



# Extractive Industries in Mozambique

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*Which are the main challenges ahead and how to address them?*

## *Concept Note<sup>1</sup>*

### **I. Background**

Mozambique has an enormous potential to be a world class exporter of gas and mineral resources. Recent projections indicate that GDP could triple in real terms in the next 15 years or less with mineral resources representing about 40 to 50 percent of GDP by then. Not only will total income explode, but its structure will rapidly shift towards the extractive sectors. The question is whether redistribution of income will favor Mozambican citizens and in particular the most needed.

Global experience shows that few countries have managed to transform rapid finite wealth into growth and development. Good economic and social performance is highly related to a country's institutional capacities. The stronger the institutional capacities, the higher the likelihood that captured revenue is transformed in investment, job creation and economic diversification and -- consequently -- limiting the impact of the resource curse. Conversely, countries with weak institutional capacities often register poor performance. Weak institutional capacities and rapidly amassed finite revenues are highly associated with poor economic growth, poverty persistency, loss of competitiveness in particular in the non-extractive tradable sectors (which shrink as a result of the fast real appreciation), accelerated inflation, and explosive corruption. In other words, Dutch Disease and the resource curse prevail and countries end up with stagnant individual incomes, dubious economic and social prospects, and often political instability.

Mozambique's future should be bright but challenges lie ahead. The first challenge is the appreciating real exchange rate and its impact on competitiveness. The second is the country's limited institutional absorption capacities. The third is the potential for galloping corruption. The fourth challenge is the urgent need for more transparency in governance to improve citizens' knowledge of resource mobilization and use, limit corruption and contribute to improved budget prioritization and efficiency.

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## II. Objective

The objective of this Note is to discuss these challenges and propose areas where USAID/SPEED could assist through research and policy recommendations. The aim of the Note is not to include policy recommendations at this stage but rather to set the groundwork for initiatives to be developed and drive a discussion on USAID/SPEED's assistance to the reform process in Mozambique. This discussion takes into account the current work by the EI taskforce and others, aiming to complement and leverage their work rather than duplicate it.

## III. The Challenges Ahead

Mozambique's future should be bright and prosperous. Achieving this objective will require hard work and the right policies. The gas and mineral resource sectors will have significant impacts on the Mozambican economy and society. The exchange rate will rapidly appreciate in real terms and the economy will lose competitiveness – tradables from the non-mineral resource sectors could gradually disappear, with agriculture, manufacturing, and tourism suffering the most. These are the sectors that have the highest potential for creating jobs<sup>2</sup> and transforming the economy – they compete with the rest of the world, face the law of one-price, affect job creation and, therefore, determine success of the economy.

### i. Exchange rate management and competitiveness

Mozambique must actively manage its real exchange rate appreciation. Fast appreciation implies a proportionally fast loss in competitiveness of tradable goods<sup>3</sup> (from the non-mineral sectors). This can only be overcome by even faster gains in domestic productivity, which are difficult to achieve in the short-term. Increases in productivity require spending on human capital, technology, basic infrastructure and utilities, an enhanced business environment, and a strengthened rule of law.

#### a. Exchange rate

The policy option cannot be to do nothing. Decelerating the real appreciation of the exchange rate has to be at the core of the GOM's policy to gain time to transform and adjust the economy. Letting markets clear in an environment of an appreciating exchange rate will condemn tradable sectors to disappear. In particular, it will imply that: (i) smallholders cannot sell their surpluses as imports are cheaper, being then trapped in poverty; (ii) industrialization of Mozambique can only happen through capital-intensive investments; and (iii) job creation opportunities shrink, in fact, opposite to the needs of a growing young population.

Experience shows that the best policy option is to set up a sovereign wealth fund. This fund has to be kept abroad to significantly reduce the supply of foreign exchange in the economy, thus decelerating the appreciation of the currency. This is not conceptually different from international reserves that central banks normally keep and manage. The most important difference is that international reserves accrue costs – foreign exchange is normally bought at domestic interest rates

<sup>2</sup> The Mozambican economy is projected to have more 1.5 million youth (above 19 years of age) between 2011 and 2015 joining the labor market, an annual average of more than 370,000.

<sup>3</sup> Goods produced domestically and competing with imports and/or are exported.

(in Mozambique these are at about 14-16 % per year) through sterilization and these assets are typically invested in sovereign debt from economically strong and stable countries (US, EC, Germany, UK) with returns of 1-2 % per annum. In contrast, sovereign wealth funds mobilize revenues abroad directly from the mineral resource sector companies (from royalties, licenses, income tax and others) and invest the funds abroad in government debt as international reserves. The revenues do not flow into the country and do not accrue the cost of buying the foreign exchange. Budget appropriations from the fund are established by law and usually finance a budget deficit approved by parliament according to established rules.

### ***b. Competitiveness***

Competitiveness does not only encompass the exchange rate. The business environment in Mozambique is cumbersome and presents an obstacle for private sector development and sustainability.<sup>4</sup> Stagnant productivity in agriculture is a significant component of competitiveness and needs to be addressed. Access to markets and utilities is difficult and industrialization is almost non-existent. Tourism also has a tremendous potential as do the energy, transport and telecom sectors. Linkages to the more dynamic extractive sectors offer a significant opportunity as well.

### **Business environment**

The business environment in Mozambique is weak. Mozambique was ranked 139 out of 183 countries surveyed (bottom 25 percent) in the *Doing Business 2012* report.<sup>5</sup> *Doing Business 2013*, soon to be published, will most certainly show Mozambique falling again in the ranking because no significant initiative was taken in the 12 months up to May 2012; most countries continued implementing reforms causing non-reformers to fall further behind.

The poor business environment affects mostly small and medium enterprises doing business in Mozambique. Large foreign investment projects get special deals directly from the government and, therefore, do not suffer from the business environment in the country. This policy discriminates against Mozambican held companies, which are mostly small and medium sized-companies.

Some improvements have been achieved, for instance in registering a company. The number of days and costs to register a company have been dramatically reduced. SPEED assistance to the Maputo City Council will significantly shorten the number of days and costs to obtain a construction license. These are important steps, but are small when compared to the overall business environment.

Success in job creation depends on sustained development of the private sector. Currently, the private sector is only creating some 15-18,000 new jobs per year, while 370,000 young people join the labor market every year. Due to a lack of coordination among government departments and weak institutional capacities, the GOM should prioritize a few policies to begin with and address only 4-5 policy/issues at a time.

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<sup>4</sup> SPEED has produced a few reports assessing the business environment in Mozambique. These reports include a large set of reforms to improve the business environment. These reports can be obtained from SPEED's web page: [www.speed-program.com](http://www.speed-program.com)

<sup>5</sup> This report can be downloaded via <http://www.doingbusiness.org/reports/global-reports/doing-business-2012>

When surveyed, private sector companies identified the following 3 most important obstacles for their development<sup>6</sup>: (i) criminality, (ii) high tax rates and bureaucratic processes to pay taxes and long time lags to pay VAT refunds, and (iii) corruption. Access to credit and heavily bureaucratic processes across the board are the next 2 impediments. The real appreciation of the exchange rate is also identified as a major obstacle for business success. This issue was already discussed above.

Crime is growing fast in the urban areas. The urban population is growing faster than the country's population implying that rural-urban migration is a fact. This migration puts pressure on job and income opportunities in the urban and peri-urban areas. The fact that these migrating families often still get some access to land for agricultural production gives them an income/cushion opportunity and reduces pressures on criminality. This is not to say that the informal sector is naturally criminal but the opposite. The informal sector is the way to honestly survive in an economy where jobs are created at a sluggish speed and private sector initiatives are curtailed due to a difficult business environment.

The informal sector in the urban and peri-urban areas is also growing rapidly. The positive side is that it is creating income opportunities for those without access to a formal sector job. However, some believe that the informal sector competes unfairly with the formal sector (needs to register, pay licenses and taxes). Most of the informal sector only produces and sells basic food, construction and manufacturing goods and some services, and does not compete for contract tenders as normal practices require invoices and receipts. The question is whether the informal sector really poses a competitive threat to the private sector?

The country has to be more effective transforming its business environment. This has to include radically modernization and simplification of bureaucratic processes, possibly reducing tax rates, simplifying the tax regime and broadening of the tax-base, addressing the issue of corruption in general but in particular connected with private sector development, and enhancing crime control and public safety.

### Agriculture

Agriculture has great potential for growth. Three-quarters of the population generates income in this sector. Productivity is low and stagnant. Addressing productivity in agriculture is a must if poverty reduction is to be achieved. Productivity gains entail expanding commercial agriculture across the country, which requires patience, technology, and access to markets and information. Smart engineering needs to be in place encompassing the role of the state and the private sector to develop agriculture. A clear-cut strategy with specific objectives, policies, action and results should exist – significant analytical work with recommendations has already been produced but priorities and results need to be determined in such strategy and plan has to have success – and be implemented, monitored and evaluated, and corrective measures taken when needed. Where, why, when and cost of spending should be effectively determined. A major obstacle will again be the lack of skills, a cumbersome business environment, and an appreciating exchange rate.

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<sup>6</sup> Two studies were prepared based on surveys made with the private sector: The World Bank through the report "Mozambique Investment Climate Assessment 2009" identified the top 5 obstacles to private sector development as: informal sector competition, access to finance, crime, high tax rates, and corruption. This document can be obtained through the link: <http://siteresources.worldbank.org/INTMOZAMBIQUE/Resources/ICAMoz.pdf> ; and KPMG through its publication "Business Climate Index 2010" identified as top 5 obstacles for private sector development: illegal imports, HIV/AIDS, malaria and other diseases, corruption, and organized crime and criminality. This report can be obtained through the link: <http://www.kpmg.co.mz/corporate/Midia/Files/Indice-do-Ambiente-de-Negocios-2010>

## Tourism

Tourism also has great potential to generate direct and indirect jobs. The direct jobs occur during construction of facilities and operation of those same facilities. The indirect jobs will be created by the suppliers of goods and services that the tourism industry requires – from food, to entertainment, transport and others. This industry needs to get access to land and less costly transport services – air ticket prices currently charged in Mozambique are expensive and not stimulating tourism. Mozambique will have distinct tourism customer segments, for instance, wealthy vacationers that use beaches and oceans, safari parks and nature to relax in a comfortable, enjoyable manner versus business tourism related to business opportunities. Opportunities will often be located in different places and will also have different demands and requirements.

Action in the tourism sector has to include improving land concessioning and the business environment, access to infrastructure and utilities, enhanced links with suppliers to expand Mozambique's participation and job creation, and dramatically lower cost transportation in the country via air transportation liberalization.

## Supply linkages to extractive sectors

The extractive sectors will be the most dynamic sectors in Mozambique in the next few years mostly due to the enormous volumes of investment that will materialize. These companies will demand a long-list of goods and services for their operation and expansion activities. Mozambican companies can and should be the generators of these goods and services to not only add more value to the country's resources but also to expand job creation activities, assisting in this manner private sector development in the country. The success of these linkages will depend on business environment, access to skills and expertise and a set of rules that should possibly be imposed on the mega-projects to create, expand and sustain the linkages.

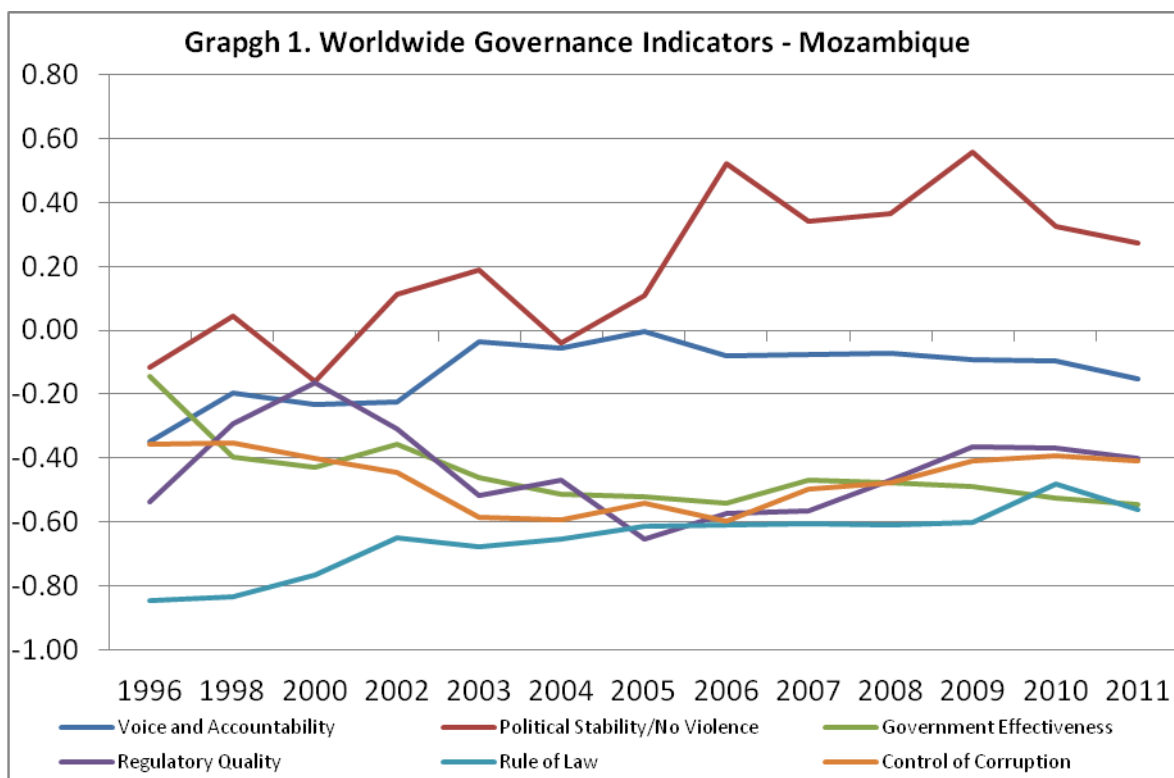
### **ii. Institutional capacities and absorption**

Institutional capacities are paramount for a country to transform its fast revenues into a blessing. Strong, accountable and efficient institutions have the capacity not only to define objectives, priorities and results, but also to implement policies, investment and recurrent expenditure that will efficiently impact growth and development. Stronger institutions also help set a policy framework and environment conducive of stimulating economic growth through private sector and public sector growth, increasing the efficacy and transparency of revenue mobilization and expenditures, and enhance the rule of law and public safety.

Strong, efficient and effective institutions entail four major factors. The first is related to human capital development and quality. Broad good education and health services are the vehicle to gradually build human capital, respond to demands from the economy, and affect economic and social change. The second factor is the simplification, modernization and reduction of bureaucratic processes which will generate more and better services, allowing for the best public servants to concentrate on setting a policy environment for growth and development – this is often also related to improved pay in the civil service to ensure that some of the best experts can be hired. The third factor is transparency and accountability of the civil service which are intimately related to government performance (see below). Political will is the fourth and last factor, but is as important as the others. Without political will, Mozambique's challenges will not be overcome and the country will end up as just another "resource curse" case.

Institutional capacities are a significant marker for success in countries blessed with mineral resources. Often, resource-rich countries are initially very poor, with enormous unsatisfied demands and a sense of urgency to rapidly deliver. Telling these countries not to spend is a difficult policy option. The large tendency is for countries to try to spend as fast as revenues are accrued in response to pressing demands. As a result of weak institutional capacities, spending efficiency reduces quickly, prioritization becomes lax to allow for more expenditure to be realized, and corruption explodes.

The Worldwide Governance Indicators,<sup>7</sup> a World Bank publication, gives an informative picture of governance – see Graph 1 below inserted with Mozambique indicators. The publication measures the following 5 indicators: voice and accountability; political stability/no violence; government effectiveness; regulatory quality; rule of law; and control of corruption. The indicators are measured between -2.5 (weak) and +2.5 (strong). The indicator related to institutional capacity and effectiveness is “government effectiveness”. The government effectiveness captures well the quality of government delivery, institutional capacities, and absorption. This indicator for Mozambique evolves from -0.14 in 1996 to -0.55 in 2011, a deterioration of some 40 percent in addition to be already low. This indicator shows that increased budget expenditure realized along the period caused absorption capacity in fact to decrease, turning the government less effective. Therefore the issue in Mozambique is not to expand budget expenditure. The only way to increase absorption capacity and government effectiveness has to include building institutional capacities together with modernization and simplification of systems and, lastly, more expenditure.



<sup>7</sup> This a World Bank publication and can be downloaded through the link: <http://info.worldbank.org/governance/wgi/index.asp>



Then the preferred policy option should involve capacity building and increasing expenditure under containment to avoid the resource curse through further negatively impacting absorption capacity. This mixed approach should have 4 major components. The first component sets a framework to allow the civil service to contract some of the best experts to deal with reform, modernization and policy recommendations, and ensure proper implementation, monitoring and evaluation, and accountability of decisions. The second component is public sector reform aimed at modernizing, simplifying systems, improving efficiency and efficacy of deliverables and defining a set of priorities. The third component includes huge investments in education and health to deliver more and better services, together with intensive and rapid delivery of vocational training that responds to the economy's demands for skills. The last component entails designing an expat recruitment strategy to bring to Mozambique some of the best skills to assist the civil service to better respond to its challenges.

In parallel and because building institutions and system takes time, it is important to explore instruments that address the basic needs of some of the poorest. Some of the captured revenues should be transferred in cash to defined groups of citizens in deplorable situations such as the elderly, the handicapped and their families, malnourished pregnant women and children below 5 years of age. Cash transfers can be sophisticated vehicles targeting specific groups of people. Experience also shows that conditional or non-conditional transfer programs are feasible to establish.

### **iii. Transparency and corruption**

Transparency is pivotal for success. It improves efficiency of the decision process and policy implementation. Transparency contributes to enhanced participation, efficiency, and effectiveness of results. Transparency improves implementation of policy decisions because the decision-making process involves stakeholders' demands and concerns. Higher degrees of transparency impose pressure on institutions to deliver well. Transparency increases accountability and responsibility of agents (economic, social, private, government). Transparency facilitates transformation and increases responsiveness and ultimately makes the economy and the business environment more conducive to private sector development.

A lack of transparency can generate waste, low levels of efficiency and corruption. Combined with a lack of political will, weak institutions and systems, a lack of transparency generates possibilities for galloping corruption, lesser efficiency of the development agenda, and unsatisfied demands and populations.

Graph 1 above shows a few indicators related to transparency and corruption. The transparency indicators are "voice and accountability" and "regulatory quality", while the indicator for corruption is "control of corruption". The "voice and accountability" indicator has improved somewhat from -0.35 in 1996 to -0.15 in 2011, after reaching zero in 2005; really since 2005 this indicator has been deteriorating. The "regulatory quality" is slightly improving from -0.54 to -0.40, between 1996 and 2011, with some better performing years in between. These two indicators reflect the weak transparency that exists as well as the low possibility given to stakeholders and, in particular, the private sector and civil society have in expressing their views and opinions, and participate in decision-making and regulatory processes.

The “control of corruption” indicator in Mozambique has a bad performance as it shows that control of corruption is deteriorating – it decreased from -0.36 in 1996 to -0.41 in 2011. Consequently, corruption is rooting deeper and growing in the economy. Transparency International through their annual “Corruption Perception Index-CPI”<sup>8</sup> ranks Mozambique at high levels of corruption; in 2011 Mozambique is ranked at 120 among 182 countries surveyed with a score of only 2 when compared to the best performer New Zealand with 9.5.

Increased resource mobilization in this type of environment produces corruption quickly. In a downward spiral, corruption in turn further destroys institutions, accountabilities, and transparency and erodes the growth and development even more. Corruption guarantees no success and instability despite that the resources are still used.

The best option is to enhance transparency and combat corruption. Doing nothing will undermine trust in the economy and governance, concentrate income distribution in the few rich and with access to power while driving the great majority into deeper levels of poverty, curtail private sector expansion and job creation at least in the formal sector of the economy.

#### IV. How Could SPEED Assist?

SPEED’s assistance should concentrate on competitiveness, institutional capacities and, transparency and advocacy. As the next 12 to 18 months will be very political because of the city elections and later the presidential and parliamentary elections, significant work should be on communication and research and Notes. This communication should involve SPEED’s webpage and blog, but also and, quite importantly, through workshops with CTA, associations and civil society to spread as much as possible the reform message, its urgency and steps.

The following outlines a possible agenda for SPEED in this space:

1. Competitiveness:
  - a. Exchange rate:
    - i. Prepare, disseminate and communicate small Notes on the exchange rate, in particular:
      1. What happens if Mozambique does nothing to slow down the real exchange rate?
      2. Appreciating exchange rate and effects on tradables (especially agriculture).
      3. Instruments to manage an appreciating exchange rate – sovereign wealth funds versus international reserves, fiscal rule, or other instruments.
      4. Whether the government should push expected revenues forward via bank borrowing today – pros and cons and under what conditions
    - ii. Realize workshops with academia, government institutions, civil society, and international partners on the exchange rate, impacts, and management instruments.

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<sup>8</sup> The Transparency International CPI can be obtained through the link: <http://www.transparency.org/research/cpi/>



- b. Business environment:
    - i. Prepare, disseminate and communicate on the business environment:
      - 1. Note on Doing Business 2013.
      - 2. Implications of no-action in business environment, consequences on job creation and tax revenues.
      - 3. Quick-wins to fix the three most important impediments to private sector development.
    - ii. Assist preparation of CASP 2012 – Private Sector Annual Conference.
    - iii. Coordinate business environment reform with CTA and MIC and prepare research and policy recommendations accordingly.
    - iv. Prepare study on whether the informal sector has a negative or positive impact on the development of the economy in general and on the private sector in particular.
    - v. Continue work with Maputo City Municipality to streamline construction licenses.
  - c. Agriculture (may need to discuss several of these items with AgriFuturo):
    - i. Prepare Note on non-tax barriers to agriculture.
    - ii. Prepare Note on implications to agriculture if no-action is the action in the sector.
    - iii. Prepare a study on “whether agriculture in Mozambique is competitive and how to make it competitive”.
    - iv. Prepare a study (AgriFuturo possibly has already done this) on agriculture sector business environment: main obstacles for private sector and smallholder sector development and brief policy recommendations.
    - v. Identify if are there policy recommendations already in place that could imply changes in productivity.
    - vi. Identify the most important impediments to productivity change and produce policy recommendations.
    - vii. Note on land comparing rights of use to land property.
    - viii. Workshops to communicate and disseminate findings in Notes and research.
  - d. Tourism:
    - i. Arco Norte.
    - ii. Open-skies.
    - iii. Other?
  - e. Supply linkages to extractive sectors
    - i. Workshop to share South Africa’s experience on supply-linkages with extractive industries.
    - ii. Prepare study on supply-linkages in 4-5 countries from which Mozambique could extract a framework to develop these linkages in the country.
2. Institutional capacities: This includes many areas, which mostly are often developed by international partners and the World Bank in particular. SPEED could research:
- a. Note on the impacts of not doing action in terms of improving institutional capacities.

- b. Note on the need to prepare institutional reforms and capacity building: shall government hire some of the best Mozambicans to assist with defining the reform strategy, how to hire, where to begin and what to do.
  - c. Note on whether government should push forward revenues to build capacities, develop institutions and increase absorption capacity.
  - d. Prepare study on cash transfers, conditional and non-conditional, objectives, targeting, launching, monitoring and evaluation and policy recommendations.
  - e. Promote workshops on these studies.
3. Transparency and advocacy:
- a. In the area of transparency SPEED should mostly research on independence of institutions, accountabilities and responsibilities as key vehicles for enhanced transparency.
  - b. Continue assistance to Mozambique-EITI efforts together with the government, civil society and international partners, focusing on preparation of annual reports, publication and dissemination of these reports, and improving civil society participation.
  - c. Work with the 2 Extractive Industries Task-Forces (donors, and government), in terms of research, policy recommendations, workshops and dissemination.
  - d. For advocacy, SPEED should focus mainly in spreading the reform agenda, the implications of no reform, which recommendations to implement, sequence, and the risks of no-action.

All USAID / SPEED work will be done in consultation with key private and public sector clients, other development partners, and USAID colleagues from across the relevant sectors.