mozambique could grow its services sector in both size and sophistication, while also pursuing industrial sectors where it has a comparative advantage. Growth in the services industry (notably in backbone services) could catalyze growth in other export-oriented activities, including agribusiness. With Mozambique's capacity to substantially increase employment in the public sector limited by high debt burden, expansion in the size and number of private sector firms is the main source of job growth.

Reforms to reduce the cost of doing business and strengthen the role of the services sector as a backbone of the economy include:

- **Revise current regulations that require service providers to be established locally.** Mozambique's Commercial Code requires that any service supplier who wishes to perform activities for more than one year in Mozambique must open an establishment in the country and appoint a resident in Mozambique with powers to receive communication and notifications. These requirements run contrary to the expansion of global services in the current digital era.

- **Relaxing the restrictive components of the labor regulation on employing foreign workers could attract Foreign Direct Investment (FDI) and facilitate technology transfer.** Current regulations on employing foreigners impose domestic employment quota on foreign companies and have a major impact on the flow of foreign investment and overall business operation, given the shortage of skilled workers. Upgrading to high-value complex services such as professional services and business services requires specialized expertise. Alternative approaches, such as knowledge transfer programs including training and skills development, can ensure an adequate supply of skilled labor while protecting domestic workers. The new labor law under preparation, which is part of the Government's new reform iniative (Pacote de Medidas de Aceleração Económica—PAE), is expected to lift some of these constraints.

- **Review the rationale for state participation in the business sector.** The government should consider revising the Law on Public Enterprises, separating commercial and non-commercial activities of state-owned enterprises (SOEs). High degree of overlap between the ownership, management, and regulation of SOEs, including in the transport and telecom sectors, undermines market contestability and services growth. Several underperforming SOEs continue to receive substantial preferential treatments, crowding out productive private investments.

- **Improve the land-use regime by extending flexibilities on use of urban land to rural areas,** as well as lease periods, to facilitate business operations, including foreign firms. Land-use regulations and practices increase risks and operating costs for businesses, especially in areas like services that are not directly dependent on natural resources. Asymmetrical rules governing the transfer of infrastructure, structures, and land improvements in urban and rural areas have caused major inconveniences and incurred extra costs for businesses. The authorities have recently approved a new land policy and envision to prepare a new land law that may address these bottlenecks.

- **Stimulate the formalization of informal enterprises** by promoting access to finance including through offering credit guarantees to small enterprises and lowering the cost of bank credit. The latter will require reducing government recourse to the domestic debt market, among others.

- **Facilitate innovation** by improving the quality of education and investing in skills (including management skills) to boost the productivity and competitiveness of services firms.

Part One: Recent Economic Developments

Economic Growth

Economic recovery has gained momentum, despite global economic headwinds. Good performances by the agricultural and services sectors, combined with higher demand and prices for Mozambique's exports, supported growth. However, elevated global fuel and food prices have exacerbated inflationary pressures.

Mozambique's economic recovery from the COVID-19 pandemic has strengthened, with growth reaching 4.1 percent in 2022 (Table 1). Growth was underpinned by agriculture and services, reflecting enhanced agricultural productivity and the resumption of mobility (Figure 1). Higher external demand and prices for Mozambique's key exports—coal and aluminum—bolstered the recovery further (Figure 2). The growth impact of the war on Ukraine has been mitigated by Mozambique's weak trade and investment links with Ukraine and Russia, and increased global prices for the country's key export products. Key economic indicators reflect the broader growth story, with the purchasing managers' index (PMI) and the demand expectations index showing consistent expansion throughout the year (Figures 3 and 4).

Services and agriculture accounted for 60 percent of the total growth registered in 2022, largely reflecting the complete resumption of mobility and improved agricultural productivity. Investments in inputs since 2019 (notably improved seeds, irrigation, and machinery) helped improve farm productivity. Private services grew by 4 percent, compared to 1 percent in 2021, driven by a boost to consumption by the lifting of COVID-19 restrictions around mid-2022. Commerce, transport, and hospitality all saw improved performance, although from a low base. Public services, mainly education and social protection, also contributed to the recovery, underpinned by increased mobility and expanded social protection coverage.

Table 1: Services and agriculture are the key sectors driving GDP growth
(Percentage points)

	2016	2017	2018	2019	2020	2021	2022e
Agriculture	1.1	0.9	0.8	0.6	0.6	1.2	1.2
Extractives	0.8	1.9	0.9	-0.3	-0.8	-0.1	0.7
Manufacturing	0.5	0.1	0.0	0.2	-0.1	0.0	0.1
Private services	0.5	0.5	1.4	1.2	-0.6	0.7	1.8
Public services	0.9	0.3	0.2	0.6	-0.3	0.4	0.4
GDP growth	**3.8**	**3.7**	**3.4**	**2.3**	**-1.2**	**2.2**	**4.1**

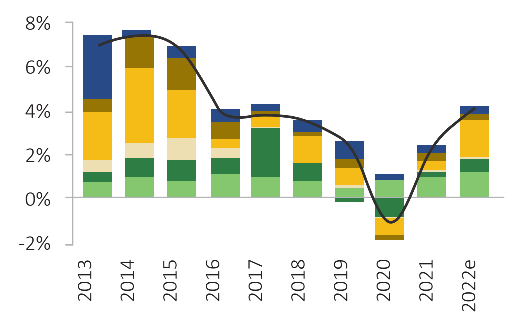
Source: National Institute of Statistics (Instituto Nacional de Estatística, INE) and World Bank estimates.

Higher global prices and demand for Mozambique's export commodities have supported export growth, compensating for subdued domestic absorption. Total exports nearly doubled in the year to September, driven by exports of coal and aluminum, which increased by more than 180 and 50 percent, respectively (Figure 2). Coal production soared as maintenance operations in the Moatize coal mine were completed. However, the inflation shock caused by higher international prices of fuel and cereals dampened consumption growth. Further, the tight monetary policy stance limited credit growth, slowing investment growth. Global economic headwinds impacted domestic sentiment. After starting the year with solid readings in the first quarter, the PMI fell steadily between September and December (Figure 4).

Mozambique exported its first shipment of LNG in 2022, supporting the growth recovery. Almost a decade after gas exploration began, the US$7 billion offshore gas project operated by *Ente Nazionale Idrocarburi* (ENI) started producing and exporting liquefied gas at the end of 2022. As a result, extractive industries grew by 9 percent and contributed 45 percent of total export growth in 2022.

Figure 1: Growth is driven by good services and agriculture performance

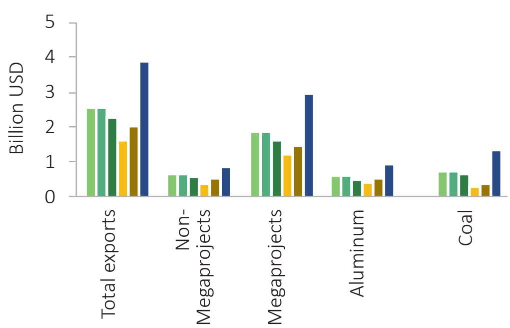
Sectoral Contributions to GDP Growth



Source: INE data, various years; World Bank staff estimates.

Figure 2: Increased commodity demand and prices, and higher production, support export growth

Total exports (third quarter)



Source: BM.

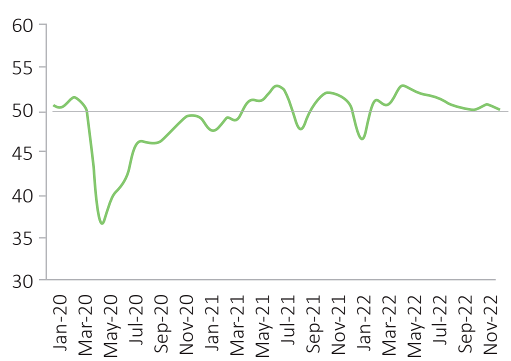
Figure 3: Demand expectations improved but remained below pre-Covid levels

Demand expectations indicator

Source: INE data, various years; World Bank staff estimates
Note: The demand expectation index measures economic agents' reports on current and expected demand in specific sectors (including transport, hospitality, commerce, and manufacturing). It results from an average, converted to an index, of the numbers reported by different sectors.

Figure 4: Economic indicators were strong at the start of 2022, but decelerated as global conditions worsened

Purchasing manager index

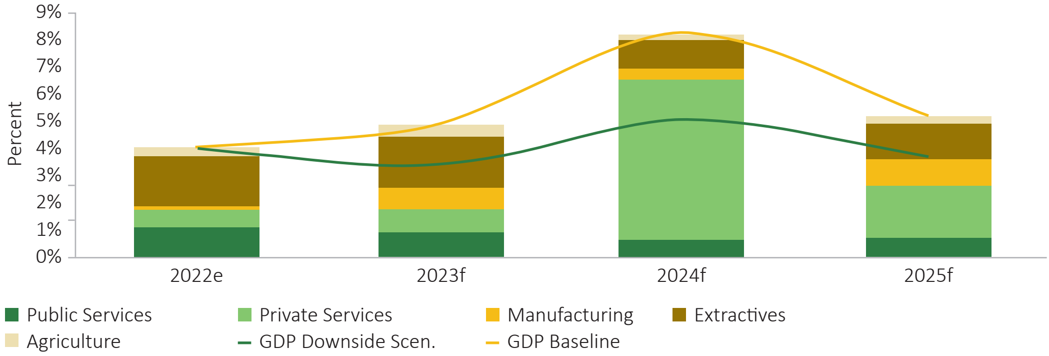


Source: IHS Markit (2015, 2021).
Note: A reading >50 indicates expansion.

Medium-term prospects are positive, but downside risks could undermine the outlook

Growth is expected to reach 6 percent over 2023-2025, driven by continued recovery in services, increased LNG production, and high commodity prices (Table 2). The offshore Coral South LNG project is expected to reach full capacity between 2023 and 2024, boosting GDP growth to 8 percent in 2024. High commodity prices—notably coal, aluminum, and gas—will continue to boost export growth, and foreign direct investment (FDI) inflows (mainly linked to LNG) will sustain investments. Assuming favorable weather conditions, agriculture will maintain a positive performance in the upcoming years, supported by ongoing investments in inputs. These trends are anticipated to be reinforced by the resumption of LNG projects, increasing FDI and domestic demand for services, particularly real estate, hospitality, transport, and construction.[1] The recently adopted economic stimulus measures are expected to help accelerate Mozambique's economic recovery by promoting private sector participation (Box 1).

Figure 5: Medium-term prospects are positive, driven by the extractive sector, but downside risks are considerable



Source: INE data, World Bank estimates.

Table 2: Selected commodity prices outlook

Commodity	Unit	2020	2021	2022	2023f	2024f
Aluminum	$/mt	1,704	2,473	2,700	2,400	2,434
Natural gas, Europe	$/mmbtu	3	16	40	32	28
Natural gas, U.S.	$/mmbtu	2	4	7	6	6
Liquefied natural gas, Japan	$/mmbtu	8	11	18	17	16
Coal, Australia	$/mt	61	138	320	240	212

Source: National Institute of Statistics (Instituto Nacional de Estatística, INE) and World Bank estimates.

1 Three main project LNG projects are underway in Mozambique: (i) Coral South Floating LNG—approximately US$7 billion in investment (started production in 2022); (ii) Golfinho/Atum—approximately US$23 billion in investment, led by TotalEnergies (started development in late 2019, which was interrupted in 2021 by the escalation of insurgency in the north); and (iii) the Mamba project—estimated at US$30 billion, led by ExxonMobil (which saw its final investment decision postponed due to COVID-19 and insurgency).

Box 1: The new economic acceleration package tackles critical issues undermining the private sector's potential

In August 2022, the Government of Mozambique launched the Pacote de Medidas de Aceleração Económica (Package of Economic Acceleration Measures or PAE). The plan includes 20 reform measures that aim to support the economic recovery by stimulating private sector growth—with a special focus on FDI in selected sectors—cutting red tape and enhancing resource revenue management. The PAE also reinforces important existing reforms, such as the SOE restructuring plan, land and agricultural policy revision, and improvement in fiscal transparency.

The plan comes at an appropriate time, as the economy is recovering from a protracted slowdown following consecutive shocks, including the hidden debts, cyclones, insurgency, and the pandemic. The announced measures are broadly aligned with recommendations provided in the World Bank's knowledge products and are supported by development partners. These measures include establishing a Sovereign Wealth Fund (SWF), strengthening social protection systems, improving internal audits, and enhancing the business environment, including simplifying procedures for international labor hiring.

Other notable measures include a fiscal stimulus for the private sector. Specific fiscal incentives included reducing the VAT rate, VAT exemptions for imports linked to the agriculture and electricity sectors, reducing corporate income tax in agriculture and urban transport, and lowering the cost of capital outflows. Other incentives to the private sector included cutting logistic tariffs applied in ports, airports, and logistical corridors and creating a guarantee fund to support more affordable access to credit.

The plan addresses critical challenges undermining the private sector's potential for job creation and economic transformation. The measures set the foundation to prepare the country for the impending natural resource boom. The heavy tax burden, bureaucratic and complex administrative procedures for business operations, and increased logistical and credit costs are critical limitations faced by the private sector in Mozambique. The plan addresses these issues head-on, but a lack of further implementation details prevents a full assessment of its impact.

However, downside risks could lower medium-term GDP growth to 4.5 percent. Key risks stem from natural hazards and security risks in northern Mozambique that may further delay the resumption of the TotalEnergies-led LNG project. Persistent pressures on food and fuel prices from a protracted war on Ukraine could lead to further monetary tightening, slowing the economic recovery. Setbacks in the implementation of the wage bill reform and displacement of populations due to the conflict in the north would pose significant fiscal pressures. These risks are explored through a downside scenario which assumes that: (i) instability in the north continues;[2] (ii) inflation rises further, resulting in additional monetary contraction; and (iii) natural disasters affect the sowing season. This scenario would dampen investment growth and the recovery of sectors with linkages to LNG projects, including construction, real estate, and

[2] The World Bank Group carried out a Risk and Resilience Assessment (RRA) in 2020 to identify the factors of fragility and resilience in Mozambique. As part of the process of securing eligibility to the Prevention and Resilience Allocation (PRA) under IDA19, Mozambique committed to a series of milestones to address the causes of fragility and conflict. Mozambique has maintained eligibility to the PRA into IDA20. The WBG also recalibrated its entire portfolio and pipeline in 2021, including outlining an integrated regional approach for the north of the country, to respond to the crisis in the north, address key fragility challenges, and lay the foundations for recovery and resilience-building. This approach aligns with and supports Government-led plans to address the conflict and drivers, including the *Plano de Reconstrucao de Cabo Delgado* (PRCD) and the *Programa de Resiliência e Desenvolvimento Integrado do Norte de Moçambique* (PREDIN).

other services sectors. Agricultural production would subside, inflationary pressures would undermine consumption growth, and high interest rates would constrain investment. If these risks materialize, they could lower growth to an average of 4.5 percent in the medium term (Figure 5).

Exchange Rate and Inflation

Global oil and food price increases have fueled inflationary pressures. However, stable nominal and real exchange rates have helped to minimize further price pressures.

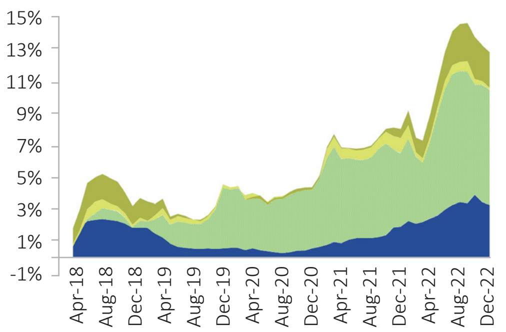
Inflation hit a five-year high as global fuel and food prices hiked, and food production declined in early 2022 due to adverse weather. Despite a gradual pass-through of international-to-domestic fuel prices, diesel and gasoline prices had increased by 42 and 26 percent as of December 2022 (year-on-year). Average headline inflation reached 9.8 percent in 2022 (Figure 6), driven by food inflation, which spiked to 14.1 percent largely owing to increased global food prices and the decimation of domestic food supply by cyclones Ana and Gombe in the first quarter of the year. Core inflation has also risen, mainly driven by transport, and clothing prices, likely reflecting the second-round effects of rising fuel costs.

The nominal and real effective exchange rates have remained stable, reflecting a comfortable supply of foreign currency. The Metical remained stable, despite increased demand for foreign currency, mainly for fuel imports. The currency averaged 63.8 against the US Dollar (USD) in 2022, with low volatility (Figure 7). These trends reflect a reliable forex supply—with the Central Bank covering foreign currency needs for fuel imports—and a preference for exchange rate stability among financial institutions. The stable nominal exchange rate minimized inflationary pressures from imported goods.

Inflation is projected to subside in the medium term as global pressures ease and agricultural production picks up. Elevated fuel, food, and transport prices are expected to continue driving inflation in 2023. As international oil prices decline, the inflation rate is forecast at around 8 percent over 2024-2025. Reasonably comfortable levels of external reserves are expected to help ensure an adequate supply of foreign currency to the interbank forex market, helping maintain the stability of the Metical and inflation.

Monetary policy will remain tight in the short term amid persistently high inflation. In January 2023, the BM raised the reserve requirements on domestic and foreign currency deposits from 10.5 to 28 percent, and from 11.5 to 28.5 percent, respectively, to reduce the supply of money and tame inflation. Looking ahead, the authorities are expected to continue monitoring the evolution of global commodity prices and may tighten the monetary stance further if inflationary pressures persist.

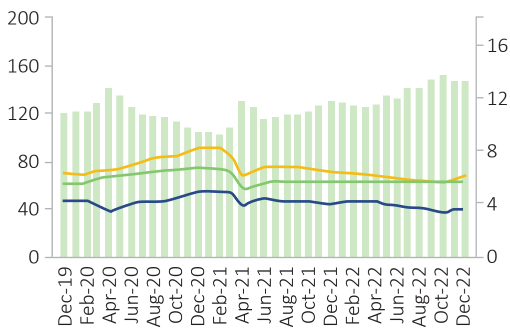
Figure 6: Inflation hit a five-year high as international fuel and food prices surged...



Source: BM; World Bank estimates.

Figure 7: ... but nominal and real effective exchange rates have remained stable

Nominal and Real Effective Exchange Rate



Source: BM; South Africa Statistics office; World Bank estimates.

The External Sector

The import of the floating LNG platform increased the trade deficit, but it was fully covered by project financing. Higher fuel and food import bills put pressure on external reserves, which declined but remain reasonably adequate. Mozambique has seen significant upsides from the higher prices of export commodities.

The current account deficit (CAD) has increased, driven by substantial LNG investments, but remains fully financed from conventional sources. The import of the offshore LNG platform, valued at US$4.3 billion, coupled with a higher fuel and food import bill, increased the trade deficit from a preliminary forecast of US$4.5 billion to US$7.6 billion. As a result, the CAD jumped from an average of 23.6 percent of GDP over 2017–2021 to 41 percent (US$7.4 billion) in

Table 3: Balance of payments

(% of GDP, unless otherwise stated)	2019 Actual	2020 Actual	2021 Actual	2022 Est.	Δ 19/20	Δ 20/21	Δ 21/22
	Percent of GDP				Percent change		
Current-Account Balance	**-19.1**	**-27.3**	**-23.6**	**-41.4**	...	...	...
Megaproject	4.2	0.7	11.9	-9.4	...	...	...
Non-megaproject	-23.3	-28.0	-35.5	-32.0	...	...	...
Current Account	**-19.1**	**-27.2**	**-23.6**	**-41.4**	**43.0**	**-13.4**	**75.3**
Trade balance, for goods	-13.5	-16.2	-14.3	-31.1	19.4	-12	118
Exports	30.3	25.3	35.3	43.3	-16.7	40	23
Megaproject	21.3	17.6	25.5	33.4	-17.2	45	31
Non-megaproject	9.0	7.6	9.8	9.9	-15.4	28	1
Imports	43.9	41.4	49.6	74.4	-5.5	20	50
Megaproject	9.1	5.5	5.0	31.1	-40.2	-8	518
Non-megaproject	34.7	36.0	44.6	43.4	3.6	24	-3
Services (net)	-11.8	-13.8	-11.8	-11.7	17.2	-15	-1
Primary income (net)	-1.8	-2.0	-2.2	-3.2	12.8	6	49
Secondary income (net)	8.1	4.8	4.6	4.6	-40.9	-4	0
Capital Account	0.7	1.0	0.4	0.9			
Financial Account	29.4	28.3	19.8	36.7			
of which							
FDI, net	22.1	21.4	32.3	17.1			
Megaproject	6.2	18.1	19.5	12.7			
Non-megaproject	15.9	3.3	12.8	4.4			
Other (net) (1)	7.2	6.9	-12.4	19.6			
Errors and omissions	-5.8	-0.7	-0.4	0.0			
Overall Balance	5.2	1.3	-3.8	-3.9	...	...	...
Financing Needs							
Financing needs	-5.2	-1.3	3.8	3.9			
Reserves (- = inflow)	-7.9	-1.2	2.6	2.3			
Net use of credit	0.5	-2.0	-0.2	1.6			
Exceptional financing (1)	2.2	1.8	1.4	0.0			

Source: World Bank staff estimates, BM data; Δ=percentage change (1) Other flows include net portfolio investment; net currency and deposits; loans; insurance, pensions, and standardized guarantee schemes (net); net trade credits and advances; net other accounts payable/receivable.

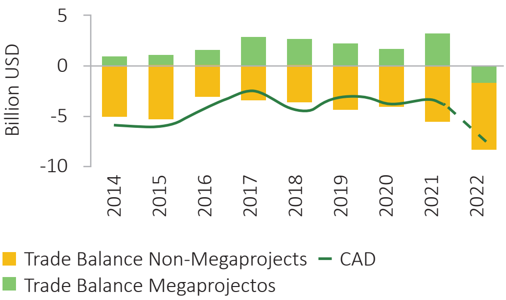
2022 (Figure 8). The financing for imports related to LNG projects is channeled through Special Investment Vehicles (SIVs). The CAD for large natural resource investments ("megaprojects") is fully financed through trade credits and FDI. Budget support, IMF credits, and a drawdown in reserves covered a total external financing gap of 3 percent of GDP at the end of 2022.

Despite pressures from higher import bill, there were significant upsides, including increased coal and aluminum prices and higher crop exports. In 2022, the non-megaproject CAD remained stable (Table 3), as strong export performance offset the higher import bill. Compared to the third quarter of 2021, total fuel and wheat imports rose by almost US$ 1 billion (5.5 percent of GDP) (year-on-year), contributing to an estimated import bill (excluding megaprojects) of US$ 7.7 billion in 2022—about 10 percent above the same period in 2021 (Figure 9). However, higher export volumes and prices offset increased import costs. Total exports registered a historical growth record of 40 percent in 2022, representing an additional US$ 2 billion over 2021. The spike was mainly due to increased volumes of aluminum, coal, and crop exports, with rising global demand translating into high international prices (Figure 10). In addition, the start of gas production in the fourth quarter of 2022 further contributed to the improved export performance.

Foreign external reserves dropped to a five-year low as import costs increased, and the BM supported forex sales for fuel imports. Between December 2021 and November 2022, gross international reserves fell by US$800 million to US$2.5 billion (equivalent to 3.4 months of non-megaproject imports) (Figure 11). The drop, which was mainly due to forex sales by the Central Bank for fuel imports, put the external reserves at a five-year low. Even so, the import cover ratio remains fairly adequate, and the nominal and real effective exchange rates have remained stable.

Figure 8: LNG investments have widened the CAD...

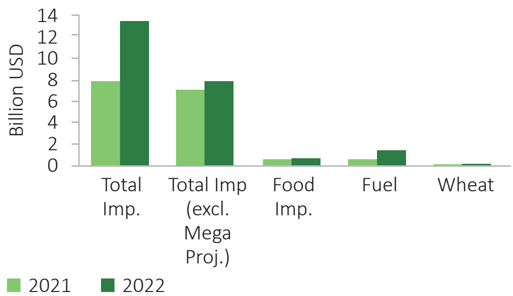
CAD and trade balance



Source: Data from BM; WB estimates.

Figure 9: ...with fuel import costs increasing significantly

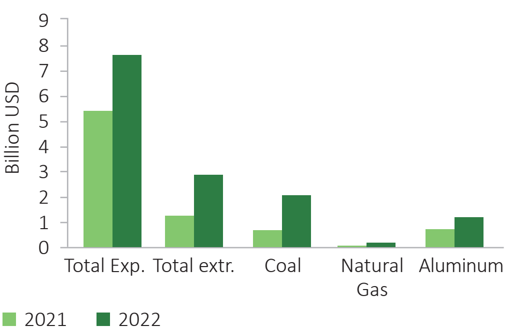
Imports



Source: Data from BM; WB estimates.

Figure 10: Though surging commodity exports have moderated external pressures...

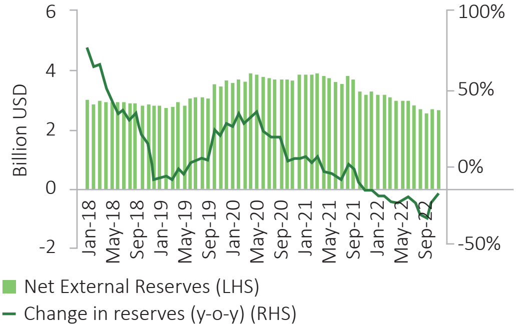
Exports



Source: Data from BM; WB estimates.

Figure 11: ...external reserves dropped to the lowest level in 5 years, but remain reasonably adequate

Net external reserves



Source: Data from BM; WB estimates.

The CAD is poised to increase in the medium-term as LNG projects advance, but will continue to be fully financed through credits and FDI without compromising external reserves. As LNG projects resume and overall imports rise, the CAD is set to remain high, averaging 30 percent of GDP in the medium term. Total imports of goods, driven by LNG investments, are projected to average 45 percent of GDP over 2023–2025, about 50 percent above the level observed during 2019–2021. This increase will be partly offset by gas exports. Gross reserves are expected to remain at comfortable levels (around 3 billion, equivalent to four months of imports), supported by FDI inflows, trade credits, grants, and concessional financing.

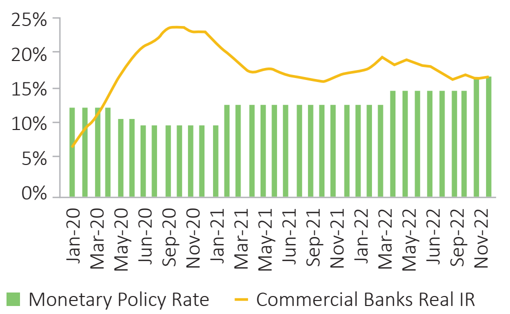
Monetary Policy

The BM has consistently raised policy interest rates to contain inflation expectations and second-round effects. This policy stance, combined with other structural factors, has put Mozambique's real interest rates among the highest in the region, further constraining credit access. Despite these challenges, overall macroprudential indicators have remained stable.

The monetary authorities have continued to raise the policy rate to contain galloping inflation. In response to soaring inflation, the BM increased the policy rate by 400 basis points in September 2022 to 17.3 percent, continuing the tightening cycle that started in 2021 (Figure 12). The policy rate has been raised by an unprecedented 700 basis points between January 2021 and September 2022, putting real interest rates among the highest in the region (Figure 13 and Box 2). As a result, nominal credit growth declined from 9 percent (year-on-year) in 2020 to 6 percent in 2021 and 5 percent in 2022. Even so, inflationary pressures persist, mainly reflecting the impact of supply shocks resulting from imported inflation.

Figure 12: The policy rate has been raised sharply to tame inflationary pressures...

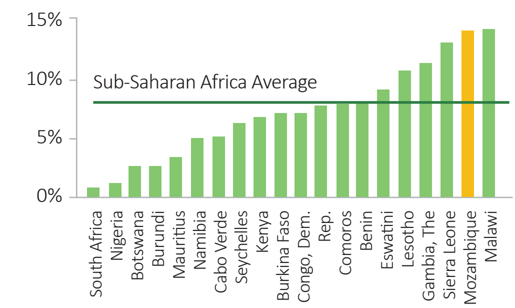
Policy rate and commercial banks real interest rate



Source: Data from BM; WB estimates.

Figure 13: ...resulting in one of the highest real interest rates in Sub-Saharan Africa (SSA)

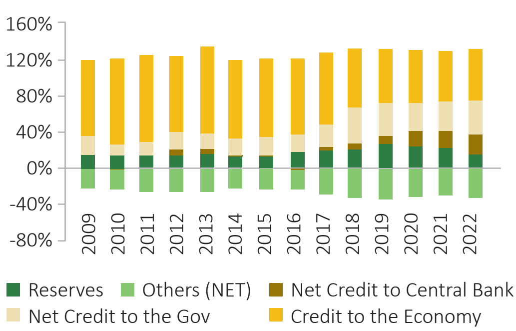
Real interest rate (2021)



Source: World Development Indicators; WB staff estimate.

Figure 14: The share of commercial banks' credit to the private sector has reduced...

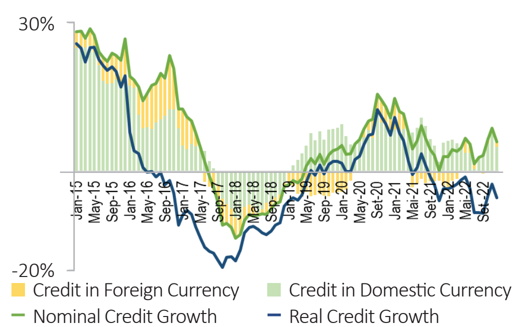
Financial Institutions' Assets



Source: Data from BM; WB estimates.

Figure 15: ...with real credit levels declining since 2021

Credit Growth Year-On-Year



Source: Data from BM; WB estimates.

The tight monetary stance has constrained access to credit—one of the most significant challenges for firms in Mozambique. Credit to the private sector (at 22 percent of GDP) is below the sub-Saharan average of 38 percent of GDP. Only 10 percent of domestic firms have a bank loan, compared to 20 percent in Sub-Saharan Africa (SSA). Despite being relatively low, the proportion of commercial bank credit to the private sector has fallen in recent years, coinciding with a steep increase in lending to the government. The monetary tightening, combined with significant public sector gross financing needs, has raised real lending rates and shortened loan maturities, including relative to Mozambique's peers (Box 2).

Commercial banks maintain high profits and have reported solid system-wide capital and liquidity ratios. As of the third quarter of 2022, the system-wide capital adequacy ratio (CAR) was 23.5 percent, well above the regulatory minimum of 12 percent. System-wide non-performing loans (NPLs) were 8.8 percent of total loans, below the 10 percent registered in the same period of 2021. However, NPLs are dispersed across banks, and mainly depend on their exposure to state-owned enterprises (SOEs). By November 2022, net lending by the financial sector to the government and the economy stood at MZN 158.7 billion (13.8 percent of GDP), a one percent decline year-on-year, but still higher than historical levels (Figure 14). Despite this, the largest banks reported profit increases of around 100 percent in 2021 compared to 2020.

Previous and ongoing reforms have strengthened regulatory oversight of the financial sector through better reporting and an enhanced legal framework for financial institutions and anti-money laundering. BM has enhanced its reporting of prudential indicators, with systemic risk reports of commercial banks published quarterly since 2017, allowing for greater transparency and better oversight. The authorities also disseminate financial soundness indicators, including the annual financial stability report, first published in March 2019. In 2020, Mozambique approved a new financial institutions law improving the legal framework for bank resolution and deposit insurance. In October 2022, parliament approved a law establishing the legal regime for bank accounts. The law enables banks to minimize documentation requirements for low-risk and low-income groups, and reduces the minimum age required to open bank accounts from 21 to 18, extending to 15 with parental consent. This legislation adds to the 2022 anti-money laundering and combating the financing of terrorism (AML/CFT) law, which aims to expand access to financial services for customers deemed at low risk of money laundering and financing terrorism.

Box 2: What explains Mozambique's high interest rates beyond the need to contain inflation?

Lending interest rates in Mozambique are among the highest in sub-Saharan Africa (SSA). At an average of 15.5 percent over 2020–2021, Mozambique's lending rates are substantially higher than those of its peers and the SSA average (Figures 16 and 17). Access to credit is the second most significant challenge for firms in Mozambique, and about two-thirds of the adult population are excluded from the formal financial sector. Innovation and mobile money have helped expand access to finance in the past decade. However, given low level of financial intermediation and poorly designed products, the financial sector does not serve most of the population. The recent tightening of monetary policy (see Monetary Policy above) has raised the cost of credit further.

Banks face high operational costs, which cascade down to borrowers. Total operational costs accounted for an average of 69 percent of total revenue in 2020, albeit with significant variation across banks.

Limited savings and institutional investors' market power push up rates. Mozambique's savings rate is low due to high levels of financial exclusion, high poverty rates, and low-income levels, among other factors. As savings are limited, financial institutions are obliged to offer very attractive rates to draw in large investors with bargaining power (such as pension funds).

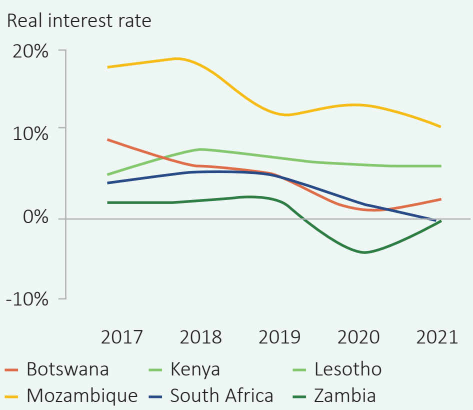
The financial sector is relatively shallow and lacks competition, dominated by a few commercial banks. With a total of 18 banks, the financial system is highly concentrated. The top three banks represented 70 percent of total assets in 2021, capturing most deposit and lending business opportunities.

Banks face high credit risks, exacerbated by the lack of credit information and limited use of movable assets as collateral. The risk premium in Mozambique is about 5 percentage points which is added to the monetary policy rate to estimate the final benchmark rate. In addition, banks impose a perceived risk premium on individual clients, which is prohibitive. The risk premium reflects poor credit information, perceived macroeconomic risks, and fiscal risks from SOEs. Banks' portfolios focus on short-term, high-return activities and risk-free cash flow management, mainly through leasing, real estate, and government bonds and bills.

Government borrowing in the domestic debt market push up lending rates and limit credit to the economy. Growing fiscal financing needs have led to increased borrowing from the domestic market, contributing to rising interest rates through pressures on credit demand and the risk premium. Given limited credit information and high informality, banks prefer lending to the state, crowding out the private sector. The double-digit interest rates that the government pays on T-bills and T-bonds set "a floor" on the rates paid by other instruments. In other words, T-bills and T-bonds rates are key in setting interest rates in Mozambique.

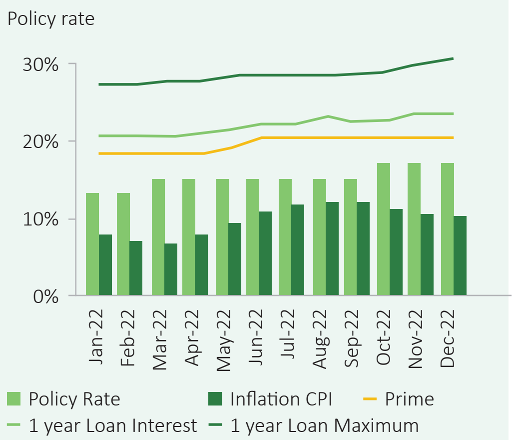
The existing regulatory framework limits financial product development. The restrictive nature of the regulatory framework limits banks' incentives to expand portfolios away from risk-free clients and government bonds. Banks have reported their intention to diversify products further and expand their client base, but the current regulatory framework curtails profitability. Introducing a new product can involve one or two years of negotiations with the authorities, and considerable resources. In the past six years, the share of credit in banks' assets has declined (Figure 14). The recent measures—introduced under the 2022 AML/CFT law—to reduce age limits and ease requirements for opening accounts may help broaden the market.

Figure 16: Real lending rates in Mozambique are high, historically and compared to those of peer countries



Source: Banking Sector Survey 2021.

Figure 17: Commercial banks interest rates are well above the reference rates and inflation



Source: Data from BM; WB estimates.

Fiscal Policy and Developments

Implementation of the ongoing public sector wage bill reform and implicit fuel subsidies have added a significant burden to the public budget. Other spending pressures emanate from the humanitarian and security situation in the north, high debt service, and social transfers. Nevertheless, contained capital spending, stable revenue collection, and budget support have helped to rein in the fiscal deficit.

The overall fiscal deficit increased, reflecting higher spending associated with upfront costs of the wage bill reform and debt service. The wage bill and debt service absorbed over

Table 4: Selected fiscal indicators

Percent of GDP	2017	2018 Actual	2019 Actual	2020 Actual	2021 Actual	2022[1] Estimates
Revenue + Grants (excl CGT)	24.6	25.8	24.4	27.5	27.7	30.2
Total Revenue	25.1	23.8	28.9	23.9	25.7	25.7
Tax Revenues	20.0	20.5	25.0	20.5	22.1	21.3
Of Which:						
Capital Gains	2.5		5.7			
Non-Tax Revenue (Incl. Capital Revenue)	5.1	3.2	3.9	3.3	4.2	4.6
Grants	1.9	2.0	1.2	3.6	1.8	4.5
Total Expenditure & Net Lending	30.3	31.2	30.5	32.9	31.5	34.6
Current Expenditure	19.4	21.3	20.6	23.3	24.3	26.4
.... *Of which:*						
Compensation of Employees	10.6	10.8	11.8	13.4	14.3	15.2
Interest on Public Debt	3.0	4.4	3.3	3.2	2.7	3.9
......*Of which*						
Arrears	1.5	0.0	0.3	0.2	0.0	0.1
Capital Expenditure	6.7	8.1	7.6	8.8	7.3	6.9
Domestically Financed	3.2	3.7	4.7	4.4	3.8	3.2
Externally Financed	3.5	4.4	2.9	4.4	3.5	3.7
Net Lending		1.6	1.5	0.7	0.3	0.6
Statistical Discrepancy	3.0	-1.4		0.1	-1.0	-1.5
Fiscal balances						
Primary Balance	-0.3	-2.4	2.8	-2.2	-2.1	-2.0
Overall Balance	-3.3	-6.8	-0.5	-5.4	-4.8	-5.9
Financing						
External Financing	6.8	3.3	2.2	3.0	1.1	0.7
Net external Financing (commitment)	2.8	0.1	1.7	2.4	0.7	0.7
Disbursements	4.6	4.0	4.0	4.9	2.3	3.3
Amortization	-1.7	-3.9	-2.3	-2.5	-1.6	-2.6
Exceptional External Financing- debt*	4.0	3.2	0.6	0.6	0.5	0.0
Domestic Financing Needs (residual)	-3.5	3.5	-1.7	2.4	3.7	5.1

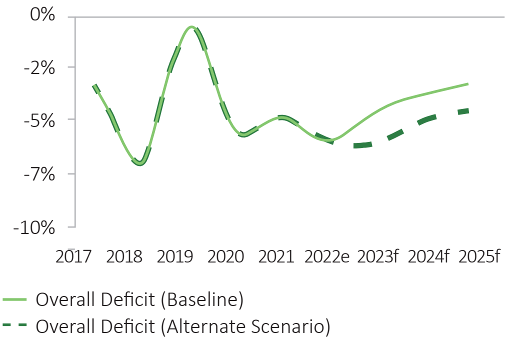
Source: MEF and IMF data, World Bank staff calculations
1) 2022 estimates are subject to change following updated information on the costs of implementing wage bill reforms.
* External exceptional financing for the external debt under negotiation.

90 percent of all tax revenues. Despite this, fiscal pressures were moderated by strong revenue collection, under-execution of capital spending, and budget support (Table 4). The overall fiscal deficit is estimated at 5.9 percent of GDP in 2022, compared to 4.8 percent in 2021 (Figure 18). Spending needs are driven by the humanitarian and security situation in the north, social transfers, debt service, and the initial cost of ongoing wage bill reforms (Figure 20). The government has provided targeted subsidies to mitigate the impact of rising global food and fuel prices on vulnerable households.[3] However, overall expenditure has remained under control as capital spending has been lower than budgeted. Revenue performance remains strong thanks to improved income tax collection, particularly personal and corporate income tax. VAT from imports is also robust as the economy recovers and key imports become more expensive. Further, budget support helped address financing needs.

The authorities have started implementing a comprehensive fiscal reform program, which is expected to strengthen the fiscal position in the medium term. With fiscal pressures persisting, particularly non-discretionary expenditures that dominate the recurrent budget, Mozambique needs to resume fiscal adjustment. In October 2022, parliament passed a new law that seeks to reduce the public wage bill by eliminating ad hoc salary increases and controlling supplementary compensation. The reform unifies and simplifies the career compensation structure, revises the wage increase formula, and freezes wage supplements in nominal terms. These measures will be complemented with an attrition rule in which only one out of three public employees who leave are replaced, except in the education, health, and agriculture sectors. On the revenue side, the authorities have eliminated VAT exemptions and zero ratings, aiming to broaden the tax base and reduce distortions. Measures are also being taken to improve tax administration, including avoiding the accumulation of tax arrears, modernizing the taxpayer registry, and increasing compliance. Finally, the GoM is embarking on legal and parametric pension reforms to address pressures from pension spending.

Figure 18: The overall fiscal deficit is declining but a pessimistic scenario could worsen the outlook

Fiscal balance as a percentage of GDP*

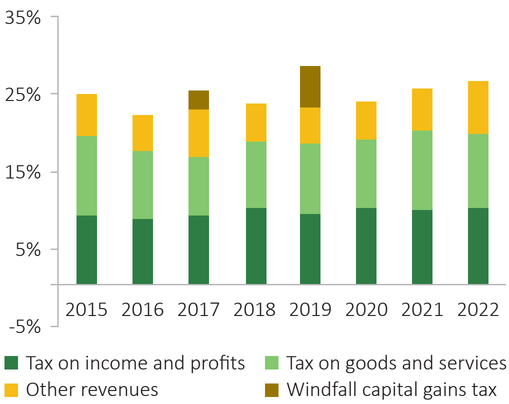


Source: Data from BM; WB estimates.

**Estimates and projections subject to changes depending on updated information on the cost of implementing the wage bill reform.*

Figure 19: Public revenue performance remained strong in 2022...

Revenue as percentage of GDP

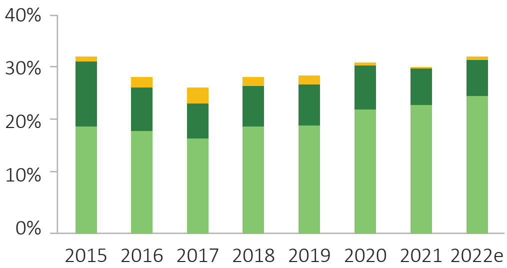


Source: Data from BM; WB estimates.

[3] The total cost of the mitigation measures (cash transfers to the most vulnerable and discount at point of sale for transport users) are estimated at US$100 million. Mozambique eliminated generalized fuel, bread, and fertilizer subsides in 2017. Further, an estimated debt of US$150 million was accumulated with fuel suppliers, as the GoM opted for a partial pass through of international fuel prices to domestic prices.

Figure 20: ...but recurrent expenditure spiked owing to wage bill and debt service

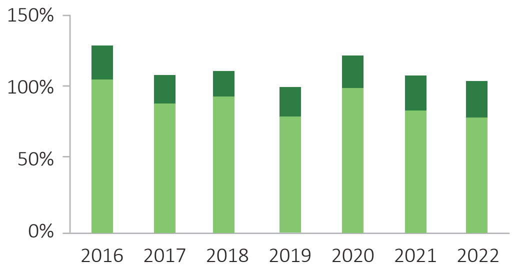
Expenditure and net lending



Source: Data from BM; WB estimates.

Figure 21: While total public debt declined, increased financing needs pushed up expensive domestic debt

Public debt



Source: Data from BM; WB estimates.

However, upfront costs of the wage bill reform have added significant pressure to public finances. The rolling out of the new compensation structure for public servants has proved problematic, with teachers and doctors particularly dissatisfied. The cost of the wage bill reform has turned out to substantially higher than budgeted. The whole reform had been estimated to cost around 3 percent of GDP between 2022 and 2024. The costs derive from upward salary adjustments and the consolidation of subsidies and complementary compensation on the base salary predicted in the new law.

Revenue performance has been strong as income tax collection has improved with the economic recovery. Total fiscal revenue is expected to have reached the budgeted 26 percent of GDP by end 2022, 0.3 percentage points above 2021 levels, on the back of improved income tax collection. The increase in revenue is mainly supported by income and profit tax collection and VAT on imports, reflecting an uptick in economic activity as the pandemic subsided and higher import prices (Figure 19).

Public debt has been declining but domestic debt has continued to rise, with the authorities resorting to the expensive domestic debt market to cover emerging financing needs. Total public debt shrank from 107 percent of GDP in 2021 to 102.4 percent in 2022 (Figure 21). The decline in external debt from 82.8 to 77.6 percent of GDP in the same period explains this drop, largely due to currency appreciation. However, the domestic debt stock rose from 22 percent of GDP in 2021 to 23 percent in 2022 due to increasing financing needs to cover the wage bill and debt amortization. The continuous growth in domestic debt poses a substantial risk, considering its maturity concentration profile and that it has been issued to finance recurrent spending at an interest rate well above the real GDP growth rate.[4] The effective average rate on treasury bills with a maturity of two months surpassed 15 percent in 2021, and the effective interest rate on domestic debt was above 10 percent in 2022. Finally, increased government borrowing through the domestic debt market has contributed to the high interest rates in the real economy, which limits and crowds out private-sector credit growth (Box 2).

The April 2022 IMF-World Bank debt sustainability analysis (DSA) concluded that Mozambique is at high risk of debt distress, but assessed debt to be sustainable in a forward-looking sense. Debt is assessed as sustainable because a significant share of projected borrowing reflects the state's participation in sizable LNG projects, which will be repaid directly from future gas revenues. Several

[4] Almost 75 percent of the treasury bonds' stock is due between 2022 and 2025, increasing debt rollover risks.

factors mitigate the DSA results. The DSA did not include LNG revenue that could accrue to the state as non-tax revenue. Currently, LNG prices are above those assumed in the DSA and the analysis does not consider any LNG spillover effects to the broader economy. The external debt assessment would not be substantially affected if the LNG projects do not resume, although future growth would be compromised. This is because the contracts between the national hydrocarbon company (ENH) and its partners would only make the state liable for the ENH share in a small amount of debt disbursed, estimated at US$ 43 million (0.3 percent of GDP) as of November 2022. A DSA update is underway.

The fiscal outlook hinges on successful implementation of the ambitious fiscal consolidation program. In the medium term, with the expected LNG revenue windfall, it is critical to put in place effective fiscal policies and institutions to ensure sound resource revenue management. In addition, it is vital to rebalance recurrent spending toward more productive activities, including high-return public investments.

The authorities remain committed to fiscal consolidation, but the wage bill reform and elections in 2024 could exacerbate fiscal pressures in the medium term. Following early implementation setbacks, the authorities are re-calibrating the new salary pyramid with a downward revision of salary increases. The adjustments are expected to bring the wage bill down to more sustainable levels. Assuming smooth implementation of the wage bill reform (baseline scenario in Figure 19), the overall fiscal deficit is projected to decline to an average of 3.8 percent over 2023-2025 (from 4.8 percent in 2021), reflecting: (i) gains from the wage bill and revenue mobilization reforms; (ii) increased donor grants; (iii) contained capital expenditure; and (iv) robust GDP growth (denominator effect). However, under a pessimist scenario, the average overall deficit could reach 5 percent of GDP in the medium term (Figure 19). This scenario assumes that: (i) adjustments to salary increase coefficients will have modest impact on the total public sector wage bill; and (ii) increased domestic debt costs as the government resorts to the domestic market to cover financing needs and monetary authorities further tighten monetary conditions for liquidity control.

Policy Recommendations

- **Accelerate fiscal consolidation through additional revenue reforms.** Supported by the ongoing IMF program, the government has eliminated zero VAT rates and cut exemptions. It is also essential to revise the excise tax to include more items consumed by specific taxpayer types (for example, including excises on private transportation could help address health and climate externalities) and address the deficiencies in the VAT refund mechanism. These measures are expected to deliver additional revenue.

- **Implement measures to create fiscal space for development spending and enhance debt sustainability.** Mozambique's new wage bill legislation needs to be rolled out effectively, complemented with a flexible wage policy that enables salaries to rise more slowly, and a functional review of public employment. The authorities also need to rebalance the composition of spending from non-discretionary recurrent spending, such as the wage bill and debt service, to more productive activities in critical enabling sectors, particularly public investments with high returns.

- **Initiate legal and parametric pension reforms.** Mozambique's public service pension scheme poses substantial fiscal risks and reforms are needed to address financial sustainability and governance challenges. The authorities may consider raising the mandatory retirement age from 60 to 65 and limiting the indexation of pensions to public sector wage growth or inflation, whichever is lower. Other reform options include lowering the benefit rate per year of service.

- **Strengthen the medium-term fiscal framework.** This is a vital reform, especially considering the upcoming resource revenue windfall. Alongside the recent Sovereign Wealth Fund Law submitted to parliament, a solid budgetary framework with clear fiscal objectives, anchors, and rules is essential for managing natural resource revenues prudently and supporting macroeconomic stability more broadly. These rules should account for spending pressures from recurrent climatic shocks.

- Review the rationale for state participation in the business sector. The government should consider revising the Law on Public Enterprises, separating commercial and non-commercial activities of state-owned enterprises (SOEs). High degree of overlap between the ownership, management, and regulation of SOEs, including in the transport and telecom sectors, undermines market contestability and services growth. Several underperforming SOEs continue to receive substantial preferential treatments, crowding out productive private investments.

Part Two: Can Services Drive Growth and Job Creation?[5]

Mozambique has sustained high economic growth for over two decades, driven by public investment and the expansion of extractives. But growth has faltered in recent years. With over half a million people expected to enter the labor force each year, creating more and better jobs is an urgent challenge for the country. Although services have emerged as a key source of job creation, the economy is still overly reliant on capital-intensive extractives and labor-intensive, low-productivity agriculture. At the same time, productivity growth in services is held back by weak governance, limited access to finance, and infrastructure deficit, among others. The expected natural gas boom is poised to boost growth, but the impact will be limited in the medium-term—hence the need for seeking other sources of growth and employment opportunities. Achieving sustained, broad-based growth will require raising productivity in services and stimulating the formalization of informal firms, while strengthening linkages between sectors.

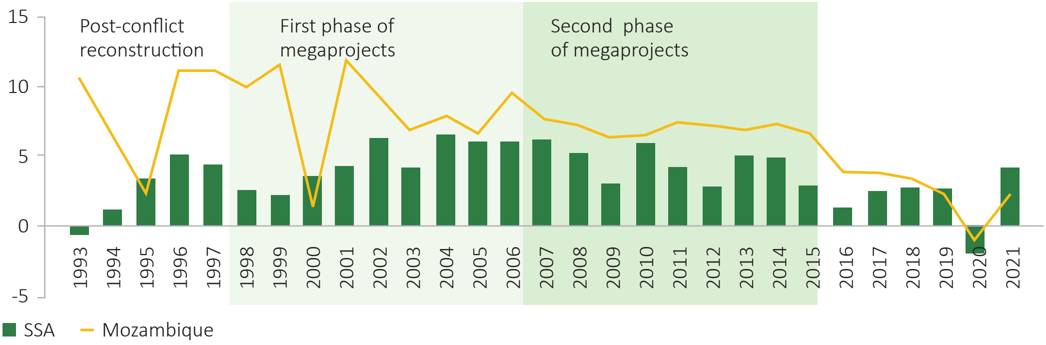
Why Mozambique Needs to Rethink its Current Growth Model

Despite robust growth over the last two decades, the economy has lost momentum in recent years

Mozambique achieved rapid and sustained growth for over two decades. Real GDP growth averaged 7.9 percent over 1993-2015, making Mozambique one of the fastest-growing economies in SSA (Figure 23).[6] During the 2000s and early 2010s, "megaprojects" (large-scale natural resource developments) in the aluminum and coal industries helped boost investment and growth. The rapid growth was also supported by expansionary fiscal and monetary policies, and sound economic management, which helped attract FDI and development aid.

Figure 22. Mozambique's growth performance has surpassed that of sub-Saharan Africa

Real GDP growth, 1993-2021



Source: World Development Indicators.

[5] This chapter draws on World Bank (2021a) and updated analysis prepared for this Economic Update.

[6] In this report, Mozambique is benchmarked against a set of regional, structural, and aspirational peers to gain insights into areas where reforms could help promote sustained and shared growth. Regional peers are average SSA and low-income countries (LICs). Structural peers are countries with economic and structural characteristics similar to those of Mozambique. These include Côte d'Ivoire, Ghana, Guinea, Tanzania, and Uganda.

The rapid growth spell in the past was not inclusive enough

The strong growth performance has helped reduce poverty, but at an uneven pace and in tandem with a rise in inequality. The poverty rate fell from 58.7 percent in 2008/09 to 48.4 percent in 2014/15. However, poverty reduction was uneven, with the bottom 40 percent of the population experiencing a decline in their share of consumption over the same period.[7] Growth has disproportionately benefited those at the top of the income distribution, with the Gini coefficient rising from 47 to 56 percent between 2002 and 2015. In Mozambique, the poverty rate was also less responsive to growth than in other SSA countries.[8] This weak relationship is partly due to heavy reliance on extractives, with limited linkages to the broader economy, and low productivity in the agricultural sector—the main source of livelihood for poor people.

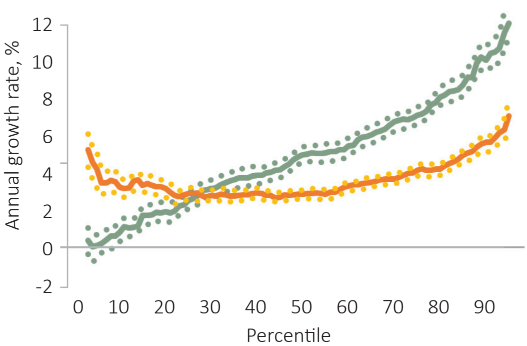
The uneven distribution of the growth benefits is also reflected in the growing gap in living standards and economic opportunities across provinces as well as between rural and urban areas. Growth has benefited large urban centers disproportionately. Household consumption was nearly three times lower in rural areas than in urban areas in 2015 (Figure 24a). In 2019, the decline in consumption owing to the economic slowdown was severe in rural areas for the bottom half of the income distribution.[9] There are large differences in human and physical capital between urban and rural areas. Disparities in access to basic infrastructure have been growing, with rural areas in the central and northern provinces lagging far behind (Figure 24b).[10] The spatial distribution of poverty is skewed, with the poor concentrated in the northern and central regions. Poverty rates are much higher in Nampula (77.7 percent), Zambezia (67.7 percent), Cabo Delgado (64.4 percent) than in Maputo Province (24.5 percent) and Maputo City (17.1 percent).

There have been limited changes in the sectoral composition of the economy

Mozambique has seen a modest shift in the structure of its economy away from agriculture. In the early 2000s, when the economy was predominantly agrarian, the country began to see an expansion of extractives, driven by FDI inflows into coal and aluminum. Agriculture's share of employment fell from 83 percent in

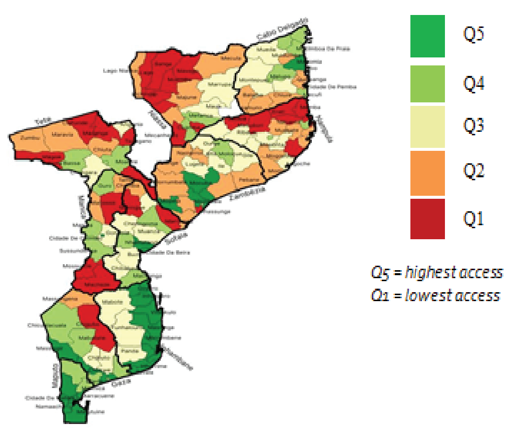
Figure 23. Consumption growth and access to basic infrastructure are not evenly spread

a. Consumption growth incidence curves, 2008–2015



Source: World Bank using household surveys conducted in 2008/09 and 2014/15. Note: Dotted lines in each graph show 95% confidence intervals. Confidence interval censored at 1st percentile. GIC=growth incidence curve.

b. Basic infrastructure access index by district



Source: World Bank (2019).

[7] World Bank (2020a).
[8] World Bank (2020a).
[9] By contrast, the decline was less pronounced for those in the top percentile in rural areas then for their urban counterparts.
[10] Regional economic disparities were aggravated by the skewness of infrastructure investment toward urban areas and export corridors and the vulnerability of rural and coastal areas to natural disasters, where poverty is the highest (World Bank, 2019).

1997 to an estimated 70 percent in 2020 (Figure 25b), while the sector's output share declined from 30 to 24 percent over the same period. By contrast, services have become the largest sector, accounting for 41 percent of GDP in 2021 (Figure 25a). The bulk of the labor force shed by agriculture moved into services, whose employment share rose from 14 to 21 percent between 1997 and 2019. Although services provided a wider pathway to non-agriculture jobs, the sector is dominated by relatively low-productivity commerce and informal activities.

While the extractive industry has spurred growth, its linkages to other sectors are weak and it has only generated limited formal employment. Despite the expectation that the demand from megaprojects would help promote manufacturing, much of the demand was fulfilled through imports. The manufacturing sector experienced a decline in its output share from 13 percent in 1997 to 8 percent in 2019—below the SSA average of 10 percent. Manufacturing created the least number of job opportunities, at about 5 percent of total employment—unchanged for three decades. Extractives' weak linkages with other sectors limit its impacts on the wider economy. Inter-sectoral linkages have been partly undermined by poor infrastructure and large geographical distances, including between areas of the highest agricultural potential and population mass (center and north) and areas of greatest effective demand (urban south).

Dynamic sectors have generated few jobs while those that employ the most people lack dynamism

High-productivity sectors have generated few jobs, while those that employ the bulk of the labor force remain less productive. A comparison of sectors' relative productivity reveals that agriculture had the lowest productivity levels but still employs the largest proportion of the labor force (Figure 26). On the other hand, productivity levels and growth are higher in industry and the services sectors (mainly construction, extractives, finance, and transport). However, these sectors generate few employment opportunities. Within services, the retail sector has created most jobs, but their productivity is mainly low.

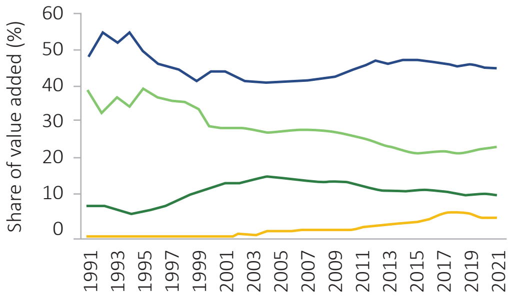
Furthermore, productivity growth has been declining in recent years, especially in services. Over 2009–2015, average annual productivity growth was highest in services (Figure 27), yet the sector registered negative growth between 2015 and 2018. Within services, transport and wholesale trade had the highest labor productivity, on a par with some manufacturing sub-sectors. Although services sectors have seen a decline in productivity, the shift from agriculture to services has still generated productivity gains because productivity in the agricultural sector was even lower than services.

The economy has become less diversified over time

Despite Mozambique's significant export growth in the past two decades, its export basket remains concentrated on primary products and lacks the sophistication of its peers. Export value rose from USD 2.6 billion (27 percent of GDP) in 2007 to USD 6.8 billion (31 percent) in 2021. However, a narrow range of natural resources and low-value-added agricultural commodities dominate the country's export basket. In 1996, Mozambique's export basket was dominated by agricultural exports; by 2018, coal and aluminum had emerged as major export products. Despite the change in product composition of the export basket, all the major export items are still primary products (Figure 27b). Such high reliance on exporting unprocessed products has increased the country's vulnerability to global commodity price shocks. Mozambique's performance on the Economic Complexity Index—which measures the sophistication or the relative knowledge intensity of an economy's export basket—has been trailing behind its peers (Figure 28a).

Figure 24. Services is the largest sector in terms of value-added, and its employment share has been growing

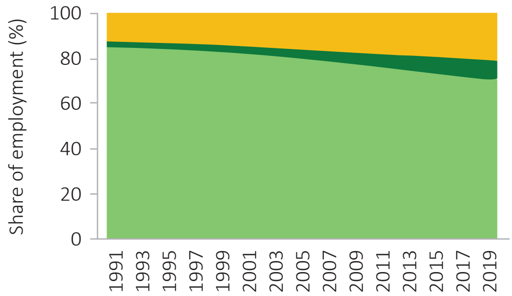
a. Sectoral shares of gross value added, 1991-2021



— Agriculture — Extractives — Manufacturing — Services

Source: World Development Indicators and National Institute of Statistics (INE).

b. Sectoral shares of employment, 1991-2019

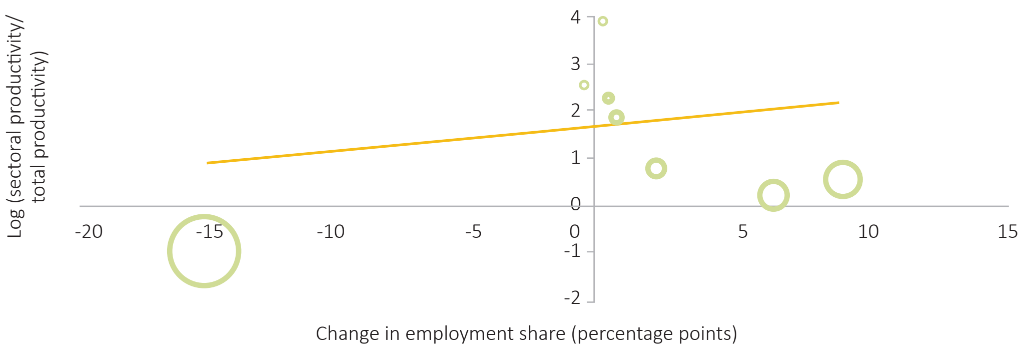


Agriculture Industry Services

Source: World Development Indicators.

Figure 25. Agriculture has the largest employment share but is the least productive sector

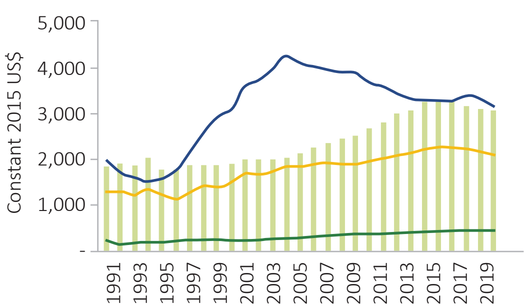
Correlation between sector productivity and change in employment shares, 1997-2020



Source: World Bank Staff estimates based on data from INE. Note: The size of a circle represents the relative size of each sector (as measured by its employment share) in 2015. The horizontal axis captures the change in a sector's employment share between 1997 and 2015 while the vertical axis measures the logarithm of the share of sectoral productivity in total productivity.

Figure 26. Labor productivity is declining across sectors

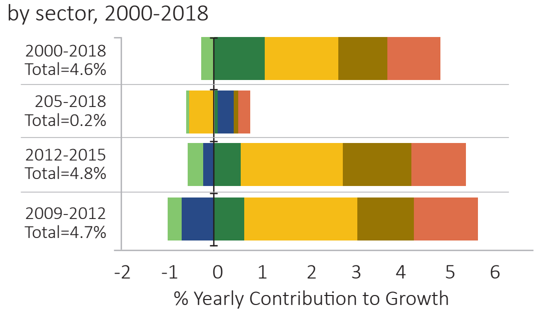
a. Labor productivity by sector, 1991-2019



Services — Agriculture — Industry — Total

Source: World Bank estimates based on data from World Development Indicators.

b. Annual contribution to labor productivity growth by sector, 2000-2018

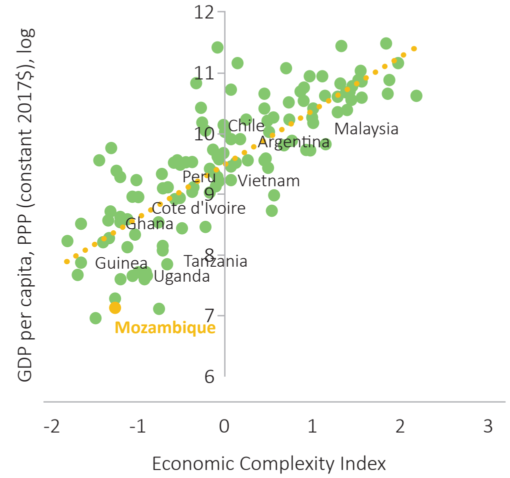


Within, Agriculture
Within, Industry
Within, Services
Inter-sectoral, Agriculture
Inter-sectoral, Industry
Inter-sectoral, Services

Source: World Bank estimates based on data from World Development Indicators.

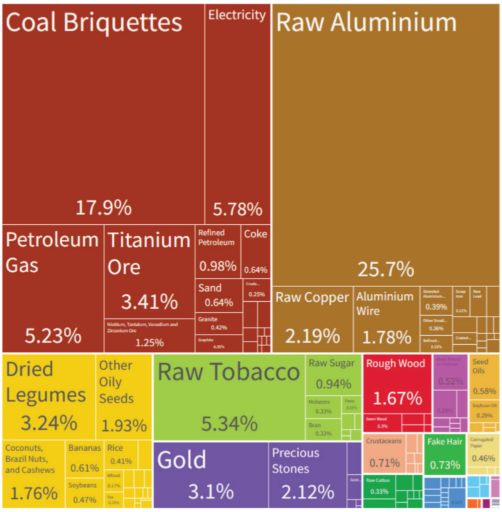
Figure 27a. Mozambique lags on economic complexity

Economic complexity and GDP per capita, 2020



Source: The Observatoy of Economic Complexity.

Figure 27b. Mozambique's export remains concentrated on unprocessed products



Source: The Observatoy of Economic Complexity.

Competitiveness needs strengthening to keep up with global technological and policy changes

Changing global technological and trade policy regimes bring both opportunities and challenges. There is a growing concern that the traditional path to development via manufacturing-led industrialization may no longer be accessible for low-income countries like Mozambique. In the past, an abundance of low-skill, low-wage labor attracted manufacturing FDI, created jobs, and promoted growth in low-income economies. Today's rapid adoption of digital and advanced technologies in production, mainly in manufacturing and service delivery, is mostly skill-biased, labor-substituting, and becoming cheaper, even resulting recently in re-shoring and onshoring.[11,12] Mozambique needs to rethink its growth strategy to position itself to better exploit the opportunities and mitigate the challenges that come with these technologies and the spatial and functional fragmentation of global output production.

A new growth model is needed

Mozambique needs to forge a new development paradigm based on more diverse sources of growth, productivity, and jobs. Sustained and inclusive growth cannot be achieved by focusing only on extractives and low productivity agriculture.[13] The new model needs to adopt a multi-pronged approach:

- Developing and upgrading the services sector
- Raising agricultural productivity through better technologies (e.g., improved seed and fertilizer) and enhancing market and climate risk mitigation. *See Mozambique Economic Update (2022).*
- Maximizing its comparative advantages in small-scale manufacturing. *See World Bank (2020b).*
- Strengthening the linkages between the

11 Onshoring refers to the process of sourcing or relocating a business' production operations to a lower-cost location within national borders. Reshoring is the process of returning a business or part of a business back to the company's original country.

12 te Velde and Banga (2018).

13 For Mozambique's development efforts toward to achieving broad-based economic growth and industrialization, Cruz and Mafambissa (2019) argue that investments in smokestacks industries such as tourism should also be considered as a complementary to the exploitation of coal, natural gas, and other natural resources as way.

extractive sectors and the rest of the economy to broaden the sources of growth and help build a more interconnected and competitive economy that shares growth more equitably.

The Growth Potential of the Services Sector in Mozambique[14]

The services industry offers both opportunities and challenges

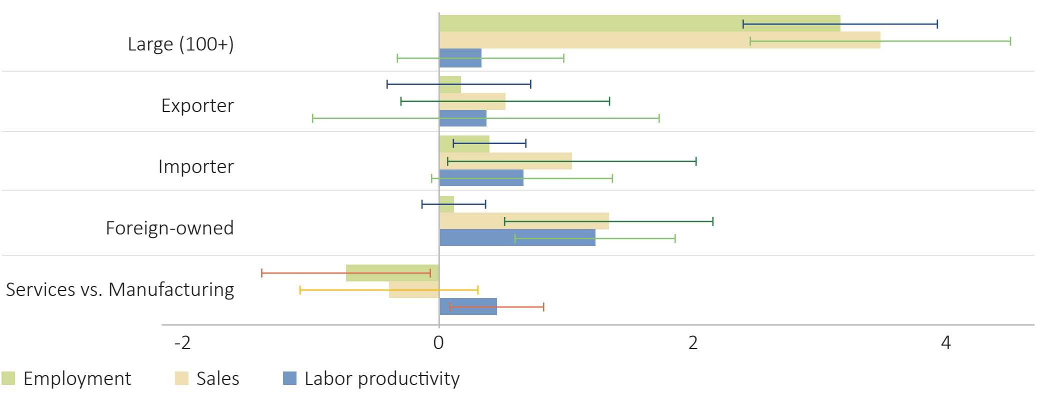
The services sector accounts for most firms, and their numbers are growing.[15] The number of services firms has almost doubled between 2003 and 2018, with the fastest growth occurring in more complex services such as ICT (an increase of 109 percent per annum), real estate (66 percent), and professional services (71 percent), followed by construction (56 percent) and transport (30 percent). Most enterprises were engaged in retail trading (39 percent), followed by hotels and restaurants (24 percent), and transport and communications (20 percent). In terms of ownership, most firms are privately owned (98.5 percent); of these, 23 percent had foreign equity, while 20 percent had at least a 10 percent foreign-ownership share.

Services firms are concentrated in and around Maputo. Based on the 2018 enterprise survey, 31 percent of services firms are in Maputo province and city. In Maputo city, the number of services firms has increased by almost 500 percent since 2003, compared with an 83 percent growth economy-wide between 2015 and 2018. Provinces such as Gaza, Sofala, and Zambezia also host large concentrations of services firms, whereas the five northernmost provinces contain only 27 percent.

The productivity of services firms varies substantially. Larger, importing, or foreign-owned services firms have higher levels of labor productivity and sales than smaller, non-importing, and domestic firms. Large firms (with 100 or more employees) have significantly better labor productivity and sales premia than smaller firms in the same sub-sector (Figure 28). Among service firms that use imported materials, both productivity and sales are considerably higher. This is partly because imported materials provide firms with cheaper and/or better-quality inputs that improve their productivity. Similarly, foreign-

Figure 28. Large firms have more employees and higher sales

Performance differentials among services firms (including micro enterprises), 2018



Source: World Bank calculations based on Mozambique Enterprise Survey (World Bank 2018).
Note: This sample includes micro enterprises (<5 workers). The plots are coefficient estimates from a weighted regression of employment, sales, and labor productivity (in log scale) on firm characteristics and sub-sector fixed effects. The sampling weights are used as arithmetic weights in the regression. Establishments with unreported or zero sales revenue, employees, and sub-sector classification are excluded. Labor productivity is value-added per worker at market prices based on constant local currency. Value-added is defined as sales revenue less material costs. Value-added is missing for most of the micro enterprise due to missing data on material costs. Standard errors are clustered at industry-region level. For regressions on services versus manufacturing, the clustering is done at the region level.

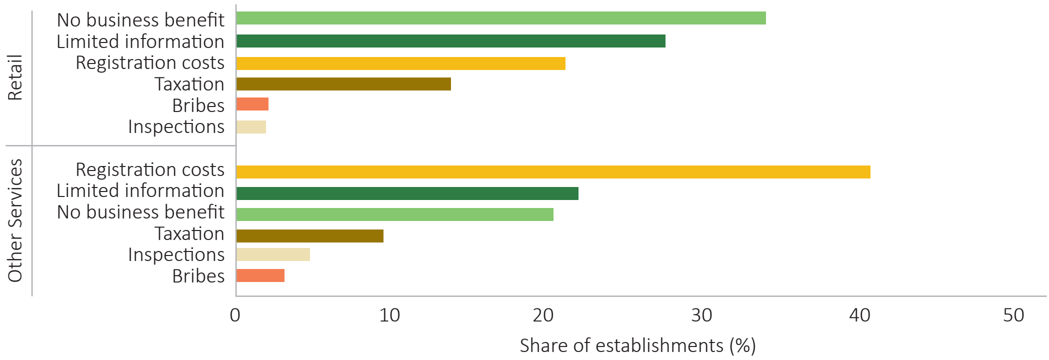
[14] Annex Box A.1 summarizes the impact of the COVID-19 pandemic on services firms based on more recent surveys.
[15] World Bank (2018a).

owned services firms outperform their domestic counterparts. Being able to access foreign equity is usually associated with improved access to credit, organizational structure and management practices, and technology.

Most informal enterprises are in the services sector. About 90 percent of informal enterprises are in the services sector, 80 percent of which are in retail, according to the 2018 informal business survey.[16] Ownership wise, about 45 percent of informal enterprises were women owned. Compared to formal enterprises, informal firms are more likely to be owned by women. Informal services firms are also smaller—employing 1.6 employees on average – and younger – averaging five years.

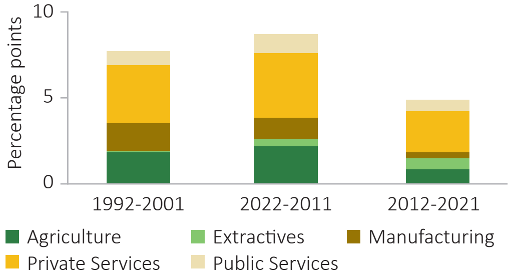
High registration costs, limited information on how to register, and the lack of benefits to registering are driving the high informality levels. Most retail establishments engaged in re-selling goods attribute their informal business status to a lack of benefits for their business. On top of being unaware of registration process, they also mention the time, administrative fees and paperwork needed to register as factors in their decision not to register (Figure 29). The

Figure 29. Costs and lack of benefits are key reasons for businesses not registering



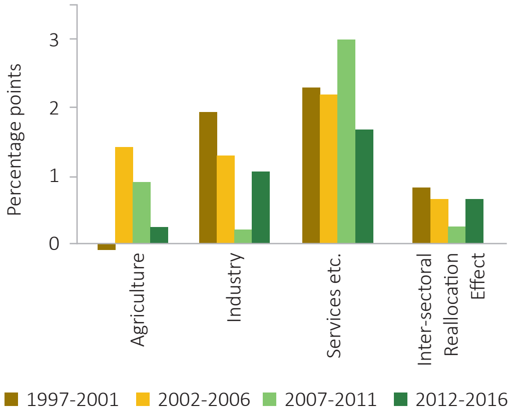
Source: World Bank (2018b) Informal Business Sector Survey 2018.
Note: "Other services" include transport, personal services, repair services and other services not classified elsewhere. A business is considered informal if it does not have at least an operating license (e.g., from the municipality, or Balcão De Atendimento Único- BAU), a business registration certificate (e.g., from the Registry Office of Legal Entities or One-stop Service), or a taxpayer's identification number (NUIT) in the name of the owner or business.

Figure 30. Services have made the largest contribution to employment growth, 1991-2021



Source: WB calculations based on data from INE and WDI.
Note: Public services comprise education, health, social security, and other activities of collective services. Private services comprise electricity and gas distribution, water, construction, automobiles sale and repair, transport, hotels and restaurants, information and communication, financial activities, and real estate.

Figure 31. Productivity is declining and overly reliant on services



Source: World Bank estimates.

[16] World Bank (2018b).

same factors are also frequently mentioned by other services businesses, who view registration costs as the most important deterrent.

Reducing informality is a critical challenge requiring policy attention. The limited number of formal services firms and small share of formal jobs offered by the services sector are holding back inclusive growth. Many informal firms do not grow, underscoring a weak enabling environment for growth as well as a lack of capabilities. Mozambique's unfavorable business environment means that services firms prefer to stay informal to avoid the costs of meeting regulations. Policy change is required to ensure that businesses can see the benefits of registering, such as access to financial resources and the legal framework.

Upgrading Services Could Unlock Growth and Economic Transformation

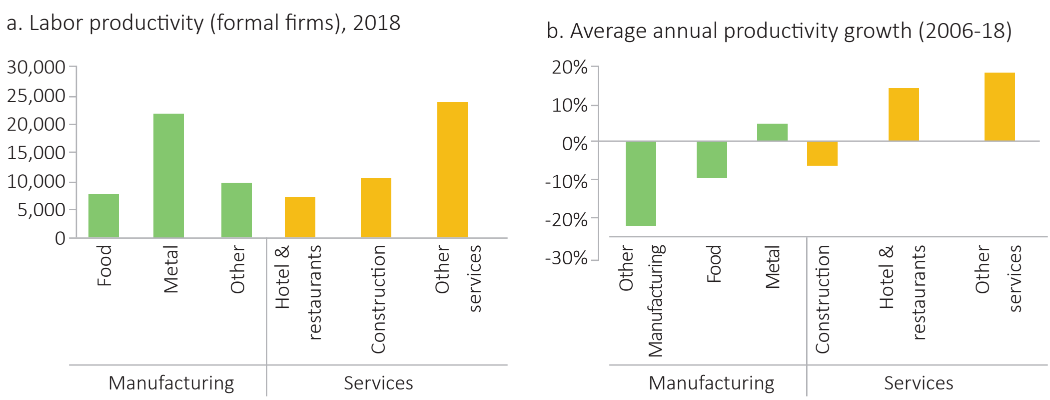
Under the right conditions, services have the potential to accelerate economic growth, job creation and economic transformation. Currently, although the services sector is the largest and relatively most productive, it is predominantly informal and oriented towards less complex activities such as retail and commerce. The sector needs to upgrade into more sophisticated and tradable activities, such as finance and professional services, to become an engine of growth.

Services are a significant employer

The services sector has been making a growing contribution to job creation. Services firms have been the largest source of employment growth over the last three decades (Figure 30). Comparing employment of both full-time and temporary workers in larger formal firms (five or more employees) between 2006 and 2017, the growing significance of services jobs is even more striking. While in 2006, more workers were employed in manufacturing than in services, by 2018 services firms had more than twice as many temporary and full-time workers, with the rise in the number of temporary workers particularly notable.

Retail is the largest, and fastest-growing, source of both formal and informal employment. Retail firms account for around 70 percent of informal employment, while among formal firms, retail (21 percent), construction (20 percent), and transport (14 percent) were the largest services sector employers. Over 2006-2018, annual employment growth in services firms (construction, hotel and restaurants, and "other services") with five or more employees exceeded employment growth in all manufacturing sub-sectors.

Figure 32. Labor productivity has been increasing for most services sub-sectors



Source: WB Enterprise Survey Mozambique 2007 and 2018.
Note: Metal includes basic metals, machinery and equipment, and electronics. Other manufacturing includes tobacco products, textiles, leather, garments, wood, paper, publishing, printing and recorded media, refined petroleum products, chemicals, rubber and plastics, non/metallic mineral products, fabricated metal products, transport machines, and furniture. Other services include services of motor vehicles, wholesale, transport, and IT. Sales in constant 2011 international U$S adjusted by PPP 2011 and GDP deflator. Growth is calculated using the sales reported by each firm for the ES year and some years before (2007 ES asks for 2003 sales and 2018 ES asks for 2015 sales). It is computed as the average over all firms of the following variable $(Sales\ ES_{i,t} - Sales\ ES_{i,t-1})/Sales\ ES_{i,t-1}$ where i corresponds to a firm. Growth of mean sales is calculated as: $(MeanSales_{2017} - MeanSales_{2006})/MeanSales_{2006}$.

Services also provide a larger share of jobs to female workers than manufacturing. In 2018, female workers represented 27 percent of permanent full-time workers in services, compared to 22 percent in manufacturing. The share of female workers was as high as 43 percent in the hospitality sub-sector;[17] while 17 percent of services firms had a female top manager—compared to 9 percent in manufacturing.

Services have the highest productivity growth, despite recent slowdown

The services sector has seen the largest productivity increases since the early 2000s, although its productivity growth is falling faster than in other sectors. Services have generally seen the fastest productivity growth. By contrast, agriculture has seen a decline in within-sector productivity gains. Since making the largest gains during 2002–2006, productivity in the industrial sector has also been in decline. However, service-sector productivity growth is declining at a faster pace than in other sectors (Figure 31). Annex Box A.1 summarizes the impact of COVID-19 on services firms based on more recent surveys.

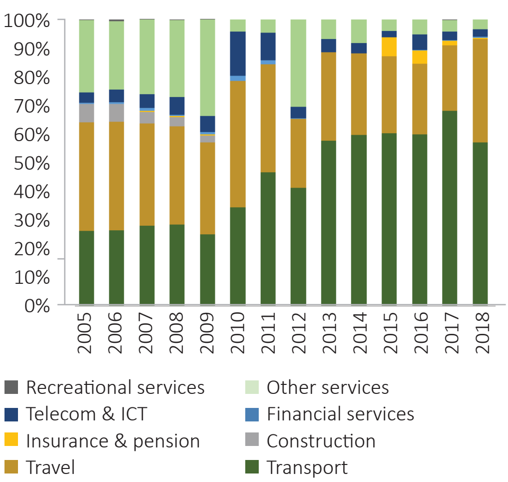
Productivity levels in service activities compare well with manufacturing (Figure 32). Within services, productivity levels in some sectors are higher than or comparable to capital-intensive manufacturing sub-sectors. There are substantial variations in productivity levels (proxied by sales per worker) within manufacturing and services. Labor productivity levels are the lowest for hotels and restaurants and food manufacturing. "Other services" had the fastest growth and highest productivity levels.

Services exhibit strong linkages with the broader economy

Services operations have strong linkages with the broader economy. While manufacturing is usually emphasized as a driver of economic growth and transformation because of the scalable and tradeable nature of manufacturing output, services also possess similar features thanks to the ICT revolution that enabled market exchange without physical proximity.[18] Analysis based on multipliers from Mozambique's social accounting matrix (SAM) shows that Mozambique's services sectors have substantial backward and forward linkages within the economy (Annex Table A.1). The sector has stronger linkages with the economy than does manufacturing, particularly through urban employment and economic output.

In recent years, global technological development and the increasing fragmentation of the production process have blurred the line between manufacturing and services. Production increasingly involves sourcing intermediate inputs from different countries and reaching buyers in distant markets. This can also involve goods and production inputs crossing borders multiple times. The availability of high-quality and affordable communication and transportation has facilitated such economic relationships. Additionally, services such as market research, after-sale customer support, recycling, and marketing are now key aspects of the manufacturing process. In other words, economies are experiencing the "servicification" of their manufacturing sectors, with services

Figure 33. Mozambique's services exports could be more sophisticated



Source: UNCTADstat.

[17] World Bank (2018a).
[18] Nayyar et al. (2021).

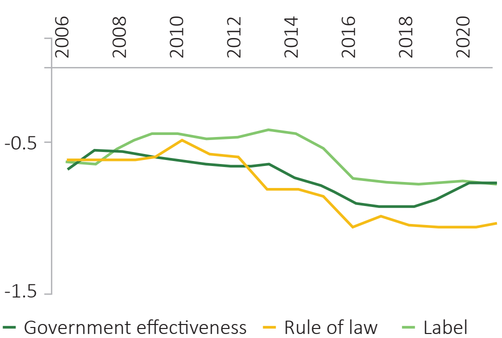
contributing significantly to manufacturing value-addition as sources of inputs.[19] Recent studies on value-added trade show that services account for a substantial fraction of the value-added in manufacturing exports. It has also become common for manufacturing establishments to handle distribution and after-sale services.[20]

Trade in services shows promise

Trade in services has gained importance over the years, and represents an alternative path toward higher export earnings, economic diversification, and productivity growth. The share of services in exports has increased globally; today they constitute about half of global trade.[21] Services are also bundled up with the export of manufactured goods, and their role is even more important in trade value-added. Specifically, services such as telecom, banking, insurance, shipping, and ICT have become increasingly central to the sector's exports, while also supporting exports from other sectors.

Mozambique's commercial service exports are small, and mainly from less complex sub-sectors such as transport and travel. Overall, the share of Mozambique's services trade more than doubled between 2006 and 2018, from 11.6 percent of GDP to almost 35 percent. However,

Figure 34. Mozambique's governance indicators have been trending downwards in recent years



Source: World Governance Indicators.

the share of commercial services exports represents only a small fraction of the country's overall exports. They are also dominated by traditional services (travel and transport), with little contribution from complex services such as ICT or professional services (Figure 32).

Weak Governance and Regulatory Bottlenecks are Impeding Services Development

The quality of institutions matters for development of the services sector.[22] Services export growth is associated with a transparent and efficient institutional environment.[23] Institutional quality plays a greater role in trade in services than in trade in goods.[24] The institutional capacity to design adequate policies, regulate different services sectors, and ensure compliance with laws and regulations is thus a key driver of success in the services sector. However, regulatory quality has steadily declined in recent years (Figure 33).

Although policies and regulations targeted at the services sector are generally open and non-discriminatory, they are hampered by weak governance and poor implementation. This is specially the case for key backbone services, such as telecoms and IT services, as well as transport and logistics (Box 3 and Box 4). Box A.2 (Annex) discusses the main challenges and opportunities in the tourism industry. Regulation in these sectors has advanced in recent years towards creating open and competitive markets, and ensuring minimum quality standards. However, oversight and enforcement have been largely ineffective, resulting in market conditions that do not reflect the regulatory guidelines. This not only impedes the expansion of these sectors by raising investment and operating costs, it also reduces economic competitiveness for trade in goods and other services by offering expensive and/or low-quality services.

Implementation of regulations is often discretionary because the lower levels of administration lack guidance. Laws and

19 Ibid.
20 Miroudot and Cadestin (2017).
21 WTO (2019).
22 Goswami, Mattoo, and Sáez (2012).
23 Grunfeld & Moxnes (2003).
24 WTO (2019).

regulations are published in the official gazette; some government agencies also publish their laws and regulations on their websites in Portuguese. However, lower regulatory instruments, such as decrees and ministerial guidelines, such as those setting out licensing requirements and criteria by each ministry, are often not available or not easily accessible.

In addition, market domination by state-owned enterprises and distortive state aid contribute to perceived low level of market competition, including in the transport and telecom industries.[25] Main competition constraints in Mozambique include relevant presence of State-Owned Enterprises (SOEs) in markets affected by distortive state aid and lack of competitive neutrality between firms. The private sector competes against SOEs basically in all sectors of the economy. In the context of a significant SOE footprint in the economy, the government may create an uneven playing field in markets where SOEs compete with private firms by receiving direct or indirect benefits not offered to private firms. If not carefully designed, state support measures afforded to market players, be they public or private, can be detrimental to productivity growth. The government has been supporting market players through various forms, including tax exemptions, loan guarantees, provision of resources below market prices, subsidies, capital injections.

Box 3. Digital transformation in Mozambique requires a stronger regulatory environment

The quality of information and communication technologies (ICT) services has significant implications given their importance for the economy. Both the manufacturing and primary sectors depend on telecommunications: modern production increasingly relies on services often performed remotely (such as research and development, and ICT services). These IT-enabled services include traditional communication as well as digital services. For these IT-enabled services to grow, they require a solid telecommunications market overseen by a sound and transparent regulatory framework.

While mobile connectivity improved substantially in Mozambique, telecom infrastructure and the IT services sector generally remain underdeveloped, especially for business purposes. With only one-fifth of the population currently using the internet, Mozambique is far below the global average of 53 percent of individuals online (Figure 34). In terms of broadband communications, it is among the laggards in the region, with only 0.07 broadband subscriptions per 100 people, behind Zambia (0.1), Tanzania (0.2), Zimbabwe (1.0) and South Africa (5.2) (ITU, 2019). According to the GSMA mobile connectivity index,[26] which captures factors affecting mobile adoption like infrastructure, affordability, consumer readiness, content and services, Mozambique scored 38.5 in 2021, below Tanzania (45.2) and Zambia (41.2).

Despite being one of the pioneers in Africa for its sectoral policy—the 2000 National ICT Policy and Implementation Strategy—telecom infrastructure remains weak in Mozambique. The Telecommunication Law, introduced in 2016, aimed to improve the quality and efficiency of the sector by strengthening the legal and institutional frameworks through reforms to fees, licensing, and networks. It also targeted domestic and foreign investment into the sector to help provide the resources needed to expand broadband connectivity via fiber optic network.

Weak regulatory compliance is currently undermining sector development.

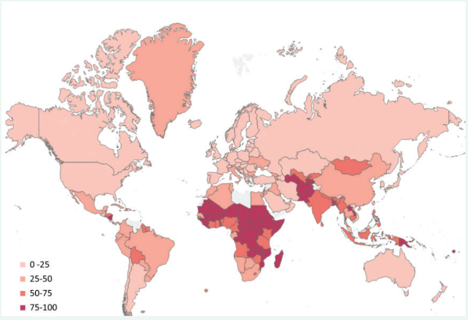
25 See World Bank (2021a) Mozambique Country Private Sector Diagnostic and World Bank (2022) Mozambique Public Expenditure Review.

26 https://www.gsma.com/

Mozambique's telecom regulator (ARECOM) has introduced regulations governing the construction and sharing of telecom infrastructure, yet mobile telecom operators continue to deploy proprietary networks. Their reasons include other networks being either sub-standard or inaccessible under fair conditions. Another example of weak regulatory framework is the management of land for infrastructure deployment. The 2016 Telecommunications Law allowed foreign operators to acquire land in rural areas under a special regime. However, lack of enforcement has forced foreign operators to make suboptimal arrangements with other property owners to install infrastructure. These regulatory bottlenecks have resulted in extra costs, unnecessary duplication of infrastructure investment, and magnified investment risks, undermining the quality and pace of digital connectivity in the economy, especially in rural areas. Regulations need to be enforced more effectively by building capacity in the governing agencies.

The authorities should promote digital entrepreneurship. Mozambique needs to promote digital skills as part of the education policy, and invest proactively in digital literacy and enhanced access to technology. It should also support innovation hubs by granting technology firms incentive packages, such as preferential import duty on imports and more flexibility with the recruitment of foreign labor. Specifically, digital entrepreneurs have limited access to finance. One option is to modify the financial regulations to accommodate the special needs of digital entrepreneurs, such as accepting intangible assets as collateral.

Figure 35. Mozambique is among the countries with the most people offline (% of people with broadband connections)

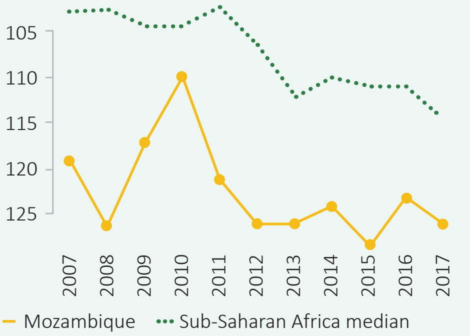


Source: ITU (2019).

Box 4. Transport and logistics are undermined by regulatory constraints

The transport and logistics sector plays a crucial role in Mozambique's economy and is open to foreign operators. Transport is the second largest employer within the services sector. There are no restrictions to foreign ownership. All transport operators based in Mozambique, irrespective of their foreign equity shares, can provide domestic and international transport and freight services. Foreign operators are also allowed to provide cross-border transport services and are eligible to obtain licenses irrespective of the countries in which they are incorporated.

Figure 36. Mozambique's infrastructure quality is low



Source: World Economic Forum, The Global Competitiveness Report, 2018.

Reforms in the early 2000s have developed sector policy and improved coordination of government efforts, but quality is failing. The development of customs and primary roads has improved the logistics sector. Thirty percent of the current road network was built in the last decade. However, infrastructure quality has recently been declining, and lags behind the regional average (Figure 35). In 2018, Mozambique ranked 126th out of 137 countries for the quality of its transport infrastructure. Its rank is even lower for the quality of roads, at 129.

Governance challenges and weak logistics infrastructure result in inefficiencies and undermine sector development. Low regulatory capacity results in opaque regulatory procedures, increasing operating costs and de facto market access restrictions. Unclear regulatory procedures and custom regulations, including multiple checkpoints, hamper the efficient transit of goods, increase operating costs, and restrict market access. Different authorities enforce the same regulations but apply and interpret the laws differently. Lack of co-ordination among ministries leads to numerous different permits and lengthy and costly processes to acquire them.

Arbitrary enforcement of rules undermines competitiveness. For instance, axle load restrictions, which are meant to limit truck freight capacity to 30 tons, are often ignored. Although weighbridges along the Beira corridor are reportedly broken, operators are still charged fees. These measures not only make it harder for services providers to compete in the market, they also exacerbate the deterioration of roads. The Beira corridor—another important transport corridor—has also been hampered by regulatory challenges.[27] Bottlenecks such as high charges and bribes or lack of risk management appear to be most prevalent (World Bank, 2021a).

As part of the South African Development Community (SADC), Mozambique is a signatory of the Protocol on Transport, Communications and Meteorology. Under that framework, the GoM has committed to harmonizing regional road policy to support commercial transport operators through nondiscrimination and fair competition. However, many obligations under this agreement remain unimplemented. For example, vehicle dimensions and weight regulations in Mozambique are stricter than those in neighboring countries, hindering competitiveness.

The development of the transport sector focuses mainly on the extractive industries, particularly the Nacala Logistics Corridor project, while other networks are neglected. Meanwhile, less than one-third of Mozambique's roads are paved, leading to access problems for the rural population and producers. Furthermore, a USAID assessment of the Nacala Corridor highlights the poor implementation of existing regulations, and informal fees.[28]

Reform Options to Further Develop the Services Sector

Mozambique needs to transition to a more complex type of service sector to bolster its contribution to growth and strengthen its role as a backbone of the economy. The country could grow its services sector in both size and sophistication, while also pursuing industrial sectors where the country has a comparative advantage. Growth in the services sector—particularly in backbone services such as telecoms, transport and logistics—has the potential to support the expansion of the economy and to spur growth in other export-oriented activities, including agribusiness and mining. Developing these sectors, which are still severely underdeveloped, should be Mozambique's top policy priority.

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[27] The corridor stretches from the Beira port to destinations in the Democratic Republic of Congo, Zambia, Zimbabwe, and Malawi. Among competitors in the region, this corridor has the highest market share for international transit cargo.

[28] USAID (2018).

A two-pronged approach is proposed: (i) economy-wide reforms to improve the business environment; and (ii) targeted reforms to strengthen the key backbone services such as ICT and transport. This final section discusses these themes in turn, making specific recommendations for reform to a range of key areas.

Improving the Business Environment

Enable cross-border services

Amend the regulations to allow service providers without a local establishment to operate. The local establishment requirement could be enforced only for certain services of high sensitivity.

Current regulations requiring local establishment of service providers hinder cross-border services and need to be amended. Mozambique's Commercial Code requires that any service supplier who wishes to perform activities for more than one year in Mozambique must open an establishment in the country and appoint a resident in Mozambique with powers to receive communication and notifications. These local presence requirements represent a de facto prohibition of the provision of cross-border services. While they may play a role in tightly regulated sectors, such as financial or professional services, they are at odds with the expansion of global services in the current digital era. Technology increasingly allows for new and more services to be performed remotely through digital means, including a range of business services that typically offer few regulatory concerns (e.g., business outsourcing services) or digital platform services that bring parties together but do not provide the services or good themselves (e.g., ride-hailing services and hotel booking services).

Simplify the administration of international transfers to attract foreign investment and frontier businesses

Improve the efficiency of handling international transfers

Transferring money is one of the key regulatory challenges facing many businesses in Mozambique. Existing foreign exchange control regulations only allow international transfers if: (i) the investment project is registered with the Central Bank; (ii) all the funds are registered with the Central Bank; and (iii) all tax obligations in relation to the investment project are fulfilled. The regulations of the Central Bank de facto require an investment license as a foreign firm to make an international transfer. This requirement causes major inconveniences and delays for firms with no or expired investment authorization. However, under the Investment Law, obtaining authorization for an investment project is only a voluntary procedure meant to unlock additional benefits (e.g., repatriation of invested capita). Commercial banks need clear guidelines and training to help them implement international transfers by already registered foreign firms.[29]

Make it easier to employ foreign labor

Consider replacing the quota system and labor market test with knowledge transfer schemes to mitigate the shortage of skilled local labor

Relaxing the restrictive components of the labor regulation on employing foreign workers could attract FDI and facilitate technology transfer (Box 5). Current regulations on employing foreigners impose domestic employment quota on foreign companies and have a major impact on the flow of foreign investment and overall business operation, given the shortage of skilled workers (Box 5). They are also implemented inefficiently through discretionary decisions and poor administrative practices, resulting in substantial delays in the hiring process and the loss of qualified candidates. Although there are exceptions to these regulations—for example, firms operating in special economic zones—upgrading to high-value complex services such as professional services and business services requires specialized expertise which is in short supply in Mozambique. The new labor law under preparation might lift some of the constraints.

[29] See Decree 49/2017 + Notice 20/GBM/2017.

Box 5. Protecting the domestic labor market while obtaining expertise: Approaches and alternatives

Restrictions and administrative hurdles in the recruitment of foreign labor pose significant challenges to the expansion of the ICT sector and development of digital entrepreneurship. Current regulations impose quota restrictions on employing foreign labor to protect the domestic workforce (Table 4). In a context of overall shortages of highly skilled labor in the economy, the shortages are especially severe for the ICT sector, which requires highly specialized experts. Not only are these experts in short supply locally, but they are also in high demand globally, making it even more difficult to hire and retain such people in Mozambique. ICT sector regulations emphasize the importance of attracting domestic and foreign investment and promoting competition, yet the existing restrictions and lengthy process for foreign workers is counterproductive.

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Table 5. Labor quotas for hiring foreign employees

Establishment size	Foreign labor quota
Small (10 employees or fewer)	10%
Medium (11-99 workers)	8%
Large (100 employees or more)	5%

Alternative approaches, such as knowledge transfer programs, can ensure an adequate supply of skilled labor while protecting domestic workers. In 1997, the aluminum smelter company Mozal set up the first major foreign investment program in Mozambique. Its training and development initiatives included a graduate development program to expose graduates to its facilities. Additionally, Mozal developed the Mozal Community Development Trust (MDCT) and the SME Empowerment Linkage Program (SMEELP), so that local small and medium-sized enterprises (SMEs) and the local community could benefit from its resources. MDCT's main objective was to carry out programs such as small business development, education, and training. SMEELP helped SMEs seeking to bid for contracts for the Mozal construction phase by providing capacity building, training, and technical assistance.[30]

[30] IFC (2003).

Review the rationale for state participation in business sector

The Law on Public Enterprises needs to be revised, separating commercial and non-commercial activities of state-owned enterprises (SOEs). High degree of overlap between ownership, management, and regulation of SOEs, including in the transport and telecom sectors, undermines market contestability and services growth. Underperforming SOEs continue to receive significant preferential treatments, crowding out productive private investments. In developing the investment strategy for the SOE sector, the state should carefully evaluate and disclose the objectives that justify state ownership. Given the demands on limited public resources, the state should analyze the costs and benefits of maintaining equity stakes in companies, particularly in SOEs that do not deliver a public service mandate or meet a strategic objective. An important factor to consider is whether SOEs respond to a market failure or if the private sector could adequately provide goods and services. SOEs that fail to meet the criteria for continued state ownership could be privatized, restructured, or wound down over time as appropriate.

Improve land use management

Improve the existing land-use regime by extending flexibilities on use of urban land to rural areas, as well as lease periods, to facilitate business operations, particularly foreign firms.

Land-use practices and regulations increase risks and operating costs for businesses and thus reduce the country's competitiveness and attractiveness to foreign investors, especially in areas like services that are not directly dependent on Mozambique's natural resources. Under the Constitution and the Land Law of 1997, all land in Mozambique is the property of the government and cannot be sold, mortgaged, or otherwise alienated. The state determines the rights and conditions under which land can be used and developed. The law declares that to obtain a land right (DUAT) foreigners must have an investment authorization and comply with certain conditions: (i) foreign individuals must have resided in Mozambique for at least five years; and (ii) foreign companies must be incorporated or registered in Mozambique. Simultaneously, asymmetrical rules governing the transfer of infrastructure, structures, and land improvements in urban and rural areas have caused major inconveniences and incurred extra costs for businesses. For example, when a building on urban land is transferred, the land accompanies it automatically. However, when a building on rural land is transferred, the land is not included unless the authorities approve. The GoM envisions to prepare a new land law that may address legislative bottlenecks.

Strengthening Mozambique's Key Backbone Services

Improve access to credit

Leveraging services sector for growth and jobs requires expanding access to credit. Access to finance for micro, small, and medium enterprises remains limited. About 75 percent of micro, small, and medium enterprises are financially excluded (World Bank 2020b). More importantly for the services sector, digital entrepreneurs have limited access to finance as they have high proportion of intangible assets. It is essential to stimulate the formalization of informal enterprises by promoting access to finance including through offering credit guarantees to small enterprises and lowering the cost of bank credit. Establishing a publicly funded universal risk-sharing facility that provide partial credit guarantees to firms that otherwise cannot secure credit, given the lack of assets that banks require as collateral can significantly relax the credit constraints. Such arrangement also provides banks with opportunities to update their risk perception of SMEs as they gain experience in this segment. Expanding firms' access to credit will require reducing government recourse to the domestic debt market, among others.

Facilitate innovation and technology transfer by investing in human capital

Mozambique's weak education system is an important obstacle to its productivity and competitiveness. Despite an upward trend in recent decades, Mozambique's Human Development Index (HDI) has been the lowest of neighboring countries. The lack of skills can be seen at all education levels. According to the World Bank's Knowledge Economy Index (KEI), which measures a country's readiness to compete in the knowledge economy, Mozambique ranked 90 out of 144 countries in 2012. Mozambique's KEI has dropped by almost 30 percent since 1995, and trails behind all its neighbors (World Bank, 2012).

Improve the quality of management skills and practices in the services sector

High-quality management skills and practices in the services sector are of utmost importance, especially for the growth of complex services and global markets. Formal services firms with more than five employees have seen a significant increase in the number of managers who have completed university. Between 2007 and 2018, this rose from 14 to 51 percent for hospitality, and 42 to 65 percent for construction. There has been a slight decline in the share of services firm managers who have completed secondary school. However, there is considerable variation in the quality of management practices across sectors, with hospitality performing worst. Management practices can be improved by providing group-based management consulting; connecting firms with professional business services to facilitate outsourcing of certain functions (e.g., marketing, accounting), and linking industry with vocational schools.[31]

Strengthen the regulatory framework and its implementation

Mozambique could further strengthen the regulatory framework in which firms operate. A critical measure relates to consolidating licensing for all economic activities. This involves unifying licensing for economic activities under a single entity and mandating centralized payment of licensing fees. This unification may prioritize firms that apply for import/export licenses, enhancing oversight of construction-related permits. It would help to reduce the cost of starting a business and the opportunities for extracting bribes. The government could also digitize the company registry and make it available to the public, which would enhance transparency and allow for easy access by ministries and civil society. The registry would strengthen the capacity to inspect and increase transparency and accountability. These measures could be most impactful in the transport and logistics sector.

[31] Lessons can be drawn from other country experiences (e.g. see several studies on the topic by N. Bloom, D. McKenize, and co.)

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Annexes

Table A.1 Backward and forward economy-wide social accounting (SAM) multipliers (based on a metical 1 million increase in exogenous demand)

Sub-sector	Output			Rural employment			Urban employment			GDP		
	Comb.	Bwd	Fwd	Comb.	Bwd	Fwd	Comb.	Bwd	Fwd	Comb.	Bwd	Fwd
Overall	1.45	1.40	1.50	1.49	1.46	1.53	4.36	4.34	4.38	0.76	0.74	0.78
Accommodation and food	1.44	1.64	1.25	1.24	1.98	0.51	2.23	2.66	1.80	0.58	0.70	0.47
Business services	1.42	1.31	1.53	0.33	0.14	0.52	2.81	2.52	3.10	0.87	0.84	0.90
Construction	1.34	1.60	1.07	0.57	0.72	0.42	1.25	1.65	0.84	0.43	0.56	0.29
Education	1.08	1.16	1.00	0.88	0.93	0.84	1.58	1.69	1.47	0.85	0.89	0.81
Electricity, gas and steam	1.53	1.26	1.81	0.42	0.31	0.53	1.42	1.30	1.54	0.94	0.85	1.03
Finance and insurance	1.88	1.67	2.08	0.56	0.35	0.77	1.94	1.74	2.13	0.61	0.52	0.69
Health and social work	1.13	1.27	1.00	0.62	0.69	0.56	1.76	1.94	1.57	0.75	0.81	0.68
Information and comm.	1.74	1.41	2.08	0.58	0.35	0.82	2.70	2.05	3.36	0.81	0.68	0.95
Other services	1.68	1.48	1.88	4.51	4.40	4.61	16.28	16.03	16.52	0.73	0.65	0.80
Public administration	1.27	1.49	1.05	0.35	0.48	0.22	1.32	1.64	0.99	0.52	0.63	0.41
Real estate activities	1.10	1.09	1.11	0.07	0.07	0.07	0.18	0.15	0.22	0.98	0.97	0.99
Transportation/storage	1.66	1.25	2.07	0.66	0.32	1.01	1.89	1.22	2.56	0.89	0.71	1.07
Water supply and sewage	1.90	1.60	2.19	0.64	0.50	0.79	1.78	1.59	1.97	0.75	0.62	0.88
Wholesale and retail	1.51	1.53	1.48	1.17	1.10	1.24	4.21	4.30	4.12	0.65	0.68	0.62

Source: van Seventer (2019).
Note: SAM: Social accounting matrix. Averages for services and manufacturing output are weighted by output. Average employment multipliers are weighted by their respective employment shares in services employment. Average GDP multipliers are weighted by the shares in services GDP. All multiplier indicators exclude the household income-expenditure loop.

Box A.1: More Recent Waves of Firm Surveys: COVID-19 and its impact on the services sector [32]

Significant number of services firms have exited marked or scaled down their operation owing to the pandemic. In comparison with the baseline enterprise survey in 2018, about 1 and 48 percent of services firms are confirmed or assumed permanently closed in 2020 and 2021, respectively (World Bank 2020 and 2021). Services firms reduced their weekly work hours. In 2020, about 70 percent of the firms reduced their weekly operations and by 53 percent in 2021 compared with the previous year. These firms also reduced their workforce, especially the number of temporary workers. About half of the firms stated they decreased temporary workers since the beginning of the pandemic. On the positive side, more than 20 percent of services firms started or increased online business in 2020, and which was even higher

32 Firm closure has a relatively loose definition in that it includes businesses that closed since the baseline ES in 2018 as well as business that could not be reached during fieldwork for the COVID follow-up surveys in 2020 and 2021. World Bank (2020, 2021). *Enterprise Surveys Follow-up on COVID-19.*

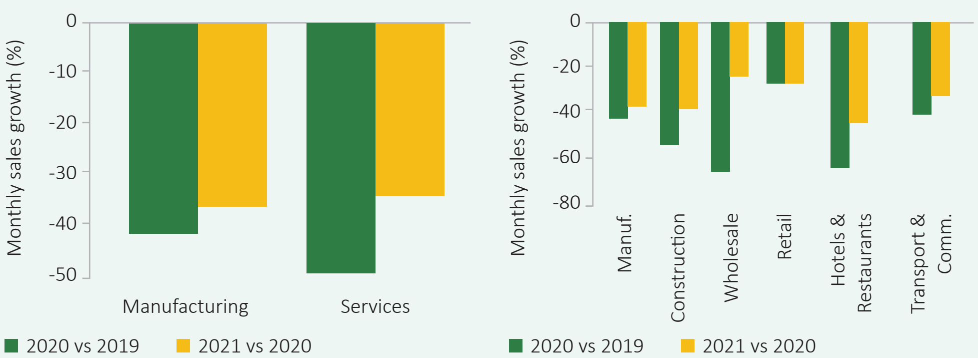
in 2021 (35 percent). Also, services firms in retail and transport and communication are likely to re-hire their previous employees, although hotel and restaurants firms tend to hire new workers.

Sales markedly declined relative to the pre-pandemic levels. The decline in average monthly sales compared with the year before was sharp and pronounced in the services sector (52 percent versus 44 percent for manufacturing in 2020 relative to 2019). Within services, it was more severe among wholesale (69 percent) and hotels and restaurants (67 percent) businesses. Firms in the hospitality industry were particularly affected due to movement restrictions. The commerce and retail sector, representing over 74 percent of the small firms in the country, suffered from import constraints. This hit informal cross-border traders, that were no longer allowed to cross the border with their goods.

In view of the severity of the COVID-19 crisis, authorities took measures to mitigate the impacts of the crisis on services as part of broader support to the private sector. The Government and the Central Bank provided support that included: (i) postponement of tax payments and compensation of private sector tax credits; (ii) reduction of electricity tariffs for businesses; (iii) reduction in monetary policy rates and Central Bank's reserve ratio; (iv) credit lines at discounted interest rates; and (v) credit lines to finance transactions linked to the imports of essential consumer goods.

However, the effectiveness of the measures taken was limited. The percent of services firms that received national or local government assistance were below 2 and 4 in 2020 and 2021, respectively. First, the implementation of the measures was hindered administrative bottlenecks. Support measures needed to be more rapid, transparent and time bound to address immediate liquidity challenges, prevent widespread layoffs, and limit firm bankruptcies effectively. Second, the measures had insufficient scope and did not fully target the services activities most affected by the pandemic, such as hotels and restaurants, tourism, transport, informal micro firms, or household enterprises. Incentives, cash injections and tax relief were not tailored to the characteristics of firms in these industries.

Figure 2.1 Average monthly sales growth in percentage compared with pre-pandemic levels (based on ES 2018 as a baseline)



Source: World Bank Group. Enterprise Surveys Follow-up on COVID-19.

Box A.2. Enhancing the Role of Tourism

Although Mozambique's tourism has strong potential and has been prioritized as a strategic sector, it exhibits weak performance and has limited contribution to the economy. Mozambique has rich tourism assets because of its natural endowments and cultural heritage that can be leveraged toward creating jobs, raising productivity, and accelerating economic growth in both rural and urban areas. GoM has recognized the sector's potential by designating tourism as one of the strategic sector in the National Development Strategy (2015–35) and the government's five-year program (2020–24). Aligned with these strategies, the Strategic Plan for the Development of Tourism in Mozambique (SPDTM II, 2015–24), developed by the Ministry of Culture and Tourism (MICULTUR) with support from the World Bank, emphasizes the importance of prioritizing source markets, products, and places with expenditures in tourism. However, the sector has underperformed, particularly compared with regional peers such as Kenya, Madagascar, and Tanzania. In 2019, Mozambique ranked 127th of 140 economies for overall competitiveness. the sector's total (direct and indirect) contribution to the Mozambican economy was 6.6 percent of GDP and about 4.6 percent of the total exports (World Bank 2020b). Additionally, the travel and tourism sector created direct and indirect jobs representing 6.7 percent of the country's total employment. Furthermore, only a small share of the international arrivals high-spending, long-haul leisure tourists.

Addressing the sector's demand and supply constraints enables exploiting the tourism potentials encouraging domestic travels and attracting MICE[33] and high-end leisure tourism. Despite expansion in the capacity of tourism accommodations, there are still only small clusters of high-value leisure tourism lodges and internationally branded resorts only small clusters of high-value leisure tourism lodges and a few internationally branded resorts. Approved investment projects in the sector have also decreased significantly in recent years, partly due to unfavorable business environment (e.g., lack of clarity in the Investment Law and the role of different agencies). Besides weak infrastructure and services (e.g., roads, water, and electricity), the shortage of qualified labor in the sector has undermined standards and service quality, reflecting the weakness of the education system in general and inadequacy of the exiting hospitality and tourism training institutions. Overall, promoting the sector's performance require Interventions in areas of building infrastructure, attracting investment, stimulating demand, an strengthening the links of the local operators to the tourism value chain to reduce reliance on imports and fill the skill gaps.

[33] Meetings, incentives, conferences, and exhibitions.

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