MOZAMBIQUE ECONOMIC UPDATE

Making the most of demographic change

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

December 2017

The World Bank's biannual Mozambique Economic Update (MEU) series is designed to present timely and concise assessments of current economic trends in Mozambique in light of the country's broader development challenges. Each edition includes a section on recent economic developments and a discussion of Mozambique's economic outlook, followed by a focus section analyzing issues of particular importance. The focus section in this edition addresses the search for a demographic dividend in Mozambique. The MEU series seeks both to inform discussions within the World Bank and to contribute to a robust debate among government officials, the country's international development partners, and civil society regarding Mozambique's economic performance and key macroeconomic policy challenges.

The cutoff date for the current edition of the MEU was November 30, 2017.

Contents

Abbreviations and Acronyms iii
Acknowledgements iv
Executive Summary 1
Part One: Recent Economic Developments 3
Economic Growth 3
Exchange Rate and Inflation 8
The External Sector 9
Monetary Policy 12
Fiscal Policy 14
Outlook 19
Part Two: Searching for the Demographic Dividend 22
A Worrying Demographic Picture 22
A Three-Pillar Policy Framework to Harness the Demographic Dividend 25
Estimating the Effects of Implementing Key Policies 28
References 30

FIGURES

Figure 1: Growth is slowing in 2017 5
Figure 2: ... despite a sharp increase in coal exports 5
Figure 3: Industrial production trends have been unfavorable 5
Figure 4: ... and both credit and investment levels are at a low point 5
Figure 5: The share of employment has grown most in the services sector 6
Figure 6: ... where growth in labor productivity has been lowest 6
Figure 7: Worldwide, urbanization is associated with significant poverty reduction 8
Figure 8: In Mozambique, urban growth and consumption have not been associated with substantial poverty reduction 8
Figure 9: Population growth explains most of the increase in Mozambique's urban population 8
Figure 10: Prices in urban areas are higher than in rural areas, especially in Maputo 8
Figure 11: Food inflation has slowed since the start of the year 9
Figure 12: ...together with a strengthening metical, this has resulted in reduced inflation levels 9
Figure 13: Megaproject exports are supporting a narrowing current account balance 10
Figure 14: ... and along with reduced imports, are contributing to improved reserve cover 10

Figure 15: Megaproject FDI has fallen due to maturing projects and delays to implementation 11
Figure 16: Although the REER has appreciated recently, it is now lower being back at 2011 levels 11
Figure 17: Lending rates remain above peer countries..... 13
Figure 18: ... but may have room to ease given the drop in inflation..... 13
Figure 19: Tight monetary policy has reduced the demand for credit..... 13
Figure 20: ...in almost all sectors of the economy..... 13
Figure 21: On-budget spending on health and education has remained constant..... 16
Figure 22: Investment in secondary education has increased significantly in recent years..... 16
Figure 23: ...but spending has been inefficient compared to peers..... 16
Figure 24: Fertility rates are high when compared to peer countries..... 17
Figure 25: ...despite higher spending on reproductive and maternal health since 2012..... 17
Figure 26: Central bank advances have been increasingly financing the fiscal deficit..... 19
Figure 27: The Government wage bill remains sticky and above peer countries..... 19
Figure 28: Mozambique Lags Behind SSA Countries in the Demographic Transition..... 23
Figure 29: Socio-Economic Inequality is Reflected by Unequal Fertility..... 23
Figure 30: Observed fertility is higher than desired for the lowest quintiles..... 23
Figure 31: Conceptual Framework: The Demographic Dividends..... 24
Figure 32: The growth rate of formal jobs will be crucial to the rate of decline in informality..... 27
Figure 33: Achieving the Low Fertility Scenario Means an Enormous Boost in GDP per Capita by 2050..... 28
Figure 34: Only by Improving Education and Reducing Fertility that Mozambique Eradicates Extreme Poverty by 2050..... 28

TABLES

Table 1: The Balance of Payments 11
Table 2: Central Government Finances 18
Table 3: Outlook 21

BOXES

Box 1: Is Mozambique's pattern of growth generating enough "good jobs"? 6
Box 2: Why is urban growth providing few "good jobs" for rural workers? 7
Box 3: Maintaining service delivery outcomes with fewer resources 15
Box 4: What is the Demographic Dividend and how does it impact Poverty Reduction?..... 24

Abbreviations and Acronyms

BoP	Balance of Payments
BdM	Bank of Mozambique (*Banco de Moçambique*)
CAD	Current-Account Deficit
CPI	Consumer Price Index
DHS	Demographic Household Survey
EDM	Mozambique Electricity (*Electricidade de Moçambique*)
EMATUM	Mozambican Tuna Company (*Empresa Moçambicana de Atum*)
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign Direct Investment
FPC	Standing Lending Facility (*Facilidade Permanente de Cedência*)
FPD	Standing Deposit Facility (*Facilidade Permanente de Depósito*)
GDP	Gross Domestic Product
GFSM	Government Finance Statistics Manual
HCB	Cahora Bassa Hydroelectric (*Hidroeléctrica de Cahora Bassa*)
IGEPE	State-owned Equity Holdings Management Institute (*Instituto de Gestão das Participações do Estado*)
INE	National Statistics Institute (*Instituto Nacional de Estatística*)
IMF	International Monetary Fund
IPI	Industrial Production Index
LIC	Low Income Countries
LNG	Liquefied Natural Gas
MAM	Mozambique Asset Management
MASA	Ministry of Agriculture and Food Security (*Ministério da Agricultura e Segurança Alimentar*)
MEF	Ministry of Economy and Finance (*Ministério da Economia e Finanças*)
MBTU	Million British Thermal Units
Mt	Metric tons
MZN	New Mozambican Metical
NPLs	Non Performing Loans
OECD	Organization for Economic Co-operation and Development
PER	Public Expenditure Review
PPI	Producer Price Index
PPP	Public-Private Partnership
PROSAUDE	Common Fund Mechanism for Health Financing (*Programa de Saúde*)
REER	Real Effective Exchange Rate
SADC	Southern Africa Development Community
SIMA	Agricultural Market Information System (*Sistema de Informação de Mercados Agrícolas*)
SSA	Sub-Saharan Africa
SOE	State Owned Enterprise
TFR	Total Fertility Rate
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNFPA	United Nations Population Fund
VAT	Value Added Tax
WDI	World Development Indicators
WEO	World Economic Outlook
WB	World Bank

Acknowledgements

This edition of the Mozambique Economic Update was prepared by a team led by Shireen Mahdi (Senior Economist, GMF13). The team included Sara Troiano (Young Professional, GTI11) and Peter Holland (Program Leader, AFCS2) - lead authors for part two, Anna Carlotta Allen Massingue (Research Analyst, GMF13), Fernanda Ailina Pedro Massarongo Chivulele (Research Analyst, GMF13), Adelina Mucavele (Program Assistant, AFCS2), Ian Walker (Lead Economist, GPSJB), Andre Herzog (Senior Urban Specialist, GSU13), Julian Casal (Senior Financial Sector Economist, GMF01), Jorge Faria (Financial Sector Analyst, GMF01), Humberto Albino Cossa (Senior Health Specialist, GNH01) and Miguel Angel San Joaquin Polo (Senior Health Economist, GNH01). Peer reviewers were Fausio Mussa (Chief Economist, Standard Bank Mozambique), Ulrich Bartsch (Lead Economist, GMF01), and Fulbert Tchana Tchana (Senior Economist, GMF05). The report was prepared under the overall guidance and supervision of Mark R. Lundell (Country Director, AFCS2), Mathew Verghis (Practice Manager, GMF13) and Carolin Geginat (Program Leader, AFCS2).

Executive Summary

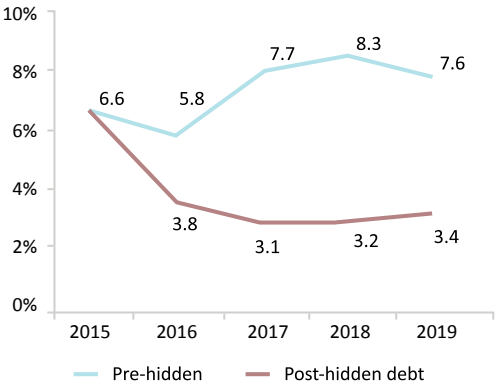
Mozambique is shifting to a period of reduced growth and increasing concentration.

Developments in the second half of this year indicate that the slowdown in Mozambique's economic performance may be taking hold and shifting this once fast-growing economy to a more modest pace of growth, barely above that of the population. After registering 7 percent GDP growth on average between 2011 and 2015, growth is expected to dip to 3.1 percent in 2017. This reduction in growth is expected despite the substantial increases in coal and aluminum exports seen in 2017, Mozambique's prime tradables. Whilst these exports boomed over the past year, small and medium enterprises have fallen back even further, especially in the manufacturing sector, which contracted for this first time since 1994. Their growth, and capacity to generate jobs, has been restricted by the economic downturn in the post-hidden debt period through reduced demand from both private consumers and the public sector, reduced investment, and the high cost of credit. Small and medium enterprises are crowded out, and not even the sizable growth in commodity exports is sufficient to counteract the effects this is having on growth.

The level of concentration in the economy also increased in 2017. A few commodities dominate exports and represent a larger share of foreign currency inflows, which heightens exposure to external shocks. The increased concentration of output in the extractive and minerals sector keeps Mozambique on the path of a two-speed economy that is less capable today of generating sufficient jobs to absorb a net inflow of almost 500,000 people annually that will enter the labor force each year over the next decade. Hence, the trends observed in 2017 make it clear that Mozambique needs to redouble its efforts to support small and medium enterprises, and to look beyond the extractive sector for more balanced growth.

GDP growth expectations pre and post hidden debts

(Annual % change)



The appreciation of the metical helped to lower external debt from 103 percent of GDP at end 2016 to an estimated 83 percent by end 2017. This continues to be an unsustainably high level of debt with a high burden in terms of debts service. Moreover, Mozambique's public finances have continued to worsen under the ongoing downturn. The budget continued to adjust by reducing public investment in favor of a still growing wage bill and higher debt service costs. These spending pressures, along with increasing fiscal risks from weakened state-owned enterprises, have limited progress towards fiscal adjustment in 2017 and contributed to the rapid increase in domestic borrowing, adding further to the debt burden. Without progress in

the debt restructuring process launched by the government in October 2016 and measures to control spending, including the adoption of a target for a primary surplus in the medium-term, it will be unlikely that Mozambique will be able to restore fiscal sustainability.

A stronger fiscal policy response and increased transparency are key for recovery.

There is no doubt that the scale of the shocks faced by Mozambique's economy over the past two years has been immense, including the El-Nino drought and falling commodity prices in early 2016, and the hidden debts crisis which amplified an already ongoing slowdown. Since then, commodity prices and conditions for agriculture have more been favorable. There has also been notable progress achieved towards the development of the Rovuma basin gas reserves as the Coral South project reached the final investment decision. As the external factors become less of an impediment, the economy turns to the policy response in pursuing a recovery. Decisive monetary policy measures and the strong commodity export performance helped to stabilize the Metical and bring inflation down to 7 percent from a peak of 26 percent a year earlier. Fiscal policy also began responding, but at a slower pace. Progress has been made in reforming subsidies and strengthening revenues, but more needs to be done to restore the health of Mozambique's public finances and set a path to debt sustainability in the medium term.

Stabilizing the outlook through more definitive fiscal policy measures and the resolution of the debt restructuring negotiations are urgent priorities that would help to balance the macroeconomic policy mix. Monetary policy has been active and has contributed to a stabilizing currency at a critical time. The space is now opening for the monetary policy cycle to begin easing as inflation continues to fall, which would improve the private sector's access to credit. But this requires a tighter fiscal policy response and more sustainable levels of debt. It would also require a more proactive approach to tackling fiscal risks from weak state-owned enterprises. In addition, increased transparency and accountability in the handling of the hidden debts investigation would support this reform package, and help to restore investor and donor confidence.

Making the most of demographic change.

In order to examine the expected future demands on Mozambique's growth path, the special focus section in this economic update discusses the challenge of transforming Mozambique's growing and youthful population into a demographic dividend for future growth. This is an ever more urgent agenda given the drift towards a natural resource extraction based economy with low employment generation. Mozambique lags behind other sub-Saharan African countries in kicking off a demographic transition. With children aged 0-14 representing more than 45 percent of the population in 2015, the country has an extremely young age structure. From about 2000-2010, there was no progress toward a demographic transformation; in fact, high fertility levels appeared to have increased further. By 2011, the total fertility rate was estimated at 5.9 children per woman on average, one of the highest rates in the world. Perhaps more importantly, in Mozambique, although the *desired* number of children among women is high, the *observed* fertility is even higher, especially amongst the poor.

This challenge is immense, but so is the opportunity: World Bank analysis estimates that reducing fertility levels, investing in skills, and productive jobs would represent an enormous boost to prosperity. Helping fertility levels to drop faster is estimated to increase real GDP per capita by 31 percent by 2050. To achieve this, and transform the demographic challenge into an economic opportunity, Mozambique must actively promote policies to trigger the fertility transition through job opportunities for women and better family planning services to delay the onset of early marriage. It also calls for a sharper focus on building skills for youth and an economy that grows whilst generating productive jobs for the next generation of Mozambicans.

Part One: Recent Economic Developments

Economic Growth

Slower growth as the private sector is crowded out and generating fewer jobs.

Mozambique is shifting to a reduced growth trajectory. As opposed to 2017 being the year when Mozambique begins to slowly recover from a debt driven economic downturn, output growth has slackened even further, shifting Mozambique further away from its track record of high growth. Gross domestic product (GDP) growth is expected to slow to 3.1 percent in 2017, down from 3.8 percent in 2016. This continued slowing signals the depth of the ongoing downturn, and the continued transmission of the debt crisis to the real sectors of the economy.

Manufacturing, which represents 13 percent of GDP, contracted for the first time since 1994. The contraction was felt in all three sub-sectors: manufacturing, energy and construction. Once a key catalyst in the economy, with annual growth averaging at 8 percent since the start of the decade, the construction sector has faltered as public and private investment declined.[1] Hydropower generation has also experienced a slump, having been affected by low water reservoir levels.[2] Lastly, core manufacturing industries, including food processing, are struggling to maintain their levels of output considering the high cost of credit, slow demand and low competitiveness vis-a-vis imports as the real exchange rate appreciated.

Without the ramp up in coal exports, the slowdown in growth would have been more pronounced. A 40 percent growth rate in extractives has been the most pronounced trend of the year, largely driven by higher coal exports. As a result, extractives are expected to account for 2.3 percent of the 3.1 percent growth expected in 2017. Services, the largest sector in the economy, was the second largest contributor to growth. Demand for transport services increased compared to 2016, spurred by increased security in the center of the country and demand for both rail and port logistics as coal exports boomed. Currency stability and easing inflation reduced pressures on purchasing power, but this has not been enough to restore consumer demand for services, whilst public sector activity remains diminished. Agriculture also contributed to growth given increased output of both grain and export crops[3] with maize production, Mozambique's

[1] According to the Economic Climate Confidence Index, almost 50 percent of firms in the sector reported facing limited activity in August 2017, and 39 percent cited low demand as a significant obstacle to activity.
[2] Reservoir levels were severely affected by the drought experienced in 2016. Despite normal precipitation levels during the last rainy season, which ended in March 2017, HCB's data on reservoir levels shows that quota has not exceeded 319.8 meters – putting it 6.2m below the minimum requirement level for storage. [see http://www.jornalnoticias.co.mz/index.php/provincia-em-foco/67166-tete-hidroelectrica-de-cahora-bassa-mudancas-climaticas-limitam-producao-energetica.html for further coverage on this issue.]
[3] Grains include maize, sorghum and rice, whilst export crops refer to tobacco and cashew nuts.

main agricultural product, expected to increase by 11 percent compared to 2016.[4]

Mozambique's economy is facing the symptoms of an economy in debt overhang whereby today's high debt levels are crowding out the firms outside the extractives sector and impeding tomorrow's growth. A debt overhang occurs when debt levels are sufficiently high to deter investment in activities that would have contributed to future growth. Under this framework, firms expect that the increases in output that come with investment would be consumed by debt service costs or high taxation when debt levels are high, deterring investments from taking place at all.[5] This echoes the situation facing manufacturing enterprises and other firms in the formal sector today, which are experiencing a spike in the cost of credit and reduced investment levels. Hence, it is apparent that much of Mozambique's private sector is being crowded-out as firms struggle to obtain affordable financing at the same time as the public sector's domestic financing needs have grown, and as both private and public demand settle into a new low.

The recent trends also keep Mozambique on the track of a two-speed economy[6] with limited growth in productive jobs, in a demographic context of an increasingly young and under-employed population. With current growth patterns being driven by capital intensive megaprojects in the extractives industry, Mozambique's economy today is generating fewer productive jobs for an ever-larger population of rural and urban jobseekers. Instead of capitalizing on its demographic prospects, the economy is likely to forgo potential demographic dividends if job creation in important sectors such as manufacturing is stalled (see part two of this edition for a discussion of demographics and growth in Mozambique).

The international audit on Mozambique's previously undisclosed borrowing has not restored the much-needed confidence for economic recovery.

The fallout from revelation of USD 1.4 billion in previously undisclosed borrowing has had severe consequences on Mozambique's economy, extending well beyond the nominal burden of the additional debts. The debt caused a loss in confidence by investors and donors, and has been a major contributor to the significant drop in national output over the past 18 months. It also signaled weaknesses in the institutional frameworks for debt and public investment management. The Mozambican authorities commissioned an independent external audit of the hidden debts in November 2016, with support from development partners, as key a measure for restoring confidence and responding to the public's calls for accountability and transparency in the handling of the issue.

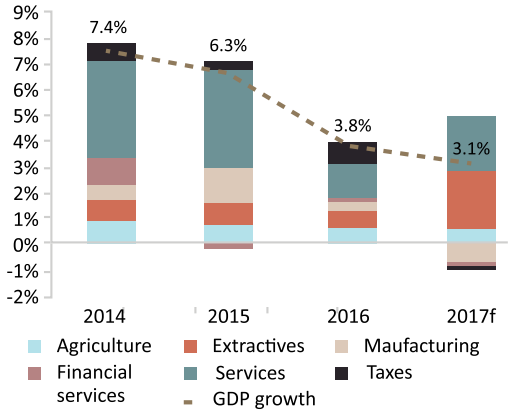
Whilst the audit created an opportunity for Mozambique to restore confidence and support economic recovery through increased transparency and accountability, it fell short of this goal due to important information gaps in the report. Upon its completion in May 2017, a key finding of the report was that the three companies (EMATUM, Proindicus and MAM) were never fully operational and did not generate any significant revenues. The audit report also found that the loan proceeds were never paid directly to the companies, but were instead paid straight into various accounts owned by the main contractors to the companies. Incomplete information was provided to the investigation by various actors involved, resulting in outstanding questions as to the use of the loan proceeds, amongst others. As a result, investor and donor sentiment continue to be low, and Mozambique has not been able to agree on a program with the International Monetary Fund. The inadequate outcome of the audit has been a holdup to debt restructuring negotiations with creditors and economic recovery, contributing to the sequence of events that are now placing Mozambique on a lower growth path.

---

[4] FAO – Global Information and Early Warning Systems (GIEWS) Country Brief for Mozambique, June 2017.
[5] Myers (1977); Krugman (1998); Sachs (1984, 1986).
[6] The July 2017 edition of the Mozambique Economic Update highlighted the two-speeds at which economic growth is taking place, with an acceleration in output and productivity in extractives, and slower growth in the rest of the economy.

Figure 1: Growth is slowing in 2017...

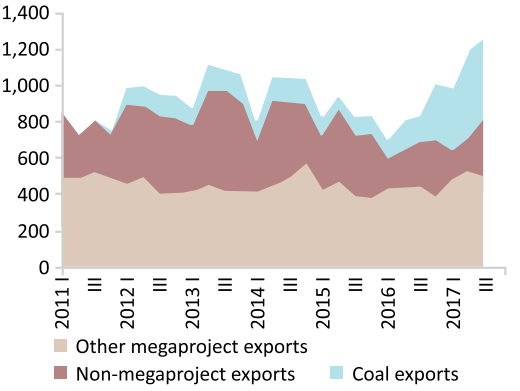
Sectoral contribution growth, 2014 – 17



Source: INE

Figure 2: ... despite a sharp increase in coal exports.

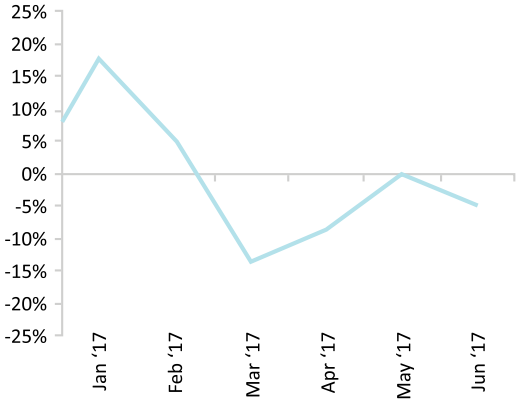
Exports, 2011 - 2017 (USD millions)



Source: BdM

Figure 3: Industrial production trends have been unfavorable...

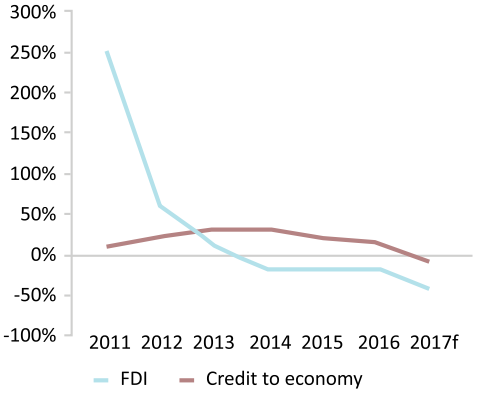
Industrial production index, 2017
(12 month % change)



Source: INE

Figure 4: ... and both credit and investment levels are at a low point.

Investment and credit trends, 2011 – 17
(annual % change)



Source: BdM

Box 1: Is Mozambique's pattern of growth generating enough "good jobs"?

Mozambique is in the early stages of its demographic transition, which raises the question as to whether its economy can generate enough new jobs to employ the increase in the number of workers. Almost 500,000 people (net) will enter the labor force each year over the next decade – almost twice as many as over the last decade. From a macroeconomic perspective, Mozambique's impressive growth performance over the last 18 years (averaging over 7 percent per annum) indicates that the economy has grown fast enough to generate a significant number of jobs. The more pertinent question, however, is whether the economy is capable of generating enough "good" jobs that can raise the jobholders' prospects of escaping poverty in the foreseeable future.

Mozambique's structural evolution over the last two decades and recent growth trends raise concerns. As noted in the forthcoming World Bank Jobs Diagnostic Report, Mozambique's jobs transition has been lagging the country's output expansion. This means that megaprojects and extractive industries that contributed most to Mozambique's rapid economic growth in recent decades have not expanded their employment proportionally. Instead, most labor force entrants have been accommodated in the sectors or job types that exhibit the lowest productivity levels (i.e., agriculture and non-farm informal services jobs), while relatively few labor force entrants have gained access to jobs in industry or to wage-based service jobs with higher labor productivity. The ongoing economic downturn is likely to deepen this trend as weak demand and the high cost of credit contribute to the contraction of the manufacturing sector. These recent trends are bound to create frustration and disappointment among youth, and slow Mozambique's ability to generate more and increasingly productive jobs.

Figure 5: The share of employment has grown most in the services sector...

Percentage change in sectoral employment share between 1996 and 2014

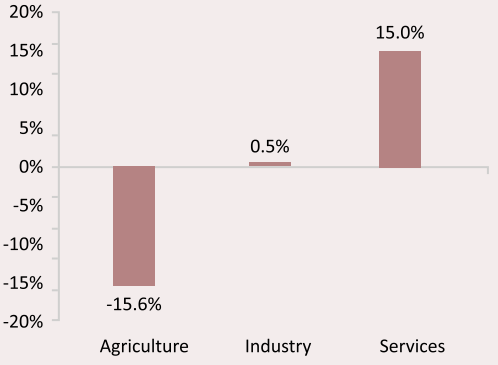
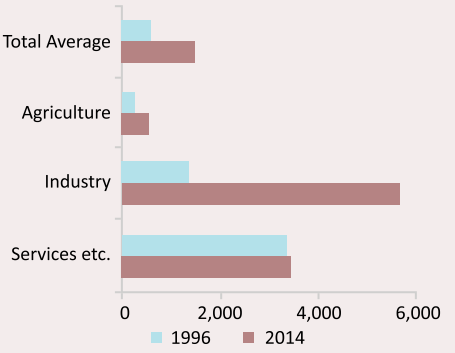


Figure 6: ... where growth in labor productivity has been lowest.

Average labor productivity between 1996 and 2014 (Constant 2010 USD)



Source: World Bank Jobs Diagnostic Report. December 2017.

Box 2: Why is urban growth providing few "good jobs" for rural workers?

Urbanization, if managed well, can accelerate economic growth and job creation. Faster urbanization and "agglomeration economies" can provide a catalyst for broad-based economic development by reducing transport costs, developing markets for specialized services, and labor market matching. The World Bank's Mozambique Urbanization Review (2017) shows that urban centers hold significant promises: Even though Mozambique's cities are a home to only 22 percent of the total population, they generate 51 percent of the national GDP, and average per capita consumption in cities is at more than triple the rural average. In the next 25 years, the urban population is expected to more than double, adding more than 11 million people to cities.

However, past urban growth has not yielded its full benefits and has not been a significant source of jobs for rural workers. Around one third of the urban population is poor and inequality levels have been on the rise. Moreover, most municipalities have not been able to cope with the pace of urban growth, and have been unable to make progress in closing the significant infrastructure and services deficit. About 70 percent of urban dwellers live in informal areas with only a basic level of infrastructure, in houses built with nondurable material, and without land use rights titles.

The limited economic benefits from urbanization might explain why rural-urban migration is much lower when compared with similar countries. Natural population growth accounts for the large majority of the current increase in the urban population. Migration from rural to urban areas explains just 12 percent of the urban population growth in Mozambique. Interprovincial rural–urban migration is currently low in Mozambique, reaching just 0.4 percent, compared to around 1.5 to 2 percent a year on average for both developed and developing countries during their transition to an intermediate stage of urbanization.

The high cost of living in cities and the concentration of job growth in low value added areas has stymied the urbanization process. Compared with rural areas, nominal wages are 26 percent higher in urban areas and 24 percent higher in Greater Maputo. But, when wages are deflated to adjust for spatial differences in the cost of living, the urban wage premium disappears. One reason why the urban wage premium is low is that jobs in urban areas are predominantly growing in sectors with low value-added. In Greater Maputo, more than two-thirds of the jobs are in non-tradable sectors such as informal services, and in other urban areas, non-tradables account for 46 percent of jobs.

Limited connectivity and weak land markets are impeding urbanization. Although the Government of Mozambique has invested considerably in national roads recently, and the private sector has also contributed to extending the railway and port infrastructure, the connection between cities and rural spaces continues to be suboptimal. The urban transport system in Mozambique is also limited. Another key factor is land policy, which is not conducive to a well-functioning urban land market. Land tenure management mechanisms are complex, opaque, and inefficient and municipal governments have very limited institutional capacity. This has implications, given that a dysfunctional land market prevents cities from making early and coordinated infrastructure investments in housing and basic urban infrastructure.

Figure 7: Worldwide, urbanization is associated with significant poverty reduction.

Poverty headcount and urbanization
(various countries)

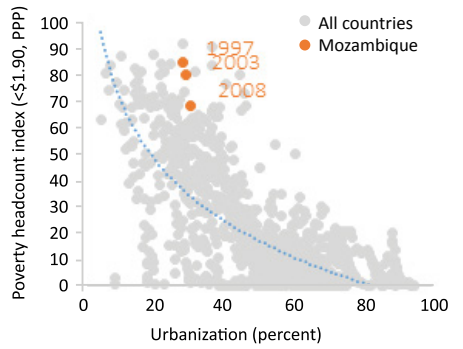


Figure 8: In Mozambique, urban growth and consumption have not been associated with substantial poverty reduction.

Output per km²
(USD millions)

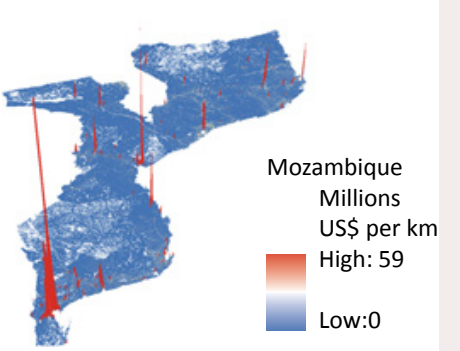


Figure 9: Population growth explains most of the increase in Mozambique's urban population.

Annual urban population growth (%)

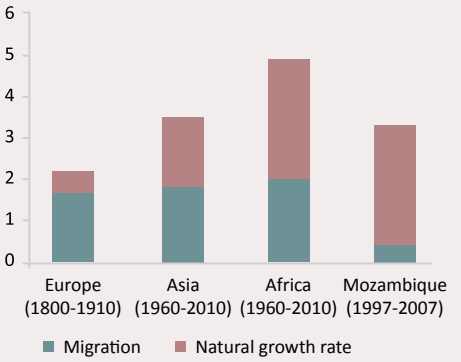
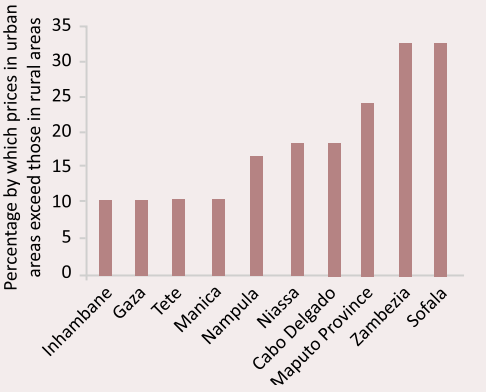


Figure 10: Prices in urban areas are higher than in rural areas, especially in Maputo.

Rural /urban price differential by province (%)



Source: Mozambique Urbanization Review: Accelerating Urbanization to Support Structural Transformation in Mozambique. June 2017.

Exchange Rate and Inflation

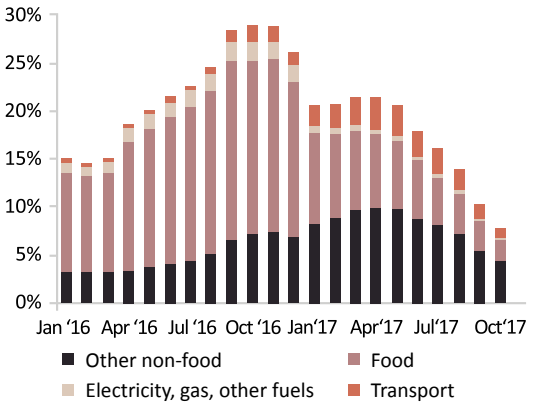
A stable currency has contributed to more manageable levels of inflation.

Inflation has eased to 7 percent, supported by a more stable metical and falling food prices. Having appreciated approximately 16 percent against the US dollar in 2017, the metical has remained relatively stable, trading at an average MZN 61 to the US dollar since June 2017. Given Mozambique's dependence on imports for numerous consumer products, this has contributed to a downward trend in inflation: by November 2017, headline inflation stood at 7 percent, down from 26 percent 12 months earlier. The expansion in agricultural output post el-Niño has also been essential to this trend. Food inflation dropped to 5 percent in November 2017, having peaked at 41 percent

in September 2016. The stabilization of the metical also helped ease industrial production costs as 12-month producer price inflation narrowed to 27 percent in June 2017, from 63 percent at the end of 2016.

Figure 11: **Food inflation has slowed since the start of the year...**

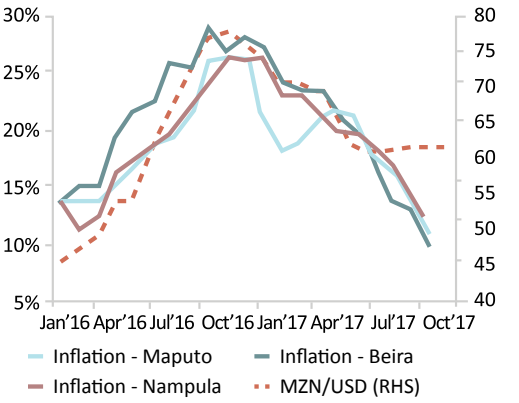
Food and non-food contributions to inflation, 2016 - 17



Source: INE

Figure 12: **...together with a strengthening metical, this has resulted in reduced inflation levels.**

Regional CPI inflation rate (12-month % change) and Nominal exchange rate (MZN / USD), 2016 - 17



Source: BdM; INE

The External Sector

A substantial external adjustment took place in 2017 as the current account deficit shrinks further to 12 percent of GDP.

The strong growth in exports seen in 2017 is a large contributor to the narrowing current account deficit in 2017. The current account deficit is expected to narrow markedly to 12 percent of GDP in 2017, from an average of 37 percent between 2011 and 2016, reflecting a shrinking trade deficit for goods. Exports are estimated to increase by 42 percent in 2017 due to a surge in megaproject exports. Coal and aluminum alone, which represent roughly half of total exports, are expected to grow by 133 and 40 percent, respectively in 2017. The remainder of the export portfolio is expected to show weaker performance in 2017, especially in agriculture related sectors.

Mozambique's real effective exchange rate (REER) appreciated in the 12 months to October 2017, after having depreciated significantly since mid-2015 (figure 16). The foreign currency influx from the boom in coal exports supported the appreciation, and demonstrates the extent to which Mozambique's REER is influenced by large swings in commodity trade, given the extent of export concentration. Currently, the REER is close to 2011 levels, setting a more competitive stage for the economy. However, structural constraints and the cost of credit may inhibit the supply response, especially amongst non-megaproject exporters.

Import levels remain subdued. After having dropped by 25 percent in 2016, imports of goods and services have remained low, and are expected to fall a further 11 percent in 2017. Consumer demand for basic goods such as rice and wheat flour also increased slowly but demand for most other consumer imports has remained low despite gains in the metical, given the weakened purchasing power of Mozambican households and the high cost of credit. The

slowdown in megaproject service imports has also contributed to narrowing the current account balance,[7] reflecting the slowdown in Foreign Direct Investment (FDI).

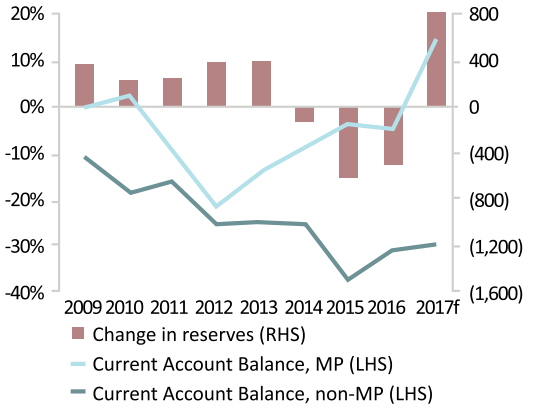
A combination of maturing investments[8] and delays to new projects has caused FDI to hit a 9-year low. FDI to Mozambique has been falling since 2013. This trend has continued into 2017 with net FDI expected to drop by 44 percent over the course of the year. A combination of maturing investments and delays to new projects has kept megaproject investment well below the average of the past five years. Investment has also dropped in non-megaproject sectors, hospitality and construction, as lower confidence and high-risk perceptions affect investor sentiment.

International reserves have been recovering but are exposed to risks.

Recovery of central bank reserves have been increasing but downside risks need to be considered. Gross international reserves registered at USD 2.5 billion by end-October 2017, up from USD 1.8 billion a year earlier. This represents an increase in import cover to 4.9 months, or 6.1 months excluding megaprojects, based on current import levels. If estimated based on pre-downturn import levels and assuming the external debt service was paid in full, reserve coverage would be lower at 1.9 months of imports, or 2.7 months of imports excluding megaprojects. Capital gains tax would boost reserves but rising prices for key consumer commodities such as fuel and grains continue to pose a drag. For instance, spending on fuel imports in the first nine months of the year has increased by approximately 40 percent when compared to the same period in 2016.

Figure 13: **Megaproject exports are supporting a narrowing current account balance...**

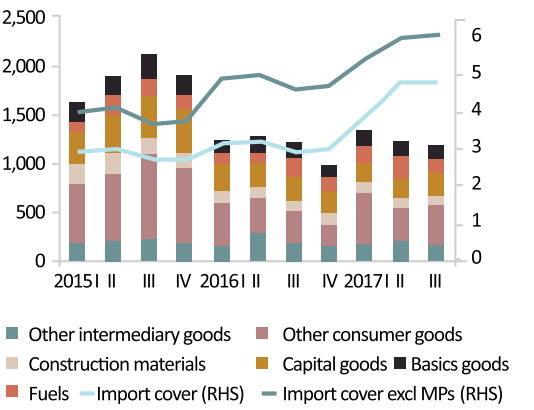
Mega and non-megaproject CAB (USD millions) and change in reserves (year on year), 2013 - 17



Source: BdM

Figure 14: **... and along with reduced imports, are contributing to improved reserve cover.**

Quarterly import levels (USD millions) and months of import cover, 2015 - 17

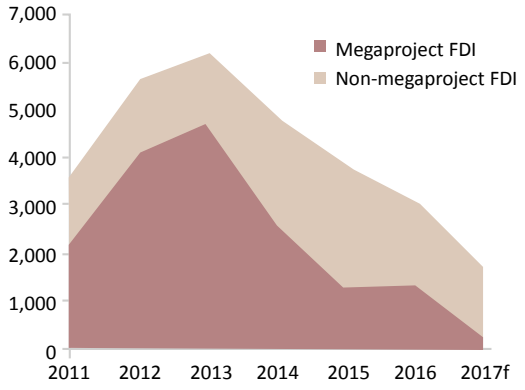


Source: BdM

[7] By the end of September 2017, technical and consulting services were almost 40 percent lower than a year earlier.
[8] Most ongoing investments are at a stage of their life cycle which is less demanding of capital injection, with some of the projects already in production/operation phase. Net megaproject FDI dropped to a low USD 184 million in the first nine months of the year, having averaged USD 2.7 billion between 2011 and 2016.

Figure 15: Megaproject FDI has fallen due to maturing projects and delays to implementation.

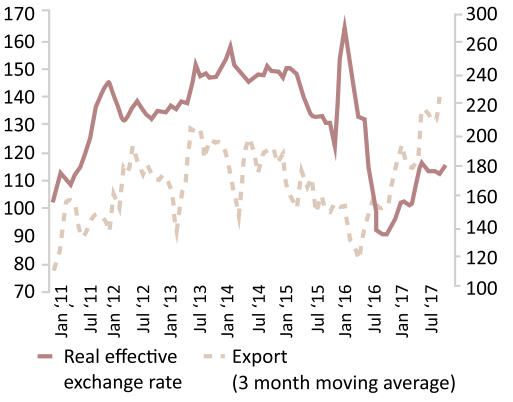
Net FDI, annual (USD millions), 2011 - 17



Source: BdM

Figure 16: Although the REER has appreciated recently, it is now lower being back at 2011 levels.

Real effective exchange rate and export indices, 2010 – 17 (2010 = 100)



Source: World Bank estimates based on BdM and INE data

Table 1: The Balance of Payments

(USD millions, unless otherwise stated)	2016 Actual	2017 Estimate	△ 16/17
Current Account (% of GDP)	36.1	11.8	...
Current Account	-3,979	-1,451	-64%
Trade Balance	-4,195	-1,881	-56%
Goods, net	-1,405	-148	-89%
Exports	3,328	4,739	42%
megaproject	2,405	3,676	53%
non-megaproject	924	1,063	15%
Imports	4,733	4,887	3%
megaproject	771	899	17%
non-megaproject	3,962	3,988	1%
Services, net	-2,847	-1,733	-39%
Income and transfers, net	272	430	58%
Capital & Financial Account	-3,485	-2,376	-32%
of which			
FDI, net	-3,093	-1,743	-44%
megaproject	-1,322	-303	-77%
non-megaproject	-1,771	-1,440	-19%
Other, net	-198	-477	141%
Overall Balance	-501	925	...
megaproject	-37.2	758	...
non-megaproject	-400.9	167	...

Source: BdM, World Bank staff estimates

Monetary Policy

Monetary policy remains cautionary despite easing inflation.

Although monetary policy is beginning to ease as inflation retreats, interest rates remain high given persisting uncertainties in the macroeconomic outlook. Monetary policy tightening in 2016 played a key role in supporting the adjustment in the external economy and contributed to stabilizing the metical this year. As inflation began to retreat, the *Banco de Moçambique* signaled that monetary policy tightening cycle had peaked by lowering the reference lending rate[9] three times in 2017, but at a cautiously slow rate given concerns regarding the pace of fiscal adjustment and uncertainties as to the macroeconomic outlook.[10] Hence, the reference lending rate has remained high throughout the year and stood at 22 percent in November 2017, and at 28.2 percent by late 2017[11] average commercial bank lending rates have reduced the private sector's demand for credit.

Credit contracted by an average 13 percent in real terms in the 12 months to October 2017. Mozambique experienced several years of expansionary monetary policy over the past decade, leading to significant rates of credit growth: annual credit growth to the private sector averaged 20 percent in real terms between January 2013 and March 2016. Heightened debt levels, the cost of credit, and reduced demand reversed this trend. Credit contracted for the fifteenth consecutive month in October 2017 with a sharp reduction in the construction, manufacturing commerce, and consumer credit sectors.

The banking sector's performance and vulnerability to risks remain a concern.

The financial sector in Mozambique is relatively shallow, bank-dominated, and predominantly foreign-owned. Commercial banks account for the bulk of financial sector assets, which are concentrated with the three largest institutions that together control more than two-thirds of total assets. Financial intermediation increased rapidly up to 2016, but is still below the average for sub-Saharan Africa. Credit and deposit concentration exceed asset concentration, which suggests that business opportunities in both the lending and deposit sides are limited outside of the largest banks.

Capital buffers have increased on the basis of recent regulatory measures to shore up the financial system. This includes the April 2017 decision to increase the minimum capital requirement from USD 1.2 million to USD 27 million and plans to increase the solvency ratio from 8 to 12 percent. System-wide solvency has increased since December 2016 and is above the regulatory and Basel II minimum requirement of 8 percent. This reflects capital increases by some banks in response to regulatory requirements, as well as resolution measures applied to two weak banks.

Asset quality has deteriorated amid application of tighter supervisory oversight. System-wide non-performing loans (NPLs) have increased since December 2016 as the banking sector, like the rest of the economy, has navigated a weakened economic setting and heightened risks associated with both public and private lending portfolios. Having registered a level of 5.2 percent in January 2017, NPLs represented over 10 percent of total credit by June 2017[12] and continue an upward trend. This rise is the result of tighter application of loan classification and provisioning guidelines as well as the consequence of higher interest rates due to tighter monetary policy. Provisions to NPLs have fallen since December 2016. Asset impairment suggests that banks may require additional provisions, which could undermine profitability.

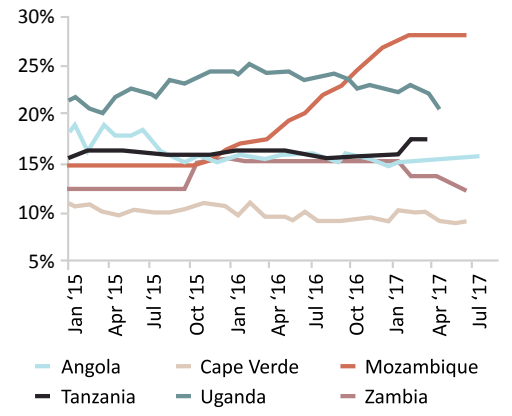
Liquidity risks remain elevated. Commercial banks and other financial institutions have limited clarity on the extent of the exposure of

[9] *Facilidade permanente de cedência (FPC).*
[10] See Banco de Moçambique's Monetary Policy Committee Comunique: *Comunicado nº5/2017 de 26 de Outubro 2017.*
[11] Average interest rate for loans with 1-year maturity registered in September, with a maximum of 36.8 percent and minimum of 23.3 percent. Interest rate spreads – the difference between lending and deposit rates – are high (above 10 percent) and attributed mostly to elevated operating costs, lack of credit information, and limited collateral.
[12] IMF Regional Economic Outlook, November 2017

their counterparts to the economic downturn and to sovereign and SOE debt. The central bank's decision to increase reserve and liquidity requirements and to limit access to its overnight window to two days a week has obliged banks to increase the share of liquid assets and tighten credit provision. As a result, the system-wide liquidity ratio (the share of short term liabilities invested in liquid assets) has increased as has the share of system-wide liquid assets to total assets. The system-wide loan-to-deposit ratio has declined since December 2016 as credit to the construction, manufacturing and commerce sectors contracted sharply.

Figure 17: Lending rates remain above peer countries...

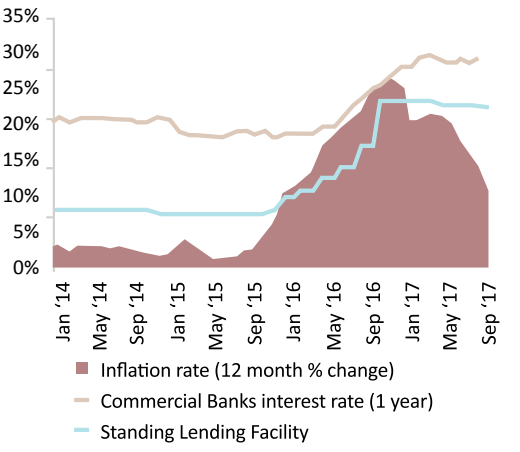
Lending rates for select countries, 2015 - 17 (%)



Source: IMF

Figure 18: ... but may have room to ease given the drop in inflation.

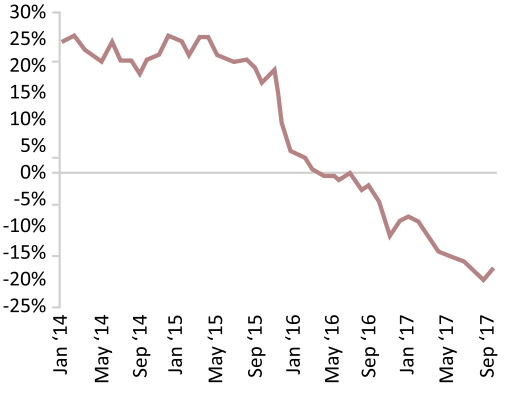
Central and Commercial Bank interest rates and CPI, 2014 - 17 (%, unless otherwise stated)



Source: BdM; INE

Figure 19: Tight monetary policy has reduced the demand for credit...

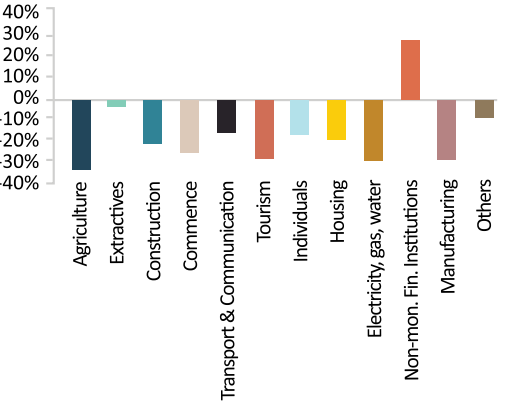
Real credit growth, 2014 - 17 (12 month % change)



Source: BdM

Figure 20: ...in almost all sectors of the economy.

Sectoral real credit growth, October 2017 (12 month % change)



Source: BdM

Fiscal Policy

The fiscal adjustment continues to be hampered by growing salary and interest costs, and increased domestic financing.

Mozambique's fiscal space has shrunk in tandem with its swollen debt burden. Mozambique's public finances have continued to worsen under the ongoing downturn. The budget has been facing large shocks since 2015, including a 5 percent of GDP reduction in donor grants and project lending,[13] a 25 percent of GDP increase in debt, and a jump in the cost of domestic financing from approximately 10 percent to 26 percent.[14] At the same time, wage bill control mechanisms have been insufficient and fiscal risks from weakened state-owned enterprises have been increasing. As a result, Mozambique's fiscal space[15] has been shrinking. Proxied as the number of tax years needed to pay off the entire debt burden, fiscal space in Mozambique has narrowed considerably from an average 2.1 years in the period 2010 – 2013 to 4.3 years in 2016.[16] Having averaged at 2.9 percent of GDP between 2010 and 2013 the primary deficit increased to 4.4 percent of GDP in 2016.

The 2017 budget has shown limited progress towards fiscal adjustment. Revenues fell from 24 percent of GDP in 2016 to an estimated 23 percent in 2017, excluding capital gains tax equivalent to 2.8 percent of GDP.[17] At the same time, spending pressures amounted, making it difficult to consolidate total spending. Mozambique's fiscal accounts are presented on a cash basis, and therefore do not report expenditure arrears, which limits fiscal transparency and the ability to clearly assess the state of public finances.[18] When estimated on a commitment basis, total expenditure (including net lending) is expected to have dropped slightly from 32 to 31 percent of GDP, pushing the overall fiscal deficit to 7.5 percent of GDP, excluding capital gains tax.

An increase in domestic borrowing signals the difficulties in controlling public finances. The stock of domestic debt is estimated at MZN 100.5 billion by the end of September 2017, 15 percent higher than at the beginning of the year and 45 percent up on end 2015. The cost of domestic borrowing has also increased substantially. The average interest rates for treasury bills and bonds stood at 25 percent and 28 percent respectively in October 2017, and market risk perception of government paper is high. As a result, the Government could only place an average of 61 percent of its treasury bond issuances during the year.[19] Because of this, and due to the budget's large financing needs and limited access in external financing, the share of domestic debt in the overall debt stock has increased. In addition, central bank financing now represents close to half of total domestic debt by October 2017.

Spending on investment, social and economic sectors: no longer a growing budget environment.

The budget continued to adjust by reducing public investment in favor of a still growing wage bill, a pattern that is not good for growth in the medium term. Investment has continued to be the main spending item under consolidation in 2017. Both the domestic and external investment budgets declined, and are expected to drop by 46 percent and 29 percent respectively since 2015, as capital spending

[13] On budget donor grants and project lending is estimated to have narrowed to 3.8 percent of GDP in 2017, down from 9 percent of GDP in 2015.
[14] Average rate for treasury bills and bonds at the start of 2016 compared to October 2017.
[15] Defined as, "*room in the government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy*". Heller, 2005.
[16] Methodology applied is based on Klose et al (2017), published in the World Bank Africa Pulse, October 2017.
[17] This indicates the challenges under the current economic context, as a significant number of entities are no longer contributing to the state's coffers due to the difficult business environment, and a drop in domestic demand affects the broader private sector. Over 1,500 companies have ceased their activities, and a further 220 have suspended payment of corporation tax according to the Revenue Authority (http://clubofmozambique.com/news/tax-collection-on-target-mozambique/).
[18] Interest payment arrears to private creditors and amounts outstanding to fuel suppliers are estimated at MZN 14 billion to date (1.8 percent of GDP). In addition, the private sector reported MZN 30 billion in supplier arrears since 2014 (3.8 percent of GDP) – see http://clubofmozambique.com/news/state-still-owes-private-sector-companies-29-billion-meticais-cta/.
[19] Five treasury bond auctions have been held in 2017, with the following demand: February 65%; April 51%; May 42%; October 67%; November 82%.

bore the brunt of the fiscal adjustment over the past two years. Given Mozambique's large infrastructure gap, a continuation of this trend represents an important risk to the country's medium-term growth strategy. At the same time, spending on the wage bill has continued to grow. The central government wage bill has grown rapidly since the start of the decade, from 8 percent of GDP in 2010 to 11.3 percent in 2016. A combination of increasing compensation and recruitment, including growth in the number of frontline service delivery personnel, generated momentum that has proven difficult to arrest despite budget constraints. By end 2017, the government wage bill is expected to exceed its budgeted allocation for the year by at least 10 percent and is estimated to edge up to 11.4 percent of GDP.[20] This is a slower pace of growth than in past years, but Mozambique's government wage bill remains above that of several of its peers in the region (Figure 27).

Efforts are being made to protect spending on social and economic sectors, but more needs to be done to increase the efficiency of spending.[21] Recurrent spending on social and economic sectors is estimated to have increased by 12 percent in 2017. Here again, an increase in recurrent spending was offset by reductions in the investment budget. The social and economic sectors fared better than the rest in terms of investment budget cuts, indicating that efforts are being made to protect resources for these priorities.[22] However, given the current budget context, there is an urgent need for increased expenditure efficiency if service delivery outcomes are to improve in the coming years (Box 3).

Box 3: Maintaining service delivery outcomes with fewer resources

Mozambique has invested significant public resources in education and health since the start of the decade. On-budget spending on priority social and economic sectors has averaged 19 percent of GDP between 2010 and 2016, with education and health benefiting from over half of this. Since 2011, on-budget resources invested in the education and health sectors averaged 6.8 percent and 3.3 percent of GDP annually, respectively, surpassing the averages in Sub-Saharan Africa (4 percent and 2.5 percent of GDP, respectively). Closer analysis of budget execution data shows a four-fold increase in amounts spent on reproductive and maternal health between 2010 and 2014. Similarly, spending on secondary schooling accounted for 22 percent of total education spending in 2016, from a low of 3 percent five years earlier. Despite this, Mozambique has elevated fertility levels and education outcomes have been low, making improvements in family planning and skills a priority for the social sectors' agenda.

Efficiency gains have been limited and outcomes remain below par. Despite the sharp pick-up in spending, secondary school completion rates have been held back by low retention and high dropout rates; Mozambique's gross intake ratio to the last grade of secondary was 22 percent in 2014, versus 41 percent in SSA countries. Low quality of service delivery has also contributed to poor results in education as shortfalls in teacher qualification, as well as high absenteeism rates, impede learning outcomes (World Bank 2014 Service Delivery Indicator survey). Moreover, adolescent pregnancy rates are amongst the highest in the world (top 5)

[20] According to quarterly Budget Execution Reports for 2017, overruns in wage spending result partly from the unplanned admission of 4,534 new staff in 2016 and the inclusion of 605 health workers, formerly covered by external funds through PROSAUDE, in the central government wage bill.
[21] This includes education, health, infrastructure, agriculture and rural development, the judicial system and social welfare and work.
[22] Social and economic sector spending accounted for roughly 76 percent of total investment spending in the first 9 months of 2017.

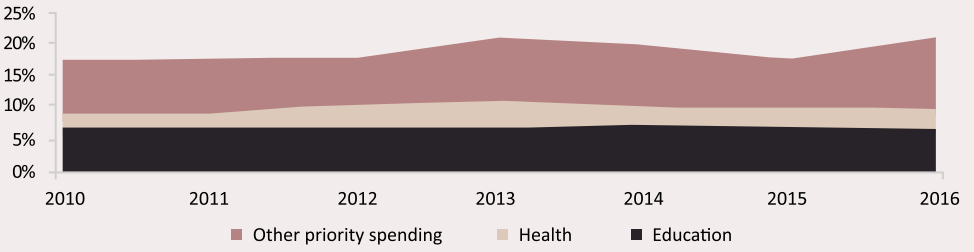
and fertility rates have remained above both the low-income country and SSA average, whilst use of modern contraceptive methods remained low. Recent World Bank reviews of public expenditure on health and education in Mozambique highlight spending inefficiencies as part of the problem. Comparing expenditure efficiency rates in 1998-99 to 2009-14, Mozambique has shown improvements in gross enrollment rates achieved at the cost of higher expenditure than expected. Similarly, provincial level analysis finds that inefficiency in health spending is linked to inequitable resource allocation and inefficiencies in the composition of staff, which increases costs of service delivery.

Expenditure in the health and education sectors has contracted by 10 percent in 2017 in real terms, limiting the availability of resources to improve health outcomes, increase skills, and help families manage fertility, all key inputs to securing the potential for a demographic dividend for Mozambique. With the health and education sectors now no longer in a growing budget context, increased efficiency will be necessary for protecting past gains and improving future outcomes.

Sources: Education Public Expenditure Review, Health Public Expenditure Review and Service Delivery Indicator survey (World Bank), Conta Geral do Estado (MEF), UNFPA, UNESCO.

Figure 21: On-budget spending on health and education has remained constant.

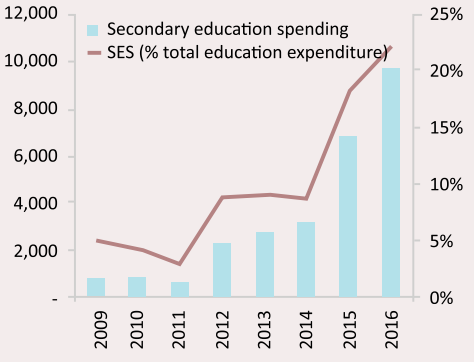
On-budget spending on priority sectors, 2010 – 16 (% of GDP)



Source: MEF

Figure 22: Investment in secondary education has increased significantly in recent years...

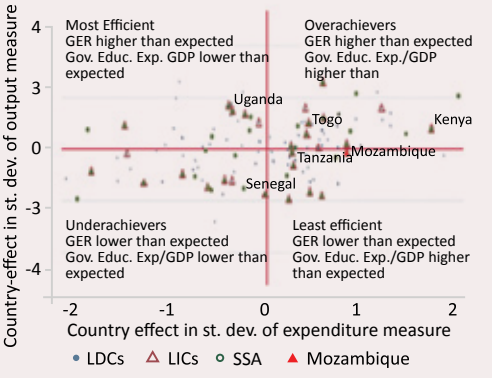
Spending on secondary schooling, 2009 - 16 (MZN million; % of total education expenditure)



Source: MEF

Figure 23: ...but spending has been inefficient compared to peers...

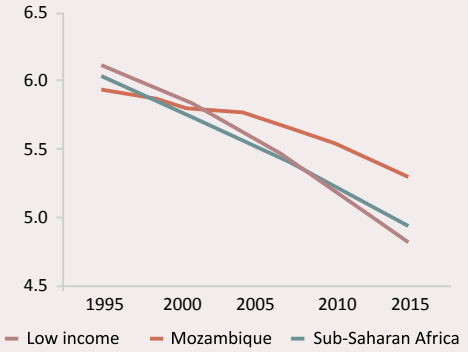
Relative efficiency of public spending in education, 1990 - 2013



Source: World Bank

Figure 24: **Fertility rates are high when compared to peer countries...**

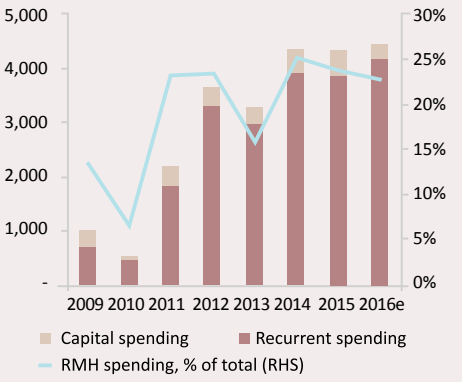
Fertility rate, 2009 - 15
(births per woman)



Source: UNFPA

Figure 25: **...despite higher spending on reproductive and maternal health since 2012**

Reproductive and maternal health spending, 2009 – 16
(MZN million; % of total health expenditure)



Source: MEF

Debt: lower but still high.

The appreciation of the metical and reduced external borrowing helped to lower external debt from 103 percent of GDP at end 2016 to an estimated 83 percent by end 2017. Domestic debt levels also have increased, pushing total debt to an estimated 99 percent of GDP.[23] This continues to be an unsustainably high level of debt with a high burden in terms of debts service. Without progress in the debt restructuring process launched by the government in October 2016 and measures to control spending, including the adoption of a target for a primary surplus in the medium term, it will be unlikely that Mozambique will be able to restore fiscal sustainability.

The 2018 budget is ambitious and seeks to boost revenues, but is exposed to important fiscal risks.

The 2018 budget seeks to increase revenues whilst rebalancing spending, but may be optimistic. The Government's budget proposal for 2018 ambitiously foresees a 20 percent nominal increase in revenue collection when compared to the expected outturn for 2017 (equivalent to 2.3 percent of GDP). Whilst the implementation of revenue enhancement mechanisms, such as the recently approved customs tariffs adjustments could contribute to this forecast, weakened output in several key sectors is likely to challenge this. This optimistic approach to the budget brings significant downside risks should revenue collection falter, and could result in a substantial increase in the fiscal deficit as well as further accumulation of arrears. The proposed budget seeks to decrease the wage bill to 10.4 percent of GDP by reducing personnel benefits and reducing admissions.[24] Investment spending is budgeted to increase by 3.1 percent of GDP in 2018, with a focus on resuming funding to ongoing investment projects, but may be under-executed if the projected revenue growth fails to materialize or salary spending overshoots as occurred in the past two years.

Fiscal risks remain elevated in 2018, particularly from state-owned enterprises.

[23] Public and publicly guaranteed government debt as at September 2017. These figures do not include the non-guaranteed debt of public sector entities.

[24] Based on WB GDP estimates. According to the 2018 budget proposal, spending on basic salaries is expected to increase, whilst other personnel expenses including travel subsistence allowances is expected to decline. In addition, planned admissions to the education sector have slowed by almost 75 percent.

Mozambique's state-owned enterprises continue to be an important source of fiscal risk as they navigate the effects of the economic downturn, the costs of their debt portfolios, and their internal operating inefficiencies. Moreover, adverse weather events such as flooding and storms have always been a major source of fiscal risk in Mozambique, and remain a concern. Lastly, the start of the electoral cycle with local government elections scheduled for 2018 and preparations for the 2019 national elections are likely to add to the expenditure needs in the next two years.

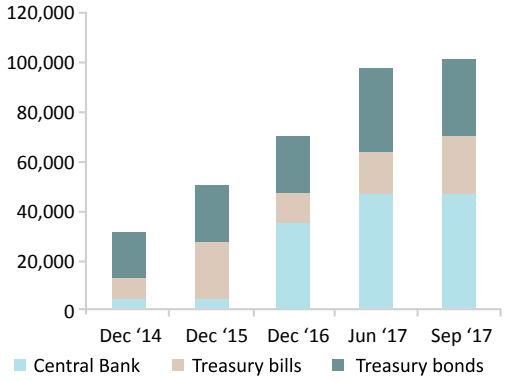
Table 2: Central Government Finances

(percent of GDP)	2016 Estimates	2017 Estimate	2018 Budget Law
Total Revenue	24.0	25.5	25.0
Tax Revenues	20.1	22.0	21.0
Of which:			
Capital Gains Tax		2.8	
Non-Tax Revenue	3.9	3.5	4.0
Grants	2.2	1.2	1.9
Total Expenditure	30.2	29.3	29.8
Current Expenditure	21.2	23.2	20.7
Of which:			
Compensation to employees	11.3	11.4	10.4
Interest on public debt	2.9	3.8	3.7
Capital Expenditure	8.8	6.0	9.1
Domestically financed	3.4	2.9	3.8
Externally financed	5.3	3.1	5.4
Net Lending	2.0	2.1	1.5
Payment in Arrears	1.3	...	...
Overall Balance	**-7.3**	**-4.7**	**-4.3**
Primary Balance	**-4.4**	**-0.9**	**-0.6**
Overall Balance (excluding capital gains tax)	**-7.3**	**-7.5**	**-4.3**
Primary Balance (excluding capital gains tax)	**-4.4**	**-3.7**	**-0.6**
GDP (nominal, MZN millions)	**689**	**787**	**891**

Source: MEF and World Bank staff estimates
Notes to table: 1) Expenditures for 2016 and 2017 are estimated on a commitment basis;
2) Nominal GDP for 2017 and 2018 is based on World Bank estimates.

Figure 26: **Central bank advances have been increasingly financing the fiscal deficit.**

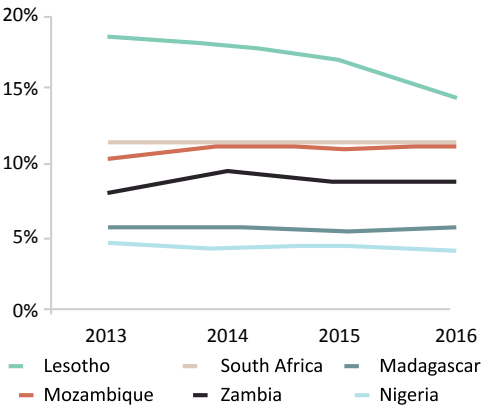
Stock of domestic debt by funding source, 2014 – 17 (MZN millions)



Source: MEF; BdM

Figure 27: **The Government wage bill remains sticky and above peer countries.**

Central Government wage bill in peer countries, 2013 – 16 (% of GDP)



Source: World Bank

Outlook

A positive outlook in the external environment as commodity prices stabilize and growth picks up in advanced and emerging economies.

Global economic activity is strengthening and set to continue into 2018. Growth in emerging market and developing economies is expected to rise over the coming year, supported by improved external factors and a pick-up in commodity prices. Downside risks to growth in sub-Saharan Africa have risen due to country-specific factors in the region's largest economies. In particular, growth prospects remain subdued in South Africa, a major trading partner for Mozambique, despite more favorable commodity export prices as uncertainty weakens consumer and investor confidence.[25]

The commodity price recovery is set to stabilize in the near-term with likely downside risks to coal prices. Developments in the coal sector have been central in 2017, with export levels set to double this year. Having increased by 29 percent in 2017, average coal prices could fall by 17 percent next year as global supply picks up.[26] Prices for coking coal, which represents two thirds of total coal exports, have remained buoyant after peaking at USD 304 in mid-April, but global forecasts predict a reduction in prices through to the end of the decade (table 3). In this context, the risk of volatile commodity prices is important in making the case for further diversification in the country's export composition – moving towards increased value added in agriculture and growth in manufacturing.

Mozambique's growth trajectory is expected to remain off course in the medium term, in the absence of more decisive policy measures.

Growth is expected to fall to 3.1 percent in 2017, and is likely to remain subdued with downside risks in view. The surge in coal exports and a stabilizing currency have been positive developments in 2017. Despite this,

[25] IMF World Economic Prospects, October 2017.
[26] World Bank Commodity Markets Outlook, October 2017.

World Bank growth estimates for the year have been revised downwards, from 4.6 percent to 3.1 percent as growth in other sectors has been downcast. Estimates for the two subsequent years have also been lowered to growth levels that are relatively flat around the 3 percent mark. Reduced confidence and investment, uncertainty with regards to the fiscal outlook, and tight monetary policy are contributing to these muted expectations for growth in the medium term. This already overcast outlook is subject to downward risks, which are characteristic of Mozambique's economy: exposure to flooding and drought, and to commodity market fluctuations. Weaknesses in the state enterprise sector are an additional source of risk that has become more pronounced in recent years. But most of all, the continued absence of a firm fiscal recovery program to restore confidence, and improve macroeconomic policy coordination, would make it difficult for the economy to recuperate: the implementation of a reform package that balances fiscal and monetary policy is a pre-condition for a stable economic recovery.

Mozambique must undertake significant structural and governance reforms to realize its growth potential. In addition to the challenge of restoring macroeconomic stability, reestablishing confidence through improved economic governance and increased transparency, including the transparent handling of the hidden debts investigation, are crucial elements for Mozambique's recovery. Moreover, structural reforms are needed in support of the currently struggling private sector. Speedy implementation of such reforms will make firms more resilient and competitive, and will promote diversification in the economy. With a large share of the population under the age of 18, investments in health, education and job creation will be crucial for Mozambique to capitalize on its demographic composition (see part two for a discussion of how investing in the demography can create conditions for economic growth).

Significant challenges continue to compromise the fiscal outlook, requiring deeper reforms to restore the health of public finances.

Prudent budget management and increased efficiency in spending are key priorities as the fiscal outlook remains under significant pressure. This includes measures to limit wage bill growth, withstand climate shocks, and manage the costs of the upcoming electoral cycle. Enhancing the credibility and realism of the budget and improving reporting methods is a necessary requirement for Mozambique to address the accumulation of arrears. An equal amount of effort should be directed towards improving revenue administration and restarting the investment program to promote long term growth. And with over a year since Mozambique signaled the need for debt restructuring, the conditions for improved confidence and macroeconomic sustainability will not be present without a breakthrough in these negotiations.

Ongoing efforts to reform the state-owned enterprise sector and the management of guarantees must be solidified to better manage fiscal risks. Mozambique has started to address the significant gaps in the frameworks for supervision and control of fiscal risks. Oversight of the state-owned enterprise sector must be strengthened, including better reporting and concrete recovery plans for entities in financial distress. In terms of debt management, the introduction of a comprehensive debt management law, as well as guidelines for management of guarantees and on-lending, would help limit future risks and strengthen public finances.

The external current account will narrow further before expanding in the medium term.

The current account deficit is expected to contract to 13 percent of GDP in 2018 before expanding to accommodate the early phases of LNG development. The increase in coal exports, lower import levels and capital gains tax receipts will contribute to a further narrowing in the current account deficit to 12 percent of GDP in 2017. In the medium-term, a rise in megaproject imports resulting from gas investments is expected to widen the current account deficit, supported by an accompanying increase in FDI.

Table 3: Outlook

	2016	2017p	2018p	2019p
External Scenario				
Real GDP (% Δ)				
Euro Area	1.8	2.1	1.9	1.5
China	6.7	6.7	6.4	6.3
Sub-Saharan Africa	1.6	3.0	3.8	4.0
South Africa	0.3	0.6	1.1	1.7
Nominal Commodity Price				
Aluminum USD/mt	1,604	1,950	1,968	1,987
Coal, Australia USD/mt	66	85	70	60
Coking coal, Australia USD/t	146	194	132	115
Natural gas, Europe USD/mmbtu	4.6	5.5	5.7	5.8
Tobacco USD/mt	4,806	4,850	4,822	4,794
Domestic Scenario				
Real GDP and Current Account Deficit				
Real GDP, % Δ	3.8	3.1	3.2	3.4
Current Account Deficit, % of GDP	-36.1	-11.8	-13.3	-30.4

Source: World Bank, Bloomberg; p = Projection

Part Two: Searching for the Demographic Dividend

Nothing will determine Mozambique's future poverty rate more than forthcoming demographic changes, and the country's ability to benefit from them. Based on recent analyses conducted by the World Bank,[27] this section begins by presenting the current panorama of population trends in Mozambique. To make the most of this opportunity for reducing future poverty levels, three sets of recommendations are then considered: first, how to trigger the fertility transition; second, where to focus human capital investments to optimize the skills development for the labor market; and third, what policies offer the best chance for the next generation of Mozambicans to find good jobs and be productive in those jobs. It concludes by estimating the effects of implementing these policies, and find that achieving a low fertility scenario represents an enormous boost in real per capita GDP of 31 percent by 2050.

A Worrying Demographic Picture

High fertility rates have characterized Mozambique's demographic trends.

Mozambique lags behind other sub-Saharan African countries in kicking off a demographic transition. Mozambique's population is dominated by a very young age structure. Children aged 0-14 went from representing 40 percent of the population in 1950, to more than 45 percent in 2015. From about 2000-2010, there was no progress toward a demographic transformation; in fact, high fertility levels appeared to have increased further. By 2011, the total fertility rate was estimated at 5.9 children per woman on average,[28] one of the highest rates in the world and almost one child more than the average for sub-Saharan Africa (see Figure 28). As in many other high-fertility countries, the number of children per woman is higher among the most vulnerable households: those in the lowest income quintiles, with no formal education, living in rural areas, and concentrated in the Northern and Central regions (Figure 29). Moreover, infant mortality is still high at 83 deaths among 1,000 live births and life expectancy at birth remains low, at only 55 years for both sexes.

Perhaps more importantly, in Mozambique, although the desired number of children among women is high, the *observed* fertility is even higher. Figure 30 shows that overall, men have on average the number of children that they desire, such that the total fertility rate (TFR) matches the men's desired fertility. This is likely driven by the unequal gender relations dominant in Mozambique, compounded by poor women's lower education levels and productive opportunities. As a result, women's family size preference is influenced by husbands or partners and other family members' desires. This is

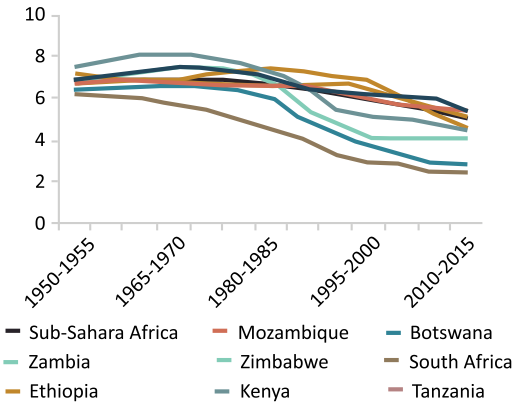
[27] Searching for the Demographic Dividend in Mozambique: An Urgent Agenda (2016).
[28] Based on DHS (2011). More recent preliminary estimates place this closer to 5.3. The ongoing population census will provide more updated, precise estimates

consistent with evidence from elsewhere, such as Nigeria and Malawi (Ibisomi and Odimegu, 2008; Yeatman and Sennott, 2014).

The gap between observed and desired fertility is even more prevalent among the poor. Among the poorest 40 percent who reside mainly in rural areas, women have on average between 1 and 1.5 children more than desired. For the men, it is between 0.5 and 1 child more than reportedly desired. For these groups, triggering the demographic transition is therefore not about changing cultural norms or preferences. Rather, it is about equipping these families with the knowledge and services that will empower them to take control of their fertility, and achieve their desired family size. This would also include addressing Mozambique's unenviable record of the country with the fourth-highest prevalence of teenage marriage in the world, with half of Mozambican women married or mothers by the age of 18.

Figure 28: Mozambique Lags Behind SSA Countries in the Demographic Transition

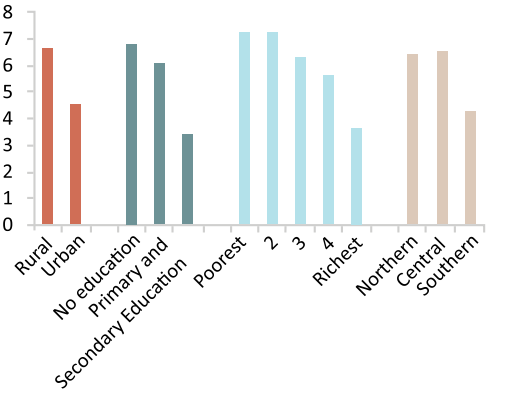
Total fertility rate in peer countries, 1950 - 2015



Source: United Nations

Figure 29: Socio-Economic Inequality is Reflected by Unequal Fertility

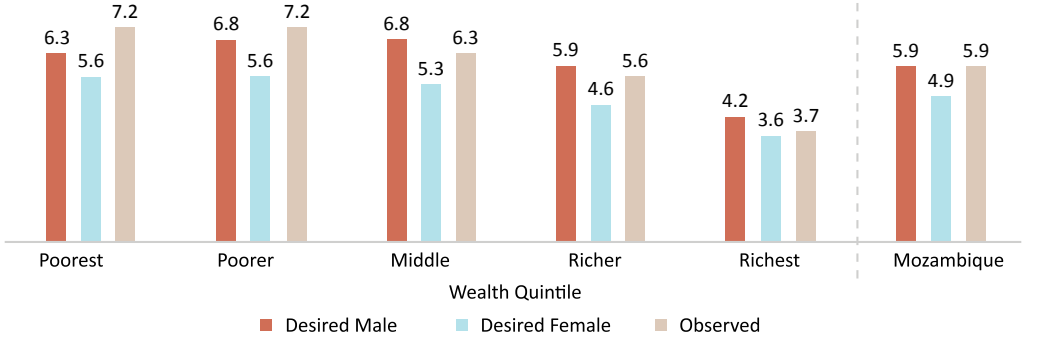
Total fertility rates



Source: DHS (2011)

Figure 30: Observed fertility is higher than desired for the lowest quintiles

Desired and Observed fertility rate per wealth quintile



Source: DHS (2011)

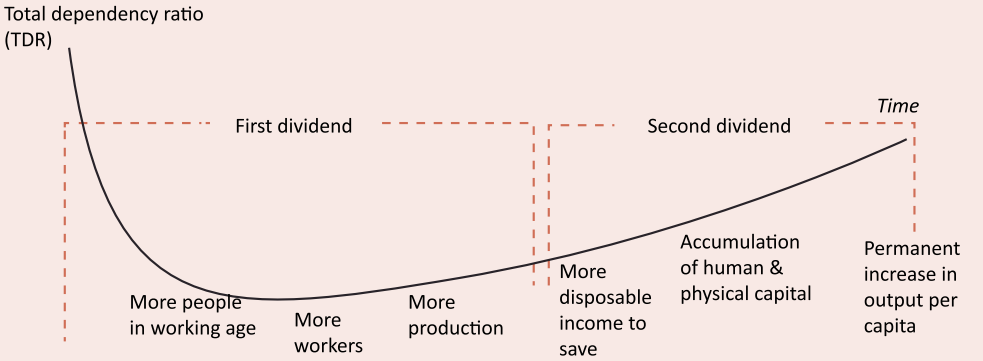
Box 4: What is the Demographic Dividend and how does it impact Poverty Reduction?

Demographic characteristics can help or hinder economic activity. Changes in the working-age share of the population can affect growth and savings and, subsequently, income per capita. For example, rising working-age population shares could lead to proportionally more income earners in the economy and thus greater growth per capita. Changes in the age structure also affect the resource constraints faced by households and the state for social spending. For example, if households have fewer children, they would have more resources to spend on human capital and consumption. In other words, more money for families to spend to ensure their kids are well-fed, attend school regularly and on-time, and are generally well cared for.

Usually, demographic trends differ across different socio-economic groups within each country. Fertility is typically higher among the poor and most vulnerable. Demography can thus reinforce a vicious cycle of poverty and inequality, as low-income households have less income to be invested, across more children. A small investment in human capital divided into a large cohort of children can put the next generation at risk in terms of employability and wellbeing, and exert a drag on the state as large cohorts of people don't acquire the right skills, and are therefore not as productive as they could be. As a result, they are likely to be more dependent on government assistance.

But changes in demographic trends can also boost growth and shared prosperity. If accompanied by proper socio-economic policies, a decrease in the fertility rate can bring an increase in the share of people of working age. If productively employed, this large cohort of workers can bring along an increase in the nation's income and savings, thereby improving per capita well-being – the first demographic dividend. The beneficiaries of the first demographic dividend may take advantage of increased savings and investments during a second demographic dividend. Increased income and savings can be invested in physical and human capital of smaller cohorts of children, leading to an intergenerational virtuous cycle of improving social welfare.

Figure 31: Conceptual Framework: The Demographic Dividends



Triggering an inclusive fertility transition, focusing on the most vulnerable groups in the population, is therefore essential to put high-fertility countries on a path toward boosted growth, poverty reduction, and shared prosperity. Demography, however, cannot do the job alone: the gains from the demographic transition will not accrue automatically, but will depend on a country's ability to set appropriate policies to reap the potential rewards from the demographic dividend.

Source: Searching for the Demographic Dividend in Mozambique: An Urgent Agenda, World Bank

A Three-Pillar Policy Framework to Harness the Demographic Dividend

To transform the demographic challenge into an economic opportunity, Mozambique must actively promote policies to trigger the fertility transition, educate its young population, and promote productive employment among the emerging working-age population.

Changing the fertility trend.

Offering family planning information and services is key to ushering in demographic change. In the agenda to harness a demographic dividend, the most urgent item is certainly to empower families to make informed reproductive decisions, by offering family planning information and services that could help women and men better meet their own aspirations for family size, and to avoid unwanted pregnancies. There are several factors that drive family size, many of which relate to cultural norms and preferences (on the "demand" side, as seen re: desired fertility vs. observed fertility) and others to the availability of services (on the "supply" side). In the case of Mozambique, given that among the poorer quintiles desired fertility is lower than actual fertility, a first step is to support those parents such that they achieve the family size desired. This means considering "supply-side" factors such as the availability of various forms of contraception, and more effective education on their usage. This is especially true for rural residents and women from lower socio-economic groups. In 2011, only 11 percent of couples used modern contraceptive methods, while 28 percent of married women had an unmet need for contraception.

Early age at first sexual intercourse, which is linked to early marriage and childbirth, is also a clear determinant of fertility. Delaying the onset of early marriage and childbirth requires a concerted effort across sectors and service providers. Schooling serves as one promising protective factor. Keeping adolescents, particularly girls in school up to completion of at least secondary education[29] or vocational training through scholarships and or conditional cash transfers would help reduce opportunity costs to their families including contributing to inhibit early marriage and early pregnancy. In addition, provision of improved and scaled sexual and reproductive health (SRH) services in schools (including dimensions of gender based violence) can further reduce unwanted pregnancies. For girls out of school, it means reaching out to non-formal service providers, and thinking about youth-friendly services, such as NGOs, Community health workers, whereby girls can have access to requisite SRH services and support to learn and acquire life skills.

There is therefore an urgent need for family planning policies to increase information about, and access to, services for reproductive, maternal, newborn, child, and adolescent health. Importantly, the likelihood of these programs to be successful in reducing excess fertility and maternal mortality, particularly among adolescent girls will depend on strong political commitment, the adoption of strong social support including the role of community leaders, politicians, opinion leaders, advocating for the elimination of early marriage/ early childbirth. The recent involvement of the First Lady and members of Parliament in a social campaign against early marriage paves the way for changing the social and cultural norms around child marriage. Aside from the health sector, in Mozambique SRH programs must also be channeled through interventions in the education sector and in the labor market. A more educated population and an inclusive, well-functioning labor market are perhaps the most promising drivers to lower fertility as they increase the opportunity costs of giving birth early and having large households.

Accelerating women's access to the labor

[29] Secondary level education makes a difference in a range of health outcome statistics: Women with secondary education use more modern contraceptive methods, their children have better nutritional status, are likely to be fully immunized and tend to deliver their babies in a facility and or by a skilled health professional.

markets would also help reduce fertility. When the opportunity cost of women increases, because of being employed in productive jobs, the demand for having children (in both members of the couple) drops. Hence, female employment, particularly in wage employment, contributes to reducing fertility rates. Ensuring that women are competitive in the labor market, and have increasing access to jobs, may represent a double push for the economy: GDP growth today and demographic dividend tomorrow.

Equipping the next generation with the right skills.

Mozambique needs to address its shortfalls in education outcomes. The second pillar of the policy response framework is to properly educate Mozambique's young population. The current levels of education attainment are dismal. The average number of years of education for the cohort born in 1980-1989 was as low as 3.8. Teachers, who represent the main drivers to ensuring that children learn, are on average absent from the classroom 56 percent of the time (World Bank, 2015). Even worse, when the teachers are present, they do not master the content of the education curricula enough to teach it: only 65 percent of teachers can do double-digit subtraction. If the next generation of workers is not adequately equipped with the cognitive and socioemotional skills usually acquired in school, they will not fulfill their productive potential in the labor market, and the dividend will not be fully exploited.

Despite being well on the way to universal primary enrollment, many children remain out of the system. Currently, Mozambique is not providing those students with any skills. Even for those in the education system, progressing through the grades remains a challenge: 40 percent of adolescents aged 15 years old had either given up or were still trying to get to fifth grade. Despite spending many years in school, students do not receive an adequate quality of learning in Mozambique, as revealed by multiple global, regional, and national assessments.

The demographic transition offers a singular opportunity to rapidly improve the educational level of the workforce. Given the country's very young age structure, if a new education system were to be implemented overnight in 2018, then by 2042, nearly 80 percent of Mozambique's labor force would have studied at least one year under the new system. Half of the labor force could thus be upgraded in two decades with the requisite cognitive and socioemotional skills needed to succeed in the workplace, while it would take at least four or five decades in demographically older countries such as Brazil or Russia. Defining what this "new educational system" should look like extends beyond this short note, but it necessarily requires at least three things:

i) Teachers that are properly recruited, prepared, managed, and motivated;
ii) Children that are ready to enter school, thanks to interventions during the early years;
iii) Spaces and materials adequate for learning, especially at the secondary level.

Special focus should be placed on creating conditions that empower female education. Adequate spaces imply schools that have separate bathrooms for boys and girls, and that generally promote a healthy, welcoming environment for young women. Rates of male and female enrollment tend to be similar from primary level through grade 9th. However, when they reach secondary level or grades 10th, 11th and 12th their participation reduces significantly (6.4 percent for males and 4.8 percent for females). To help enroll and keep girls in schools, actions on the demand-side, such as scholarships or other forms of cash transfers, can help parents invest in their daughters as described above.

Promoting productive employment.

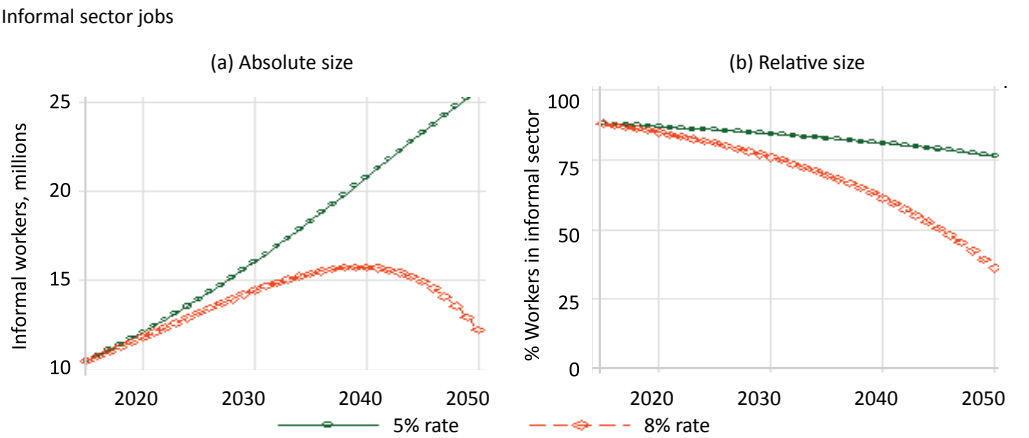
Mozambique's ability to boost growth and reduce poverty through the demographic dividend will depend on the working age population having access to productive jobs. The labor force will grow rapidly over the next two decades, at a rate of almost 500,000 people per year. The Mozambique Jobs Diagnostic shows that the share of the labor force in private sector formal jobs tripled from 4 percent to 12 percent between 1996 and 2015, but it remains low. All the recent growth in formal wage jobs is in the services sector (including commerce and construction). The higher the proportion of new entrants that gets formal jobs, the faster the

rates of informality and poverty decline. Figure 33 projects the size of the informal sector under scenarios of 5 percent and 8 percent formal job growth. The projections show that even if formal jobs continue to grow at rapid rates, informal economic activities, including smallholder agriculture, will remain important, especially for the bottom 40 percent of the income distribution. So, jobs policies should focus *both* on accelerating the growth of formal wage jobs *and* on enhancing earnings opportunities for those who remain in the informal sector, either in agriculture or in non-farm self-employment (so-called "household enterprises"). These two processes are linked, because many informal jobs depend on the spending power of households that work in the formal sector and most of Mozambique's non-farm "household enterprises" are located in the periphery of urban centers.

Policies to accelerate formal sector jobs growth should address the multiple market and policy failures that undermine the growth of private businesses – especially of small and medium sized enterprises (SMEs), which are often engaged in labor intensive activities and find it difficult to overcome the multiple problems linked to doing business in Mozambique. The rapid recent growth of formal wage jobs in commerce and services suggests there is good potential to accelerate job creation in those sectors. Relevant policies include support to SMEs to overcome difficulties in accessing capital, or through technical assistance to strengthen their business skills. Policies to promote better jobs in self-employment should concentrate on enhancing skills and strengthening linkages to product markets, finance and technology, for example, through aggregator schemes that link smallholder farmers to agribusiness. Peri-urban horticulture is one example of a high potential sector for good quality non-wage jobs. To ensure that disadvantaged youth and women can get access to better jobs opportunities, whether in formal wage jobs or in self-employment, active labor market policies should focus on those demographics. To help young people overcome the obstacles to getting their first jobs, the Government might also want to consider establishing lower minimum wages for youth, targeted internship programs, or supporting intermediary services focused on those groups.

Measures to restore macroeconomic stability and raise overall economic competitiveness are also fundamental. Among these is the need to reestablish fiscal sustainability and to maintain a stable and competitive real exchange rate. Overcoming the factors that limit the competitiveness of the private sector and its resilience to shocks are also a priority, including enhancing the quality and scope of key transport infrastructure (road, ports and rail), easing access to credit, and adopting labor policies that promote the competitiveness of firms. Improvements in these areas will boost the overall investment climate in Mozambique, bringing needed capital, and, eventually, productive jobs.

Figure 32: **The growth rate of formal jobs will be crucial to the rate of decline in informality**



Source: Searching for the Demographic Dividend in Mozambique: An Urgent Agenda (2016)

Estimating the Effects of Implementing Key Policies

What would the future look like for Mozambicans if these policies were implemented and successful? Econometric modeling helps us quantify the gains in triggering and benefiting from the demographic dividend, charting pathways for economic growth and poverty reduction. The analysis below (Figure 33) considers four future fertility scenarios for Mozambique between now and 2050. Under a constant scenario, where fertility remains at about 5.4 for the foreseeable future, the expected real per capita GDP would be about USD 1341. The high variant scenario, where modest changes in fertility rates are achieved, allows Mozambique to transition from a pre-dividend country (TFR above 4 children) to an early dividend (TFR less than 4 children) one by 2050, and reach a real GDP per capita of USD 1813. The speed of the fertility transition is key. Results suggest that a one child difference in Mozambique's fertility rate – that is, the difference between the high variant (3.89 children) and the low (2.89 children) - by 2050 can lead to a 31 percent increase in real GDP per capita.[30]

Eradicating extreme poverty, however, will require more than just lower fertility rates. If, in addition to sparking the demographic transition more quickly, Mozambique is able to implement a comprehensive policy response relating to education, the labor market, and investment climate, gains would be even larger. Figure 34 shows the share of the poverty rate that would be reduced under different scenarios. If only fertility is reduced, using the medium variant scenario, then that would already bring poverty down to just 38 percent of what it would be at constant levels. Changes in fertility and educational improvements could reduce poverty by an additional 20 percent from the constant fertility scenario, and still a further 3 percent, should Mozambique achieve the low variant fertility scenario. In short, Mozambique will only be able to eradicate extreme poverty by 2050 if demographic changes are accompanied by other reforms such as needed changes to the education system.

Figure 33: Achieving the Low Fertility Scenario Means an Enormous Boost in GDP per Capita by 2050

Expected real GDP per capita (USD) under different scenarios, 2015 - 50

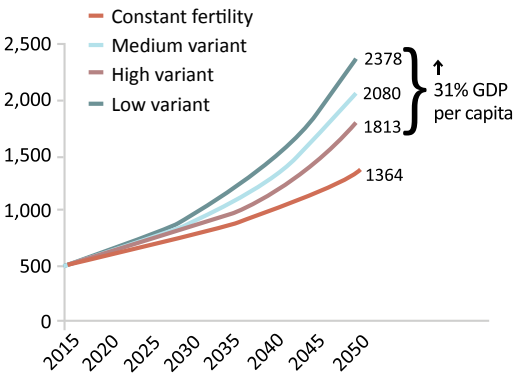
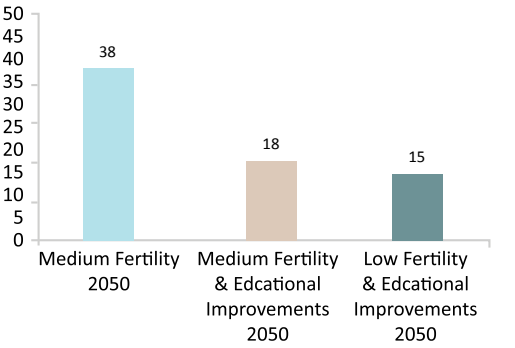


Figure 34: Only by Improving Education and Reducing Fertility that Mozambique Eradicates Extreme Poverty by 2050

Poverty headcount rate as a percentage of the "Constant Fertility" scenario.[31]



Source: BdM, World Bank staff estimates
Note to table: Estimates for 2017 include capital gains inflows of USD 352 million.

[30] Fertility rates are based on the UN population projections. The fertility rate of 3.89 is based on a slow uptake of family planning methods whilst the rate of 2.89 corresponds to the replacement rate, whereby no population growth occurs.
[31] Graph shows the expected poverty headcount, as a percentage of the poverty headcount under a "constant fertility" scenario.

Demography is not destiny: policies and programs can be designed and implemented to help Mozambicans understand the benefits from having smaller families, and support them in reaching their desired family size. This, in turn, would encourage more rapid progress in health and education outcomes for mothers and children, and would eventually result in a more favorable age structure where a larger share of the population is of working-age. If this happens, and the working-age population can find good jobs, the economy will grow faster and poverty will also decline more rapidly. This is the potential opportunity presented by a demographic transition in Mozambique. If eradicating extreme poverty is our intended destination, nothing will be more influential in helping us get there.

References

FAO (2017), 'Global Information and Early Warning System on Food and Agriculture Country Brief – Mozambique', Maputo, Mozambique.

IMF, (2017), 'World Economic Outlook: Seeking Sustainable Growth—Short-Term Recovery, Long-Term Challenges,' IMF: Washington DC.

IMF, (2017), 'Regional Economic Outlook Sub-Saharan Africa: Restarting the Growth Engine,' IMF: Washington DC.

IMF, (2015), 'Fiscal Transparency Evaluation,' IMF: Washington DC.

IMF, (2015), 'Republic of Mozambique: Fifth Review under the Policy Support Instrument and Request for Standby Credit Facility – Debt Sustainability Analysis,' IMF: Washington DC.

IMF, (2014), 'Government Finance Statistics Manual,' IMF: Washington DC.

Krugman, P. (1988), 'Financing versus forgiving a debt overhang', NBER Working Paper 2486.

Myers, C. S. (1977), 'Determinants of corporate borrowing', Journal of Financial Economics, 5, 147-175.

Republic of Mozambique, Central Bank of Mozambique, various quarters 'BOP and Monetary Survey data,' Maputo, Mozambique.

Republic of Mozambique, Central Bank of Mozambique, various months 'Monthly Situation bulletin,' Maputo, Mozambique.

Republic of Mozambique, Central Bank of Mozambique, various sessions 'Monetary Policy Committee briefings,' Maputo, Mozambique.

Republic of Mozambique, National Institute of Statistics, 2016 'CEMPRE – Censo de Empresas,' Maputo, Mozambique.

Republic of Mozambique, National Institute of Statistics, various years 'National Accounts,' Maputo, Mozambique.

Republic of Mozambique, National Institute of Statistics, various months 'Consumer Price Index bulletin,' Maputo, Mozambique.

Republic of Mozambique, National Institute of Statistics, various months 'Economic Activities index bulletin,' Maputo, Mozambique.

Republic of Mozambique, National Institute of Statistics, various months 'Economic Confidence Indicators bulletin,' Maputo, Mozambique.

Republic of Mozambique, National Institute of Statistics, various quarters 'Short-Term Industry

Indicators,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (2017), '2018 Budget Proposal,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (2016), 'Summary of Key Terms of Certain Commercial External Indebtedness,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (2015), 'Declaration of Fiscal Risks,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, 2015 'Análise da Situação Financeira das Empresas Públicas em 31 de Dezembro de 2014,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (various years), 'Audited State Accounts,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (various years), 'State Budget,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (various years), 'Budget Execution Report,' Maputo, Mozambique.

Republic of Mozambique, Ministry of Economy and Finance, (various years) 'Annual Public Debt Report,' Maputo, Mozambique.

Sachs, JD, (1989), 'Conditionality, Debt Relief, and the Developing Country Debt Crisis', NBER Working Paper 8992.

Vale Moçambique (2017), 'Quarterly Performance Report', Maputo, Mozambique

World Bank, (2017), 'Commodity Markets Outlook – October 2017', World Bank: Washington DC.

World Bank, (2017), 'Global Economic Monitor – April 2017', World Bank: Washington DC.

World Bank, (2016a), 'Breaking Down Barriers – Unlocking Africa's potential through vigorous competition policy' World Bank: Washington DC.

World Bank, (2016b), Doing Business 2017: Equal Opportunity for All', World Bank: Washington DC.

World Bank (2016), 'Searching for the Demographic Dividend in Mozambique: An Urgent Agenda', World Bank: Washington DC.

World Bank, (2016), 'Mozambique - Public Expenditure Review: Education,' World Bank: Washington DC.

World Bank, (2016), 'Mozambique – Health Public Expenditure Review: 2009-2013,' World Bank: Washington DC.

World Bank, (various years), 'World Development Indicators,' World Bank: Washington DC.

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP