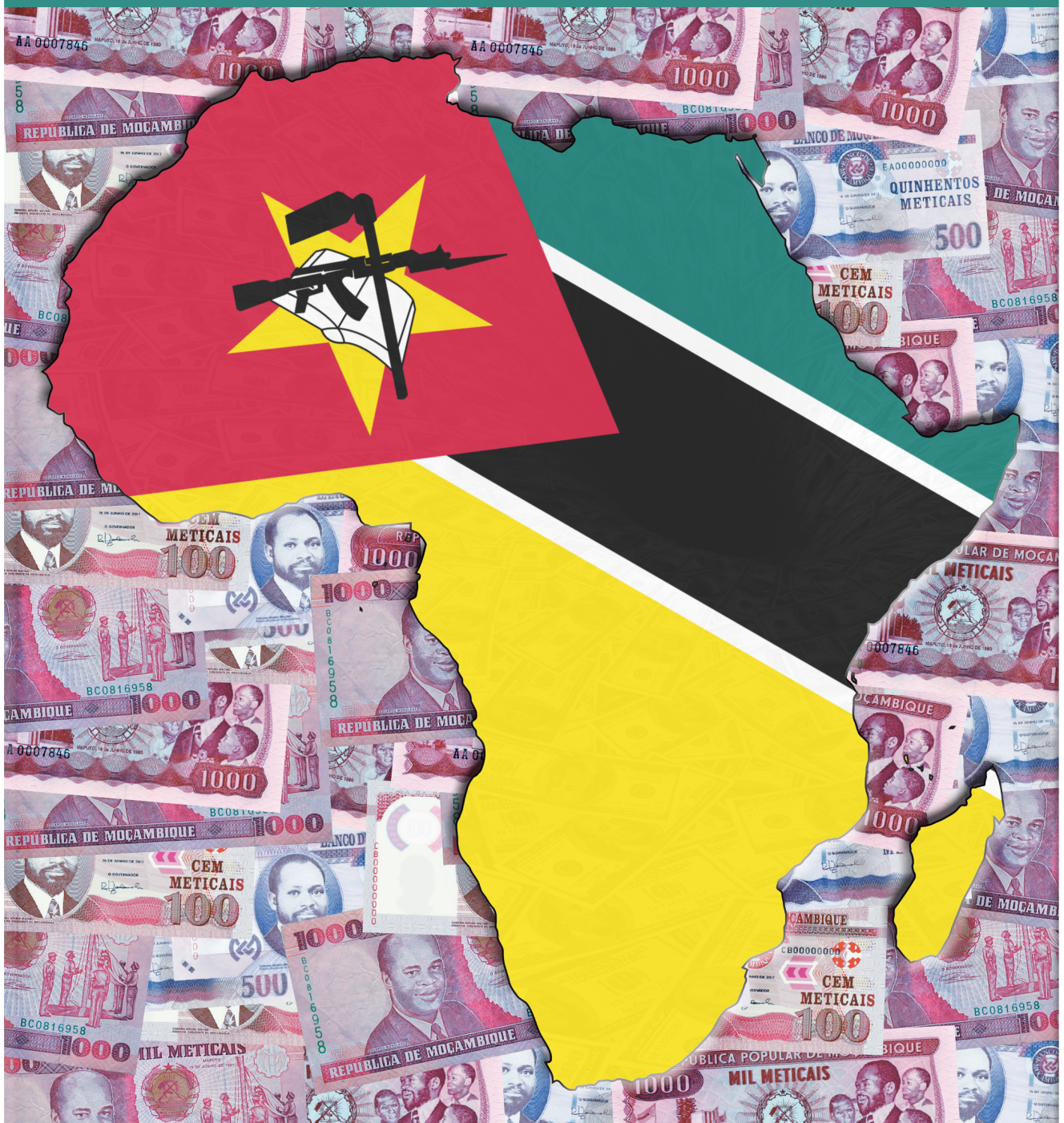


DEBT, AID AND POVERTY IN MOZAMBIQUE

LESSONS LEARNED FROM THE DEBT CRISIS

POLICY NOTE NO 1:2018



Debt, aid and poverty in Mozambique: Lessons learned from the Mozambican debt crisis

Policy Note No 1:2018

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LESSONS LEARNED FROM THE DEBT CRISIS

In opaque and unregulated financial markets, there can be strong incentives for banks to provide loans even when the appropriate guaranties or assessments are lacking. This is part of the Mozambican debt story, according to NAI researchers Navarra and Rodrigues. In this case, the consequences are most likely to be borne by Mozambican people, strongly affecting their living conditions.

CECILIA NAVARRA and CRISTINA UDELSMANN RODRIGUES, Senior Researchers at the Nordic Africa Institute

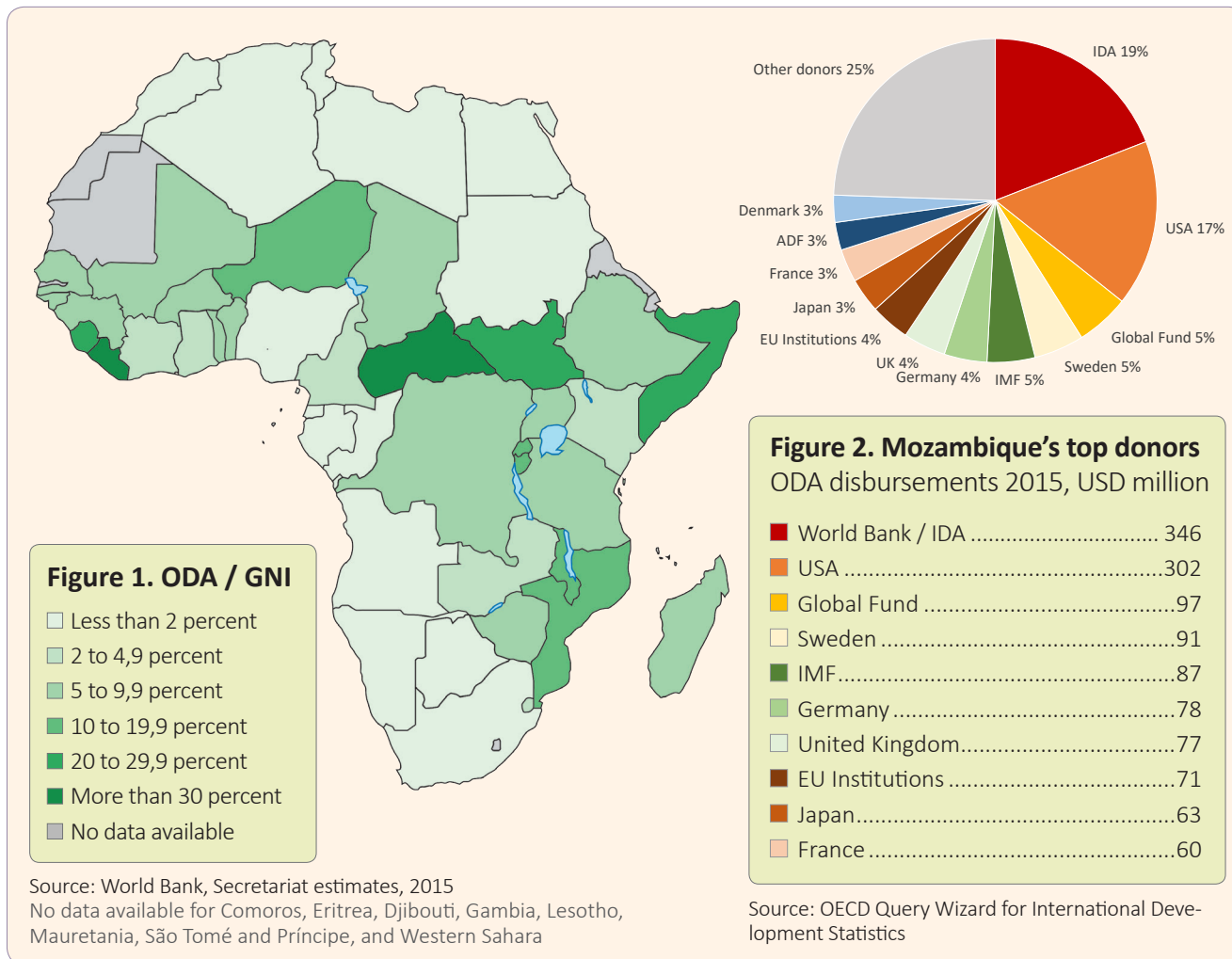
Mozambican politics and the economy are in shock following the discovery of 'hidden' state company debts of USD 2.2 billion, equivalent to 15 percent of the country's GDP. As reported by development economist Joseph Hanlon, the process began in 2013, during the previous president Armando Guebuza's rule. Three companies were created: Empresa Moçambicana de Atum (Ematum) to run a tuna fleet and provide maritime security; Proindicus, which also provided maritime security, particularly for offshore oil and gas operations; and Mozambique Asset Management (MAM), for maritime repair and maintenance. All three companies are co-owned by other state companies and also by the State

Information and Security Service (SISE). They obtained loans from two banks, Credit Suisse and Russia's VTB Capital. The state guaranteed these loans, thereby affecting public debt, which the Ministry of Finance authorised, but without a vote in parliament.

IMF and donors withdraw support

When the International Monetary Fund (IMF) was informed of the first loan (to Ematum), it required its inclusion in the state budget. In 2016, after the company incurred losses and the state faced financing problems because of falling international oil and gas prices, Mozambique asked for and obtained partial debt restructuring. Soon after, the two other debts were revealed. The three appeared to be linked to each other,





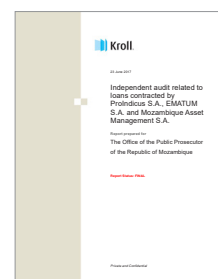
In 2015, net ODA (Official Development Assistance) receipts in Mozambique were 12,5 percent of the GNI (Gross National Income). This high quota, five times that of the African average (2.4 percent), makes it one of the most ODA-dependent countries on the continent. The highest shares of ODA disbursements to Mozambique in 2015 were from the World Bank's International Development Association (USD 346 million) and the United States (USD 302 million).

since the main contractor was the same – Prinvest, based in Lebanon and Abu Dhabi, which also owned the French shipbuilder that sold boats to Ematum.

In response, the IMF terminated its Standby Credit Facility Arrangement and many donors withdrew their support to Mozambique. These events and the continued decrease in commodity prices forced the government to declare it was unable to service its debt at the end of 2016, including the restructured Ematum debt. A parliamentary commission reported that the debts were contracted without proper parliamentary authorisation and, apparently, that their main justification had been for military security. According to the commission, the state's guarantees are void because they exceeded legal limits – thus violating the Constitution and the budget laws – and would have required a vote in the parliament.

Audit report criticizes banks for negligence

The Swedish embassy funded an independent audit. The full report is not public, but a summary, published in June, highlighted major issues. Many aspects were unclear because of lack of appropriate documentation, especially about how the loans were used. There were substantial discrepancies in the prices of assets and services delivered and, apparently, substantial overpricing by the contractor. None of the three companies had coherent business plans nor were they fully operational. The report confirmed the process for issuing government guarantees was inadequate.



The Kroll Report, funded by Sweden, suggested that the banks bore important responsibilities

» The country's reliance on donor money became its most salient economic characteristic «

The report suggested that Credit Suisse and VTB bore important responsibilities. The banks had received around USD 200 million in fees. Although they specified conditions for disbursement of the loans, these were never met and the loans were approved anyway. The lenders are likely to have known about the dubious picture that emerges from the report. In July, the Financial Times reported that the banks 'still have questions to answer', because concerns about the business plans should have been flagged up if due diligence had been exercised.

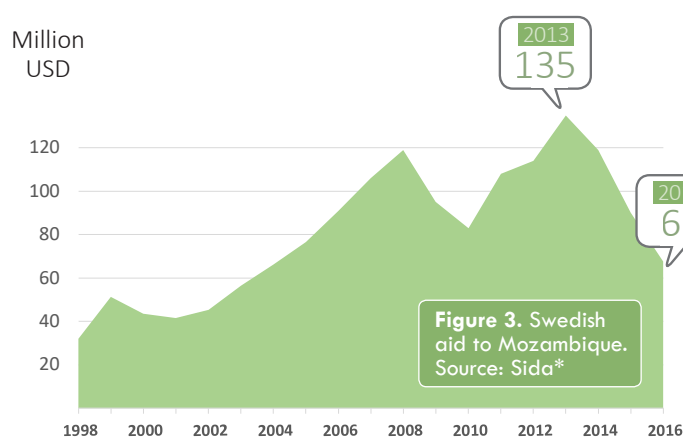
'The darling of the donor community'

The disclosure of the loans had immediate consequences internationally. Since 2004, Mozambique has received around USD four billion in budget support, representing four percent of gross domestic product (GDP) and 12 percent of the state's total income. After the disclosure, eight countries withdrew from the budget support group.

Sweden's aid to Mozambique has visibly decreased since the debt scandal. Last year's level of USD 68

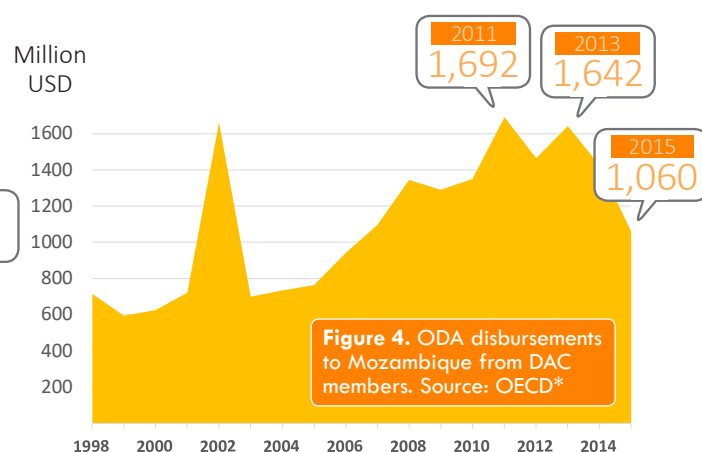
million in official development assistance (ODA), contrasts sharply with a high in 2013 of USD 135 million (figure 3). In 2015, Sweden contributed five percent of total ODA disbursements to Mozambique (USD 91 million), making it the fourth-largest donor (figure 2). But this was still the 'golden age' of donor in-flows to Mozambique. In fact, the country's reliance on donor money practically became its most salient economic characteristic.

For many years, Mozambique was, to use words of development researchers Macuane, Buur and Monjane, 'the darling of the international donor community'. However, this drew criticism: donors and lenders allegedly 'largely acted as a group to impose policies' on the country, according to Mozambique expert Joseph Hanlon. Questions he raised some 15 years ago, about whether donors were promoting corruption by pushing for modes of privatisation and liberalisation that lacked transparency, remain valid today. Hanlon says that these practices created the conditions for the deal that led to the hidden debt.



In 2013, a couple of years before the debt scandal became known, Swedish aid to Mozambique peaked at USD 135 million. In 2016, it was down to half, USD 68 million.

* Data retrieved 1 December, 2017, from openaid.se, Sida's web-based information service about Swedish aid, time series 1998-2016.



In 2011 and 2013, the DAC donors' ODA disbursements to Mozambique peaked at levels above USD 1,600 million. In 2015, it was down to USD 1,060 million.

* Data retrieved 1 December, 2017, from OECD Query Wizard for International Development Statistics, time series 1998-2015. Data for 2016 not available. ODA = Official Development Assistance. DAC = The OECD Development Assistance Committee.

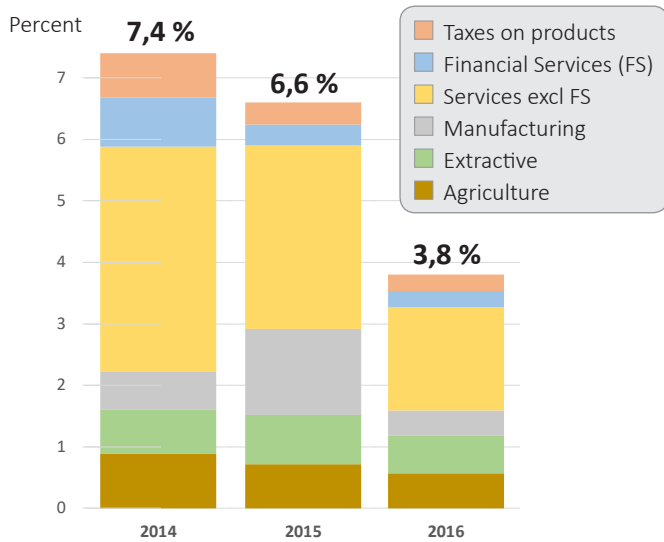


Figure 5. Sectoral contribution to growth, 2014-2016. Data for 2017 are not included in this graph but first quarter growth shows signs of improvement driven by the extractive sector.

Source: Mozambique National Institute of Statistics (Instituto Nacional de Estatística, INE)

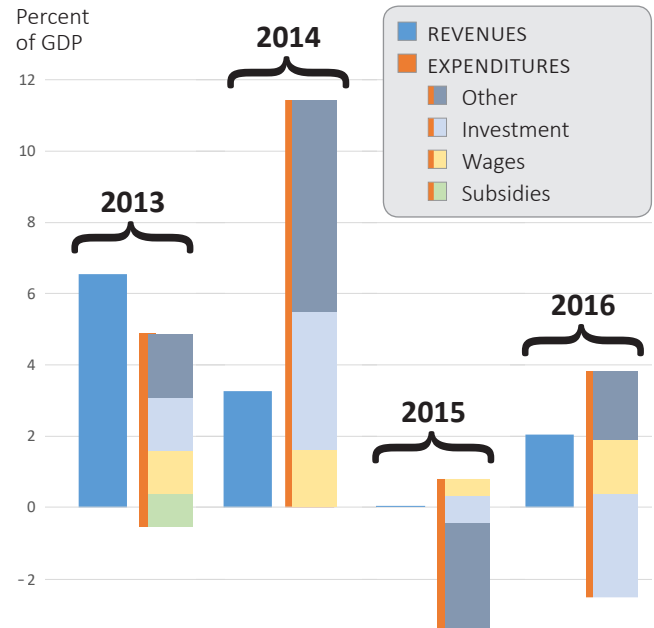
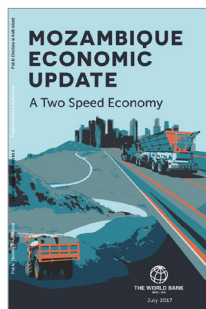


Figure 6. Annual change in revenue and expenditures, 2013-2016.

Source: Ministry of Economy and Finance (Ministério da Economia e Finanças, MEF) and World Bank staff estimates.

Recession, rising interest rates and reduced subsidies

The debt crisis produced a strong reduction in the pace of Mozambique's economic growth, from 7.4 percent in 2014 to 3.8 percent in 2016, according to the World Bank Mozambique Economic Update Report *A two speed economy* (July 2017). The relative weight of the extractives sector is increasing, as the role of manufacturing and agriculture is decreasing. This could be worrying in terms of diversification and income distribution.



According to the World Bank, interest rates have risen sharply, with the government's reference lending rate reaching 22.75 percent, one of the highest rates in Africa. Commercial bank rates average 28.6 percent, which is very high considering, for example, that the Libor reference rate for interbank loans, one of the main benchmarks for short-term interest rates around the world, is currently lower than two percent. Available credit is shrinking, posing serious problems to the private sector. On the fiscal side, the current reduction in government spending represents a dramatic drop from 39 percent of GDP in 2014 to 30 percent in 2016 (figure 6).

Government spending on wages remained at 11.3 percent of GDP, but capital expenditure almost halved, from

15.1 percent of GDP in 2014 to 8.5 percent in 2016. Also, subsidies have been substantially reduced, especially on fuel and to bread and salt producers, and electricity and water prices have been revised upwards. These changes are likely to affect the poorest in the population most.

Ten million living in poverty

In July this year, the IMF stressed that 'the 2018 budget should decisively reduce the fiscal deficit'. It suggested eliminating tax exemptions, reducing the wage bill and prioritising implementation of only the most critical public investments. The World Bank has also called for increased fiscal discipline and cutting the wage bill. However, these cuts are likely to have severe negative consequences. The IMF believes that protecting critical social programmes and reinforcing the social safety net should cushion the impact on the most vulnerable. But it is unclear which instruments will be available if fiscal policies become more restrictive. Austerity measures risk creating worse problems than the ones they are supposed to resolve, given already high levels of poverty and precariousness among the population.

The United Nations Development Programme's 2015 Human Development Report ranked Mozambique 180th out of 188 countries, with 44.1 percent of the population living in poverty, more than 10 million people. Poverty levels are decreasing, but at a slower pace than anticipated. For every percentage point of

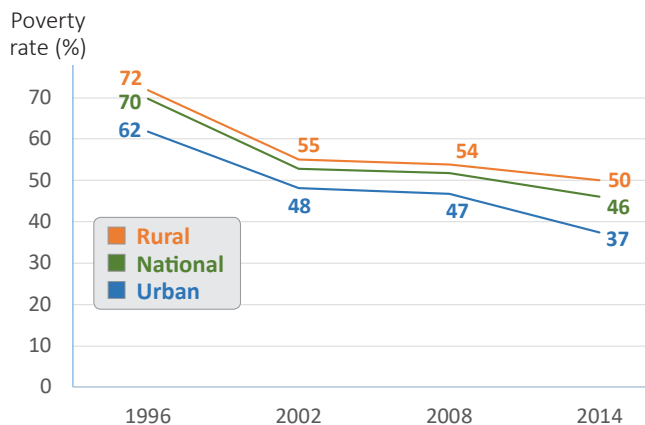


Figure 7. Poverty rate in Mozambique. Sources: Inquérito aos Agregados Familiares (IAF) for 1996 and 2002, and Inquérito sobre Orcamento Familiar (IOF) for 2008 and 2014.

economic growth between 1997 and 2009, according to a 2016 World Bank report on poverty reduction in Mozambique, poverty fell by only 0.26 percentage points. The poverty reduction record was especially disappointing in rural areas (figure 7).

More recent figures from UNU-WIDER (June 2016), based on data from the Mozambique National Institute of Statistics, show a better trajectory between 2008 and 2014: poverty headcount declined nationally, most significantly in urban areas and in the south of the country. Despite these improvements, they have not contributed to a convergence in welfare levels between rural and urban zones or by geographical region, with central and northern regions and rural areas displaying disproportionately higher poverty rates. A first attempt to simulate the effect of the debt crisis on poverty rates, estimates that they could have risen to 55-60 percent since 2014, due to increased prices, especially on basic goods, for example food.

Who should pay the price?

The arguments against putting this burden on the Mozambican people are then strong. Various voices, including civil society organisations, religious organisations and individual analysts claim that the debt is illegitimate, Mozambique should refuse to pay and the attorney-general should identify those responsible. According to an editorial in the Financial Times (July 2017), ‘the case for another restructuring is strong’, but ‘it would be wrong for ordinary Mozambicans alone to pay the price.’ Common citizens perceive the responsibility being at the level of polity and international instances and do not anticipate the full impact it will have on their daily life.

Since 1996, civil society organisation Mozambican Debt Group (GMD) has been advocating for development-related solutions to the country’s external debt. The group has pointed out that the debt scandal is inseparable from the problem of corruption and that international actors are involved.

Dependence on the extractives sector puts the debt crisis into context: analysts connect the debt to expectations of income created by natural resource (coal and gas) exploration, which is now at a standstill. According to the Instituto de Estudos Sociais e Económicos (IESE), this exposure to international price volatility and over-specialisation in the sector make the Mozambican economy vulnerable.

In opaque and unregulated international financial markets, incentives to provide loans without appropriate securities or assessments are strong. The Mozambican story illustrates how we must scrutinise lenders at least as much as borrowers.

The entanglements of international finance, national structures and aid decrease have, however, direct immediate consequences to the lives of Mozambicans and especially on poverty. This should be taken properly into account when designing a solution. ■

EXECUTIVE SUMMARY

- **Overall, it is important** to proceed with an assessment of who is responsible for the ‘hidden debt’ and to redefine the rules for using state funds and guarantees, as well as making sure that they are implemented effectively.
- **More specifically**, this analysis indicates that the consequences of the debt crisis on poverty could be severe. This is due to direct effects, such as price increases, and policy decisions, such as budget cuts and withdrawal of aid funds. It is important to avoid decisions that harm the poor – for example, cutting funding for health and education – in order not to further impact those people who are in greatest need.
- **However, the number** of poor people is likely to have increased in the past two years. National policymakers and development agencies should work together to develop appropriate tools for identifying these ‘new poor’ and design appropriate policies to support them.
- **The Mozambican story** is a tale of opaque and poorly functioning financial markets. The legal system, on both national and international level, needs to redefine the rules and financial tools available to avoid ‘perverse’ incentives in these markets. ■



CECILIA NAVARRA and CRISTINA RODRIGUES are senior researchers at the Nordic Africa Institute. Navarra's main field of research is development economics. Rodrigues' main field of research is urban transformation, rural-urban migration and urban strategies. They are both specialised on Mozambique.

About the Authors



NAI POLICY NOTES is a series of short briefs on policy issues relevant to Africa today, intended for strategists, analysts and decision makers in foreign policy, aid and development. They aim to inform public debate and generate input into the sphere of policymaking. The opinions expressed in the policy notes are those of the authors and do not necessarily reflect the views of the Institute.

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