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ECONOMIC OUTLOOK AND INFLATION FORECASTS

ECONOMIC OUTLOOK

AND INFLATION FORECASTS

SEPTEMBER 2021

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[1] Internal and/or external guests may also participate in Monetary Policy Committee meetings, whenever necessary, at the invitation of the body's Chairman.

Foreword

The primary mandate of the Banco de Moçambique (BM) is to maintain price stability so as to ensure the protection of the purchasing power of citizens. This implies keeping inflation low, at one digit, and stable in the medium term. The mandate to make this objective possible is exercised by the Monetary Policy Committee (MPC), a body composed of the Governor, Vice-Governor, BM Board Members and permanent guests. At the same time, the BM is responsible for supervising and maintaining the stability of the financial system.

Price stability also fosters balanced and sustainable economic growth. Price stability reduces the degree of uncertainty of economic agents and makes it possible to ensure more attractive interest rates, enabling a favorable environment for savings and investment.

To ensure price stability, the MPC defines the policy interest rate, known as the Mozambique interbank money market rate (MIMO). This rate, introduced on 17 April 2017, signals the stance of monetary policy and serves as an anchor for operations in the Interbank Money Market (IMM). It is expected that, through its influence on overnight interest rates formed in the IMM, the MIMO rate will affect inflation through the expectations, exchange rate and credit channels.

The decision on the MIMO rate is primarily based on inflation projections, always weighing the risks and uncertainties associated with such projections and the economic outlook. The MPC recognizes that its decisions affect the economy with a certain time lag, so it adopts a monetary policy stance based on an assessment of the economic and financial outlook and its risks and uncertainties over a time horizon of at least eight quarters. Where inflation projections deviate materially from the primary monetary policy objective set for the medium term, the MPC shall take appropriate policy measures to reverse the trend.

The MPC convenes ordinarily once every two months and, exceptionally, whenever economic conditions so require. The calendar of ordinary MPC meetings is announced at the beginning of each year. However, the body may convene extraordinarily to deliberate on monetary policy aspects, whenever macroeconomic circumstances so require.

The BM values transparency in the communication of its monetary policy. Monetary policy decisions are announced publicly, through an MPC Communiqué and / or a Press Conference Communiqué led by the BM Governor, on the same day of the committee meeting.

The Economic Outlook and Inflation Forecasts (CEPI) Report is an additional means for communicating the Monetary Policy Committee's (MPC) decisions. The CEPI report discloses the factors and rationale behind measures taken by the MPC, broadening the public's understanding of objectives and conduct of monetary policy.

Rogério Lucas Zandamela

Governor

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Decisions of the Monetary Policy Committee at Session No. 5 of September 10, 2021

The Monetary Policy Committee (MPC) of the Banco de Moçambique has decided to keep the policy rate, MIMO, unchanged at 13.25%. The decision is based on the maintenance of inflation prospects at a single digit, despite the prevalence of high risks and uncertainties, especially those arising from the impacts of COVID-19.

In addition, the MPC has decided to lower the reserve requirement ratios for liabilities in national currency from 11.50% to 10.50%, and in foreign currency from 34.50% to 11.50%, to provide more liquidity to the economy.

Risks and uncertainties associated with inflation projections have slowed down, but remain high. Domestically, it is noteworthy the slowdown of military instability in the northern region of the country and the prevalence of uncertainties as to the extension and magnitude of the impact of COVID-19 on the economy, as well as the dynamics of the prices of administered goods and services. In the external environment, the pandemic's developments also remain uncertain, in addition to the risk relating to supply chain constraints, which may limit the supply of imported goods.

Inflation is expected to remain at a single digit, in the short and medium term. Annual inflation stood at 5.6% in August, following 5.5% in July, in a context of lower depreciation of the Metical against the US Dollar. Core inflation, which excludes the prices of administered goods and services, and fruits and vegetables, recorded a slight increase. For the short and medium term, inflation is expected to remain at a single digit, despite forecasts for rising food and oil prices in the international market.

Prospects for gradual recovery of the economy in 2021 and 2022 are consolidated. Gross domestic product grew by 2.0% in the second quarter of 2021, reflecting the recovery of most sectors of economic activity. For 2021 and 2022, a gradual recovery of the economy is expected, mainly driven by external demand. However, for the economic growth to return to robust levels, it will continue to require deepening structural reforms in the economy, towards strengthening institutions, improving the business environment, attracting investment and creating jobs.

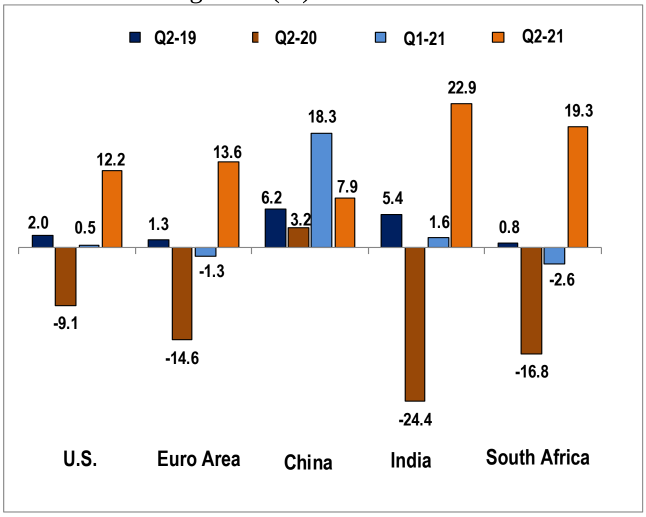
The Banco de Moçambique reaffirms its commitment to preserving the value of the Metical, which translates into low and stable inflation.

The next MPC meeting is scheduled for November 17, 2021.

Chapter I. Recent Developments in Global Economy and Forecasts

The prospects for the recovery of the world economy in 2021 and 2022 are consolidated, especially in advanced and emerging economies, in light of advances in vaccination programs and economic stimulus. However, the volatility of energy and food prices leads to mixed inflation dynamics in the short term. For 2022, a global inflationary pressure is expected, reflecting mainly the prospects for an increase in the oil and food prices on the international market, in an environment of uncertainty about the extension of disruptions in the supply chain. These uncertainties are coupled with those related to the developments of the COVID-19 pandemic, especially in economies still facing difficulties in accessing vaccines.

Chart 1-1: GDP growth (%)



Source: IMF

I.1. Recent Economic Activity and Forecasts

The implementation of fiscal stimulus and the relief of COVID-19 control measures lead to a significant economic growth.

In the second quarter of 2021, economic activity grew sharply in advanced economies, mainly influenced by the effect of the reopening of economies, as well as the implementation of fiscal and monetary stimulus that revived demand in the US and the Euro Area (Chart 1-1).

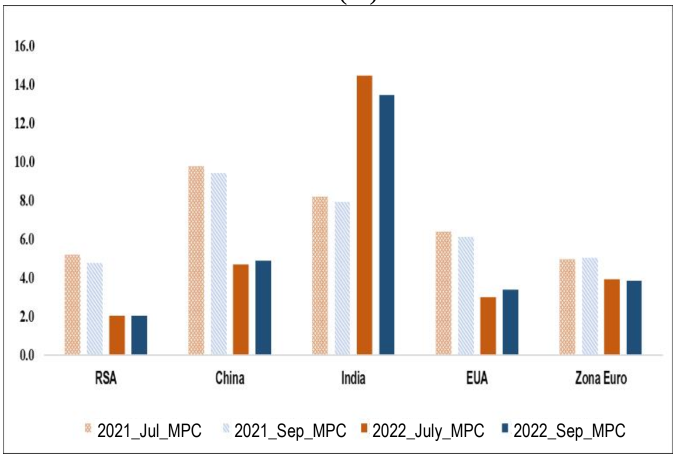
In emerging economies, the recovery of India, China and South Africa stands out in light of the additional lifting of restrictive measures to contain COVID-19 and the increase in their exports, driven by increased external demand in developed economies, as well as the recovery of commodity prices in the international market. It should be noted, however, that in China the production costs in the industry continue to increase, in part due to the restrictive measures to control COVID-19, which translates into an increase in the cost of raw materials (Chart 1-1).

Table 1-1: Global GDP Projections - 2021 (%)

Region	Achieved	Projection		Difference from April's WEO	
	2020	2021	2022	2021	2022
World Economy	-3.2	6.0	4.9	0.0	0.5
Advanced	-4.6	5.6	4.4	0.5	0.8
US	-3.5	7.0	4.9	0.6	1.4
Euro Area	-6.5	4.6	4.3	0.2	0.5
Germany	-4.8	3.6	4.1	0.0	0.7
Japan	-4.7	2.8	3.0	-0.5	0.5
United Kingdom	-9.8	7.0	4.8	1.7	-0.3
Emerging and Developing	-2.1	6.3	5.2	-0.4	0.2
Brazil	-4.1	5.3	1.9	1.6	-0.7
India	-7.3	9.5	8.5	-3.0	1.6
China	2.3	8.1	5.7	-0.3	0.1
Sub-Saharan Africa	-1.8	3.4	4.1	0.0	0.1
South Africa	-7.0	4.0	2.2	0.9	0.2

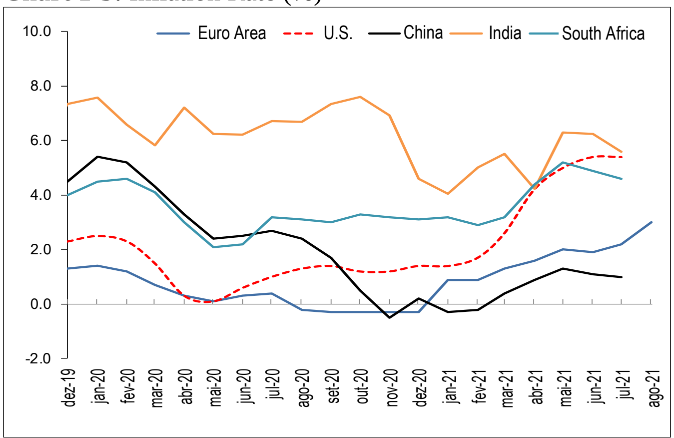
Source: IMF, WEO (July, 2021)

Chart 1-2: Real GDP Outlook (%)



Source: GPMN (Global Projection Model Network) / BM

Chart 1-3: Inflation Rate (%)



Source: Reuters and Trading Economics

For 2021 and 2022, the prospects for the resumption of global economic growth are consolidated.

In light of the reopening of the economies, coupled with progress in COVID-19 vaccination programs, as well as additional fiscal measures in advanced economies, the growth prospects for 2021 and 2022 are consolidated. For example, in the July edition of the World Economic Outlook (WEO), the International Monetary Fund (IMF) maintained the growth forecasts of the world economy for 2021 and revised upwards the forecasts for 2022 (Table 1-1). Similarly, and despite the slight downward revision in 2021, the GPMN (Global Projection Model Network) also projects significant growth in the short and medium terms (Charts 1-2).

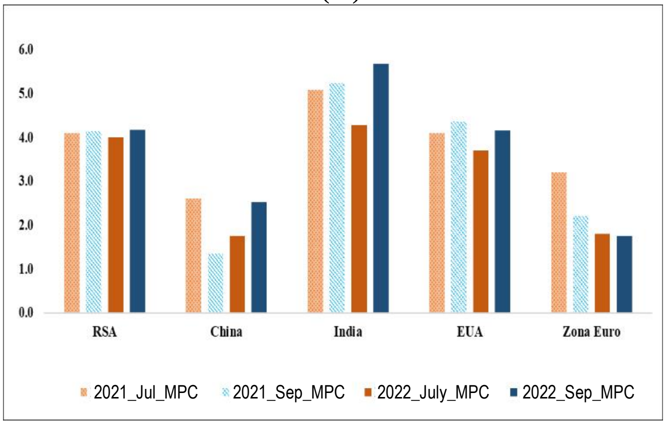
The risks to global projections are mainly related to the future trajectory of the pandemic, including, potential virus mutations and slow availability of vaccines, which may increase differences in economic performance among economies.

The volatility of the prices of liquid fuels, energy and food goods generates a mixed dynamic in the inflation of the country's main trading partners.

With regard to inflation, data from August 2021 indicate that the Euro Area continues to experience price acceleration, reflecting the increase in the cost of energy, as well as the base effect[2], in a context in which prices in the US remained unchanged compared to those published last July. It should be noted that, in these countries, annual inflation is above the convergence target of 2.0%, which may represent a potential inflationary pressure factor for Mozambique (Chart 1-3).

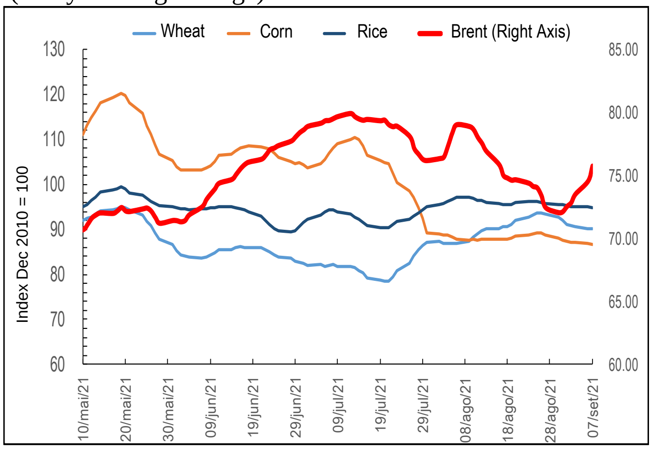
[2] The base effect occurs when the change of an economic indicator in the current period is influenced by an atypical movement in the base period of comparison.

Chart 1-4: Inflation Outlook (%)



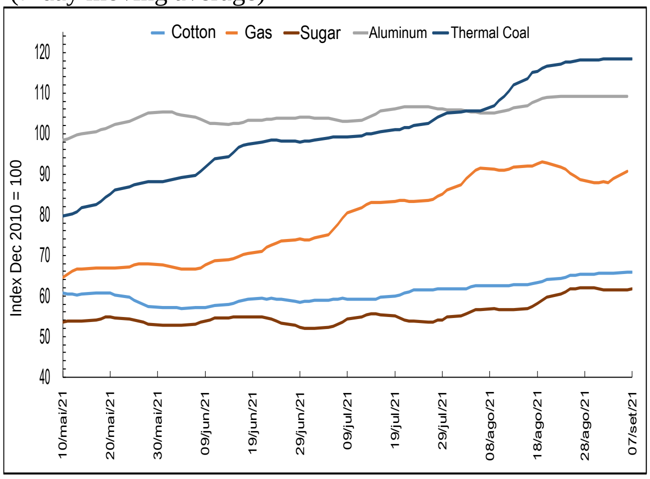
Source: GPMN / BM

Chart 1-5: Price Index of Imported Goods (7-day moving average)



Source: Reuters

Chart 1-6: Price Index of Exported Goods (7-day moving average)



Source: Reuters

In emerging market economies, notably India, China and South Africa, there is a widespread trend towards a slowdown in inflation, associated with lower food and transport prices, which has, for South Africa, supplanted higher electricity tariffs (Chart 1-3). It should be noted that for this block, only inflation in India is above the target[3].

However, the longer than expected extension of constraints in the supply chain of goods and services, brought about by the COVID-19 pandemic, at a global level, represents one of the main factors of inflationary pressure in Mozambique's main trading partners with the potential to limit the supply of imported products. (Charts 1-4).

The inflation prospects of Mozambique's main trading partners was revised upwards for 2021 and 2022.

Overall, compared to July´s MPC, GPMN projections point to an upward revision in prices for 2021 and 2022, reflecting greater fuel price pressure, coupled with the expected increase in demand in the international market (Charts 1-4).

I.2. Prices of Major Commodities and US Dollar Dynamics

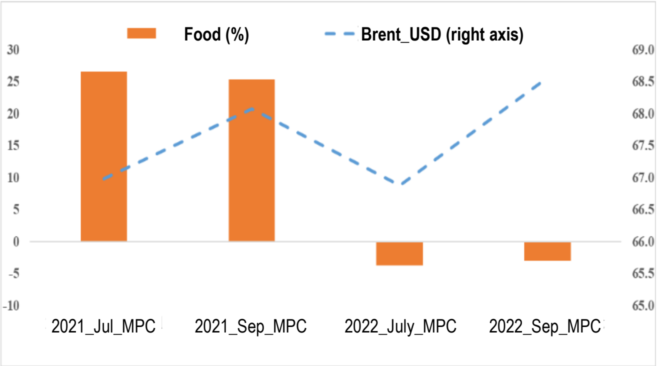
The current dynamics of the global economy continue to favor the rise in the prices of main commodities.

Average commodity prices, weighing on Mozambique's trade balance, continue to consolidate their gains, as a result of the dynamics of global demand in light of the process of reopening of economies (Chart 1-5).

Specifically, stands out the cumulative recovery of Brent prices, a trend that is expected to continue in the short and medium term (Chart 1-7). Compared to July's MPC, the forecasts for the Brent price for 2021 and 2022 were revised upwards, in line with the expectation of higher global demand as additional restrictions are lifted.

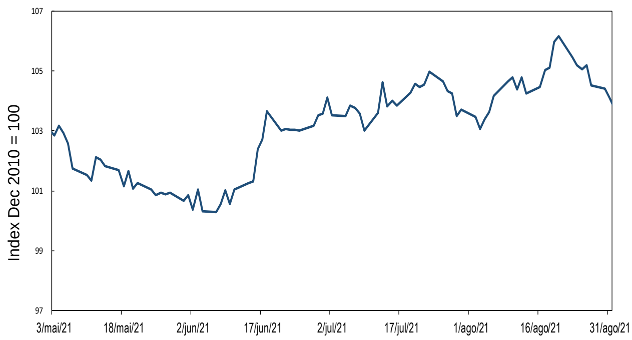
[3] Inflation targets for this block are differentiated. In South Africa and India, the target is a band of 3.0% - 6.0% and 2.0% - 6.0%, respectively; in turn in China the inflation target is 3.0%.

Chart 1-7: Outlook of Brent (USD) and Food Prices (%)



Source: GPMN / BM

Chart 1-8: USD Composite Index against the Currencies of the Main Trading Partners



Source: Reuters

With regard to food, less favorable weather conditions combined with the prioritization of sales to the domestic market, in a context of constraints in supply chains due to the pandemic, continue to weigh on the developments of this class.

However, forecasts point to a downward revision in food prices for 2021 and a recovery in 2022.

Regarding the price of food in the international market, the GPMN revised downwards the previous projections for 2021, mainly reflecting the reduction in demand from China and India, due to the restrictions imposed for containing COVID-19. However, for 2022, a recovery in food prices is expected, in line with the expectation of greater dynamics of global economic activity (Chart 1-7).

The US dollar has weakened, as a reflection of the increased number of COVID-19 infections and the maintenance of the monetary stimulus packages.

From the last MPC meeting (July/2021) to the end of August 2021, the USD Composite Index recorded accumulated losses (Chart 1-8), against some major transaction currencies (Euro, Rand, Pound and Yen), as a result of the recent increase in COVID-19 infections (delta variant) coupled with the FED's decision to maintain the interest rate and the asset purchase program (against market expectations).

In most countries, monetary policy interest rates remain unchanged. From the last MPC meeting to this date, there continues to be a widespread trend towards maintaining (i) reference interest rates and (ii) monetary stimulus packages.

Chapter II. Recent Developments in Domestic Economy and Short-Term Forecasts

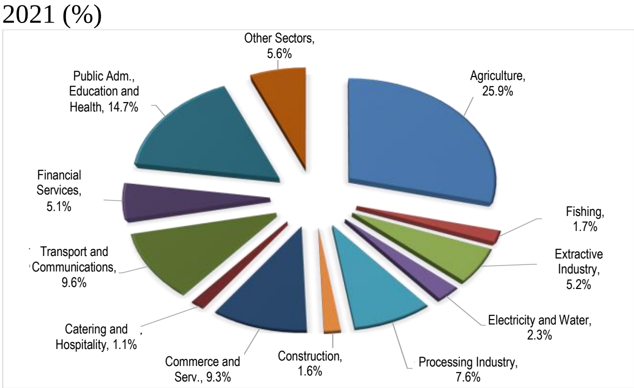
The less severe restrictive measures adopted in light of COVID-19, in the second quarter of 2021, and the base effect[4] dictated the acceleration of domestic activity in the period, against a backdrop of recovery of external demand. However, tenuous growth is expected in the third quarter, reflecting the restrictive measures to contain the 3rd wave of COVID-19, which have been implemented since the beginning of the quarter. Meanwhile, constraints on the global supply chain of goods and services translated to a slight acceleration in prices in August, with the prospect of maintaining a single-digit inflation in the short and medium term.

Table 2-1: Real GDP Dynamics of Mozambique by Sectors - Annual Change (%)

Activity Sectors	2020		2021		Q2 Contr.
	I	II	I	II	(pp)
Primary Sector	**0.35**	**-3.05**	**0.25**	**1.55**	**0.51**
Agriculture	3.32	2.65	4.84	1.62	0.42
Fishing	0.90	-2.43	1.26	2.62	0.04
Extractive Industry	-9.94	-24.06	-18.02	0.84	0.04
Secondary Sector	**3.09**	**-2.30**	**-3.05**	**-1.03**	**-0.12**
Electricity and Water	7.22	7.06	-2.21	-9.77	-0.25
Processing Industry	2.21	-5.54	-2.33	1.16	0.09
Construction	1.43	0.19	-8.41	2.38	0.04
Tertiary Sector	**0.99**	**-4.42**	**-1.11**	**2.82**	**1.27**
Commerce and Services	1.51	-6.97	-0.86	2.21	0.20
Catering and Hospitality	-0.21	-35.04	-15.13	4.03	0.04
Transport and Communications	4.85	-4.77	-9.64	2.88	0.28
Financial Services	0.33	-0.16	2.27	1.79	0.09
Public Adm., Education and Health	-3.29	-3.03	5.34	3.78	0.55
Other Sectors	2.92	2.12	2.14	1.93	0.11
GDP at cost factor	**1.07**	**-3.65**	**-0.94**	**1.84**	**1.66**
Tax on products	6.11	-2.59	7.04	3.11	0.31
GDP	**1.71**	**-3.54**	**0.12**	**1.97**	**1.97**

Source: INE

Chart 2-1: Sectoral Structure of GDP in the Second Quarter of 2021 (%)



Source: INE

II.1. Economic Activity in the Short Term

GDP accelerated in the second quarter of 2021, reflecting the base effect and less restrictive measures imposed in light of COVID-19.

Preliminary data from the Bureau of National Statistics (INE), indicate that, in annual terms, GDP grew 1.97% in the second quarter of 2021, an acceleration of 1.85 pp compared to the first quarter of 2021.

This dynamic of the economy was mainly due to the fact that the economy recorded a greater contraction in the same period of 2020 (base effect) and the less restrictive COVID-19 control measures, implemented at the domestic and global level. This made it possible to resume some sectors of activity domestically and improve external demand. In fact, the recovery of the extractive and manufacturing industries, trade and transport and communications services, construction and hospitality and catering, in a context in which agriculture and public services, with a combined weight of about 41.0%, maintained a positive momentum, contributed to the acceleration of GDP growth in the period under reference (Table 2-1 and Chart 2-1).

[4] In the case in question, the base effect refers to the contribution to economic growth in the second quarter of 2021, resulting from the sharp recession in economic activity observed in the same period of 2020, caused by the adverse effects of the COVID-19 pandemic.

Table 2-2: Balance of Payments (million USD)

	Q1 2020	Q1 2021	Var.
Current Account	**-2,226**	**-2,178**	**49**
Balance of goods	-1,435	-1,323	112
Exports	1,618	2,045	427
Imports	3,053	3,368	316
FDI	758	1,555	798

Source: BM

Table 2-3: State budget implementation in the first half of 2021 (million meticais)

(million meticais)	SemI2020	State Budget Law	SemI2021	Annual Var.
	Paid-in	**2021**	**Paid-in**	
Total Revenue	**129.630**	**265.596**	**127.422**	**-1.7%**
Total Expenditure	**164.683**	**326.038**	**157.576**	**-4.3%**
Current Expenses	120.813	238.291	115.896	-4.1%
Investments **Expenses**	31.818	83.782	23.119	-27.3%
Deficit w/ Donations	(35,053)	(57,942)	(18,264)	……
Donations	8.854	34.006	6.835	-22.8%
Deficit after Donations	(26,199)	(23,936)	(11,429)	…..
Net Foreign Financing	32.953	4	(5,471)	…..
Net Domestic Credit	(6.755)	23.933	16.900	…..
Primary Balance	(13.117)	11.179	622	…..

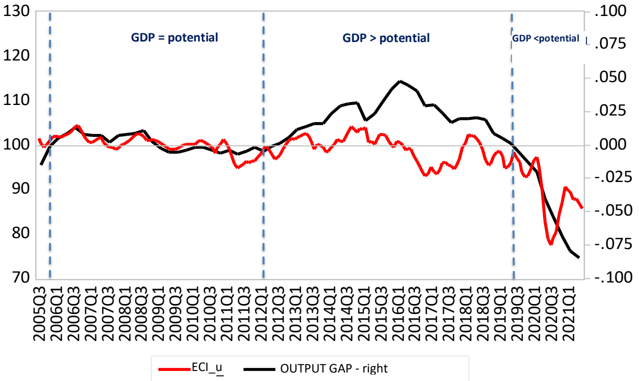
Source: MEF

Table 2-4: Domestic Public (million meticais)

	Use of T-Bills	Treasury Bonds	In the BM	Total Debt	Debt as % of GDP
Dez – 2020	44,220	88,100	54,885	187,205	21.0%
Jan – 2021	44,220	88,100	59,822	192,142	16.9%
Fev – 2021	44,220	92,238	60,105	196,563	17.3%
Mar – 2021	50,220	96,445	58,514	205,179	18.1%
Abr – 2021	57,987	96,728	56,891	211,606	18.7%
Mai – 2021	58,924	95,713	57,691	212,327	18.7%
Jun – 2021	50,208	97,453	59,011	206,671	18.2%
Jul – 2021	49,886	101,992	59,517	211,395	18.6%
Ago 2021	49,886	101,845	59,946	211,677	18.7%
Flow(Jun-Aug)	**-322**	**4,392**	**936**	**5,006**	

Source: BM

Chart 2-2: Difference between Potential and Observed GDP (Output Gap) and the Economic Climate Index



Source: INE

The heterogeneous impact of COVID-19 over the components of aggregate demand determined the moderated GDP growth:

i. The advances in vaccination programs against COVID-19 in advanced and emerging economies, not only had an impact on the increase in the prices of commodities in the international market, but also in the country's exports. In fact, in the first half of 2021 the volume of exports of main goods increased, contributing to the improvement of the deficit of the goods account (table 2-2), and to the boost of aggregate demand;

ii. However, weak investment expenditure (Table 2-3) has slowed growth, in a context in which, domestically, the COVID-19 challenges on public finances remain present; and

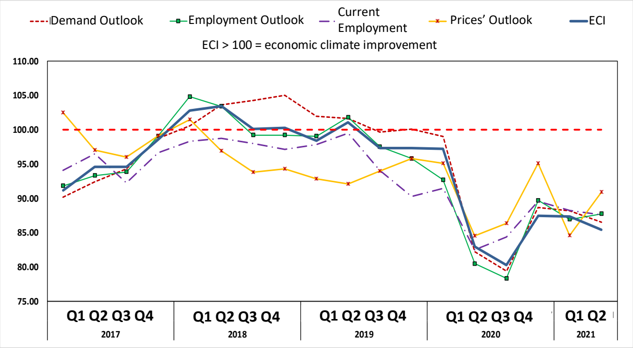
iii. **Thus, the economy continues to operate below its potential.** Output gap developments show an aggregate demand that is still suppressed, associated with various shocks that affected the country in recent years, in addition to COVID-19 (Chart 2-2).

The use of domestic financing stands out in covering the fiscal deficit. In the period under analysis, the increase in total debt in the form of bonds and advances from the BM was totally determined by the net issuance of T-Bonds, with the total balance being 211,677 million MT (Table 2-4).

In the short term, a slowdown in economic activity is expected. This forecast stems from (i) the impact of restrictive measures being adopted to contain the 3rd wave of COVID-19 and (ii) a lower base effect, despite the upkeep of favorable developments in prices of exported goods and forecasts of a rebound in external demand.

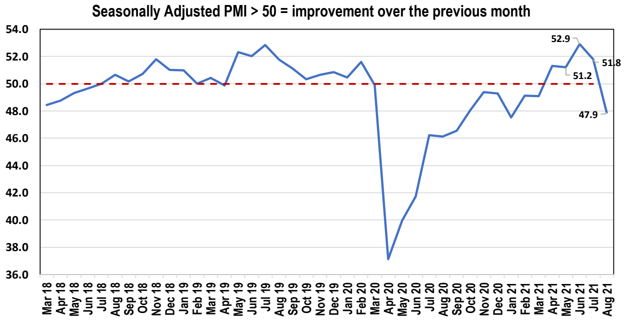
This forecast is in line with the deterioration in the operating conditions of the companies (Chart 2-3 and 2-4).

Chart 2-3: Economic Climate Index by Activity Sectors



Source: INE

Chart 2-4: Purchasing Managers Index (PMI)



Source: HIS, Markit

As measured by the gross international reserves (GIR), the country's external position has improved, partially due to the recent allocation of Special Drawing Rights (SDR). In the first week of September, the GIR balance stood at USD 4,012 million, enough to cover more than 6.0 months of imports of goods and services, excluding imports from major projects.

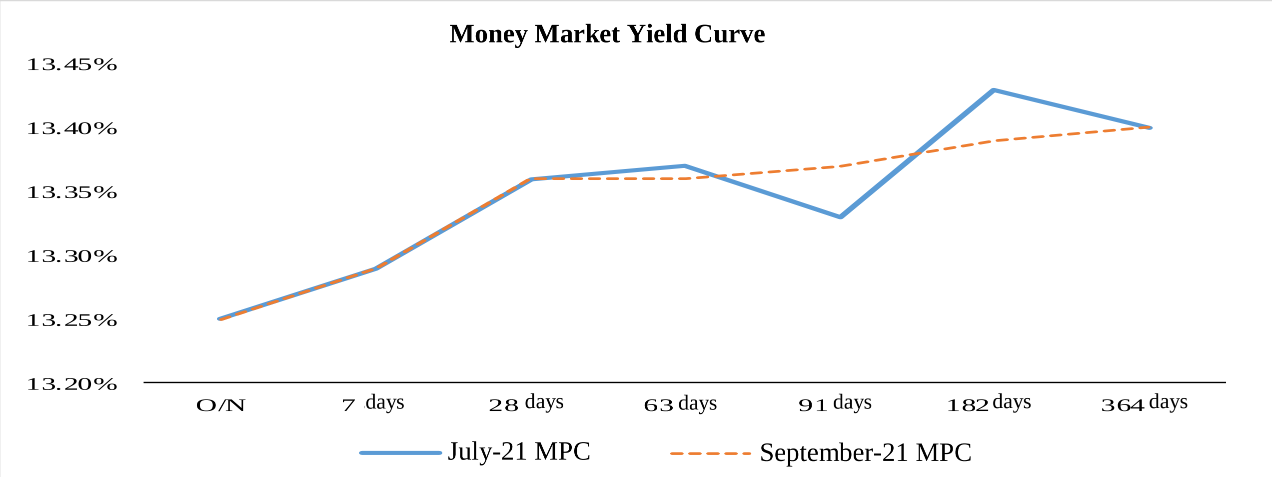
Box 1: Developments in Money and Capital Market Interest Rates

I. Yield Curve Developments

a) Money Market Interest Rates

In the interval between the two MPC sessions (July and September), the money market yield curve[5] observed a trend towards normalization. In fact, liquidity-swap operations for the 1-day period remained stable and were carried out at the monetary policy interest rate, MIMO, currently set at 13.25%. For the remaining market maturities, the yield curve was also unchanged, with the exception of the 63-day and 182-day maturities which decreased by 1 and 4 bps, respectively, and the 91-day maturity, which increased by 4 bps.

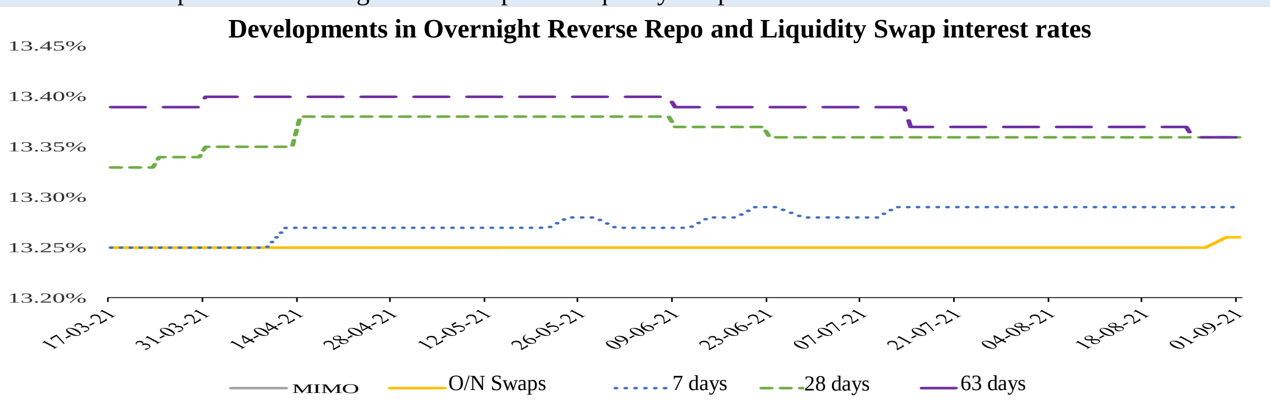
Chart 1: Money Market Interest Curve



Source: BM

In granular terms, Charts 3 and 4 show interest rate developments in the Money Market.

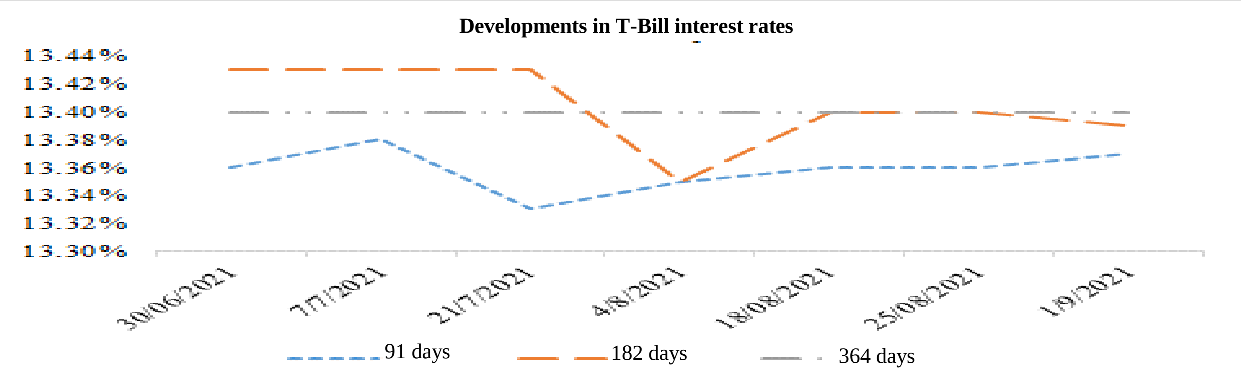
Chart 2: Developments in overnight reverse repo and liquidity swap interest rates



Source: BM

[5] In terms of instruments, the 1-day term concerns liquidity swap operations, the 7, 28 and 63-day terms concern T-Bill sale operations by the BM to commercial banks under reverse repo and the 91,182 and 364-day terms concern the issuance of T-Bills.

Chart 3: Treasury Bill Interest Rate Developments

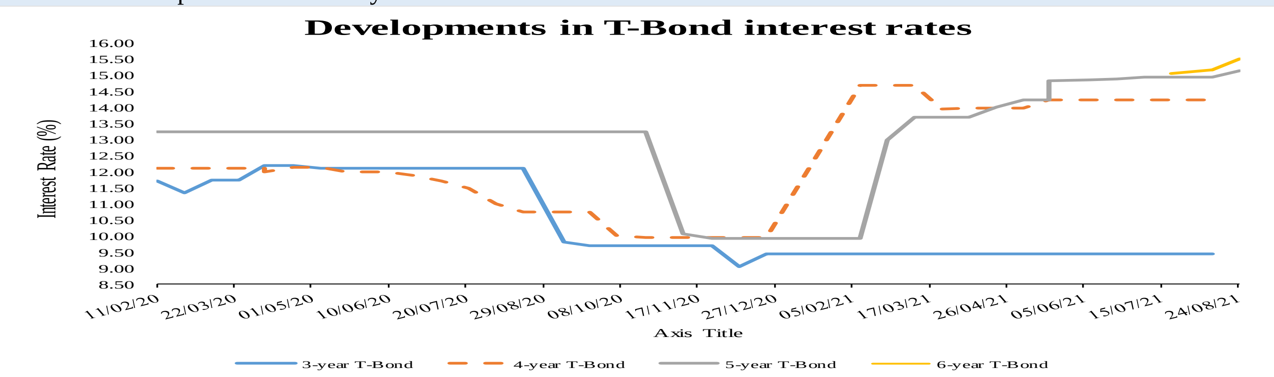


Source: BM

b) Treasury Bond Interest Rate Developments

Interest rates on Treasury Bond (T-Bond) issues maintained their upward trend. In fact, between July and August 2021, T-Bonds were issued for maturities of 5 and 6[6] years, which resulted in an increase in interest rates between 20 and 46 bp, respectively, as shown in Chart 4.

Chart 4: Developments in Treasury Bond Interest Rate

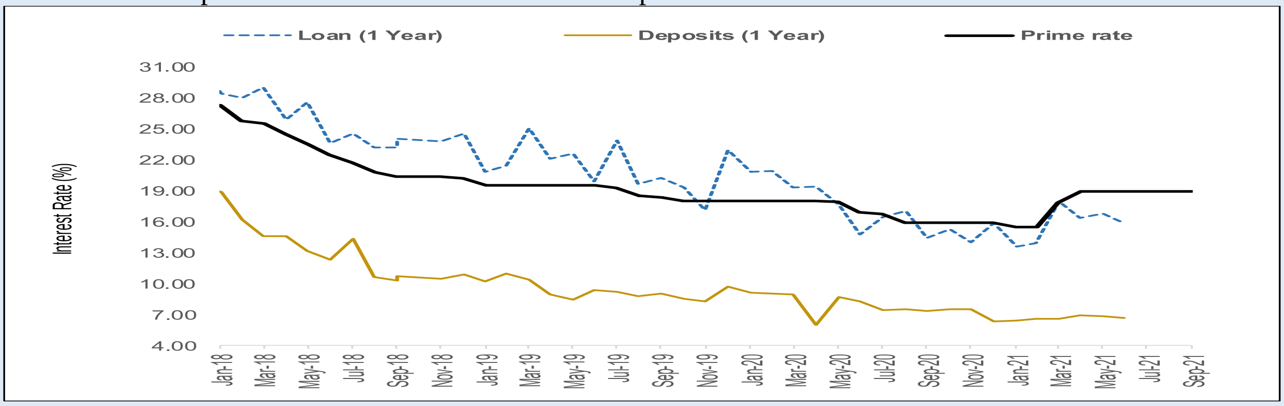


Source: BM

I. Retail interest rate

The Prime Rate remains unchanged and retail interest rates are moving downward. In fact, between the months of July and September of this year, the Prime Rate remained at 18.90%. Nevertheless, the interest rates on active and passive operations for the one-year term decreased by 94 and 19 bps, respectively, which allowed the spread between the two rates to be reduce to 9.23% in June, after 9.98% observed in May. Chart 5 shows the developments of retail rates.

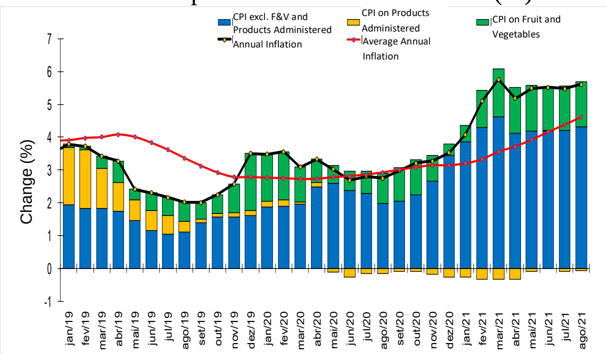
Chart 5: Developments in retail interest rates and the prime rate



Source: BM

[6] This constitutes the first issuance of T-Bonds with a maturity of 6 years

Chart 2-5 : Components of Annual Inflation (%)



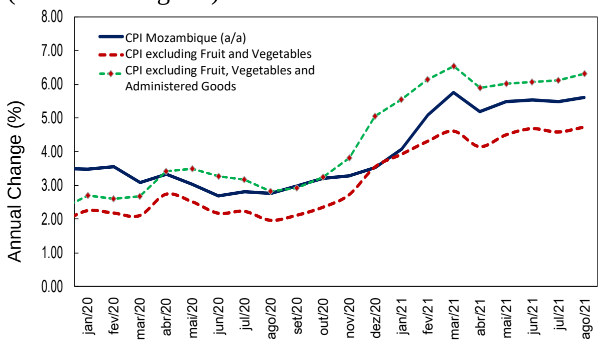
Source: INE / BM

Table 2-5 : Core Inflation - Mozambique
(Annual Change %)

	mar/21	apr/21	may/21	jun/21	jul/21	aug/21
CPI	**5.76**	**5.19**	**5.49**	**5.52**	**5.48**	**5.61**
Food	**12.65**	**11.23**	**10.88**	**10.50**	**10.45**	**10.72**
Cereals and derivatives	7.99	8.27	8.66	8.98	6.44	5.76
Fruit and vegetables	18.22	16.67	17.22	15.75	16.70	16.49
Administered	**-1.47**	**-1.47**	**-0.42**	**0.16**	**-0.37**	**-0.35**
Liquid Fuels	-6.36	-6.36	-4.34	-2.67	-2.42	-2.42
CPI x F&V	**4.60**	**4.14**	**4.49**	**4.68**	**4.58**	**4.72**
CPI x Admin.	**7.80**	**7.05**	**7.16**	**7.02**	**7.13**	**7.27**
CPI x Comb.	**6.38**	**5.74**	**5.95**	**5.87**	**5.76**	**5.89**
CPI x F&V and Admin.	**6.53**	**5.90**	**6.01**	**6.07**	**6.12**	**6.30**

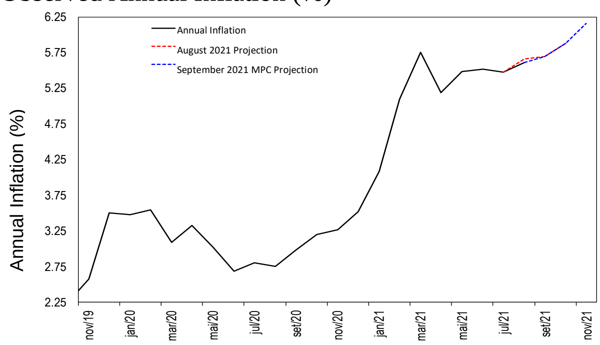
Source: INE

Chart 2-6: Annual inflation and Core Inflation
(Annual Change %)



Source: INE

Chart 2-7: Short-term Annual Inflation Projections and Observed Annual Inflation (%)



Source: BM

II.2. Recent Inflation Developments and Short-Term Forecasts

In August, there was a slight increase in prices, reflecting the increase in the food and catering class. In the short and medium term, inflation is expected to remain at a single digit.

As measured by the change in the Consumer Price Index (CPI), annual inflation rose from 5.48% in July to 5.61% in August. Also, annual average inflation upheld its upward trend, standing at 4.61% in August, following 4.38% in July 2021 (Chart 2-5).

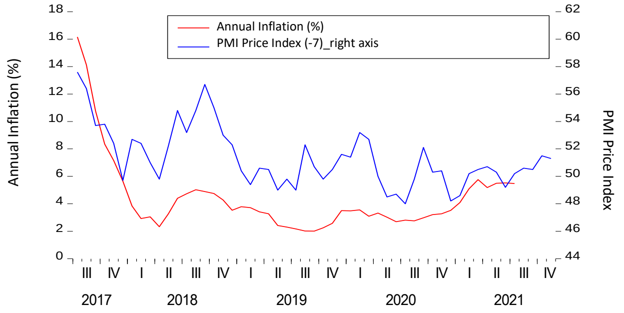
In terms of its components, annual inflation was explained by the increase in prices of some imported food products, such as fish and other frozen products, reflecting the increase in freight costs, which also affected other classes to a lesser extent, for example, clothing and various materials for housing repair (Table 2-5).

In mitigating the upward trend of these prices, stands out the relative stability of prices of administered products, favored by the maintenance of liquid fuel prices in the country (Table 2-5, Chart 2-5).

Core inflation registered an increase. From July to August, core inflation, which excludes the subgroup of fruit and vegetables (most volatile component of the CPI basket) and the subgroup of products with prices determined administratively, has registered an annual acceleration to 6.30% in August (Table 2-5 and Chart 2-6).

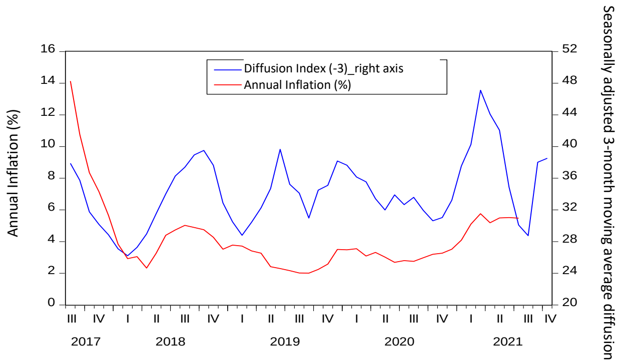
Short-term forecasts point to an acceleration in annual inflation in the coming months, nonetheless, remaining at single digits. These forecasts are mainly due to the following factors: (i) lower supply of domestically produced agricultural products, especially fruit and vegetables and (ii) increased freight costs in the international market, against a backdrop of lower depreciation of the Metical (Chart 2-7).

Chart 2-8: Price Index in Production and Annual Inflation



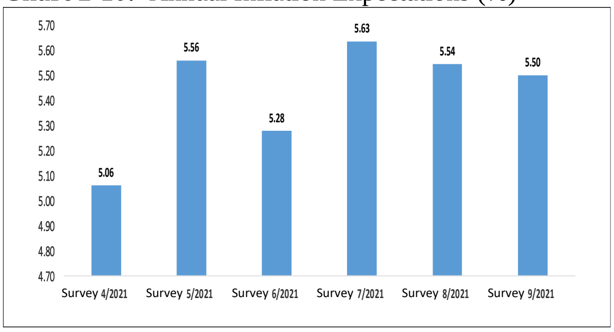
Source: BM/ HIS, Markit and INE

Chart 2-9: Diffusion Index and Annual Inflation



Source: BM/INE

Chart 2-10: Annual Inflation Expectations (%)



Source: BM

For the same period, leading indicators, such as the diffusion index and the Purchasing Managers Index (PMI), also point to this trend of price acceleration in the coming months, but remaining in the single digits (Chart 2-8 and 2-9).

By the end of the year, economic agents surveyed by the BM believe that annual inflation could stand at about 5.50%, equivalent to a slight acceleration compared to that observed in 2020 (Chart 2-10).

Box 2: Base Effect Impact on Inflation Developments in 2021

In the first quarter of 2020, with the outbreak of SARS-CoV-2, the world implemented the first measures to restrict the movement of people and goods to prevent it from spreading. Thus, the then weak global demand brought about the fall in the prices of main commodities, with emphasis on the price of oil (Brent), which registered a cumulative reduction of 47,97%, until the first week of March[7].

Mozambique introduced restrictive measures to control the pandemic on March 31, 2020, and the reduction in domestic demand and the fall in the price of oil in the international market justified a restraint in the increase in prices in some of the main classes of the Consumer Price Index (CPI), especially for liquid fuels and food, from May, where annual inflation was only 3.02% and monthly -0.60%.

In June, inflation continued to slow down, additionally, on account of the effect of a set of measures taken by government authorities: (i) exemption from VAT on essential goods (sugar, food oil and soap), (ii) energy tariff reduction and (iii) about 50% reduction in school fees. Thus, annual inflation in June slowed to 2.69%, and in the monthly terms the figure was -0.55%.

In 2021, annual inflation reached figures of 5.76%, 5.49% and 5.52% in March, May and June, respectively, in a context in which there were variations of 0.86%, -0.31% and -0.52%, respectively, in monthly terms. The low levels of CPI achieved in May and June 2020 lead to the premise of their likely impact on the relatively higher levels of CPI in the same period in 2021 – *the base effect*.

Economic definition of Base effect

Base effect occurs when changes in the growth rate of an economic indicator are attributable to an atypical movement in the previous period. In the case of inflation, it can be defined as the contribution to the change in the annual inflation rate in a given month that arises from a deviation from the month-to-month rate of change in the base period of comparison.

Specifically, a negative monthly change in prices a year ago means that the basis on which annual inflation rates are now being calculated is lower, which is why annual inflation will appear to accelerate sharply in subsequent months, even if the current increase remains negative, as is the case in 2021, unchanged or even decelerates.

Calculation methodology

In the results presented in this box, a method similar to that of the European Central Bank (ECB) was used[8] with the necessary adaptations. For the ECB, the base effect contribution to the annual inflation rate is calculated by subtracting the monthly change (not seasonally adjusted) 12 months, before the monthly change from a "normal estimate"[9]. The "normal estimate" is obtained by adding an estimated seasonal factor for each month to the average monthly change observed since January 1995 (long-term trend).

In Mozambique, two modifications were made in the implementation of the ECB's methodology, and for the (i) long-term trend, the monthly inflation moving average of the last 5 years was considered and (ii) the seasonality adjustment was based on the X-12 ARIMA method developed by the U.S. Bureau of the Census.

[7] Similar behavior was observed in other venues. In the second week of April, the price of a barrel of crude oil *West Texas Intermediate* (WTI) for future delivery entered negative ground for the first time, reaching a quote of -37,63 USD/barrel.

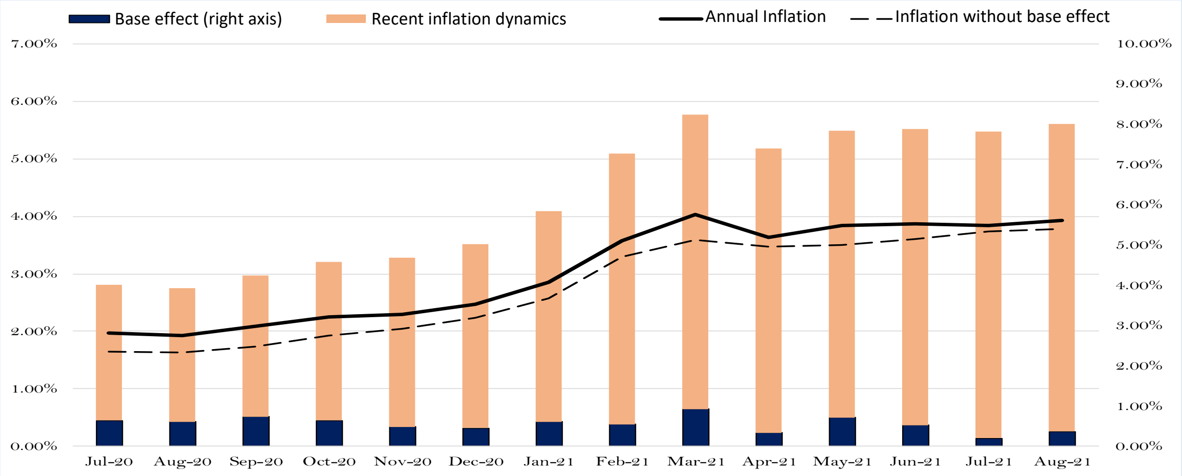
[8] ECB. (2007). The role of base effects in driving recent and prospective developments in HICP inflation. Monthly Bulletin

[9] January: 33-35. Available at: https://www.ecb.europa.eu/pub/pdf/mobu/mb200701en.pdf

Analysis of the Base Effect contribution in Mozambique

Chart 1 shows that the base effect has always been present in the contribution to annual inflation in all analyzed series. However, in the months of March, May, June and August 2021 there was a significant contribution, and annual inflation accelerated noticeably as a consequence of this effect, not least because inflation without regarding the base effect remained stable throughout this period.

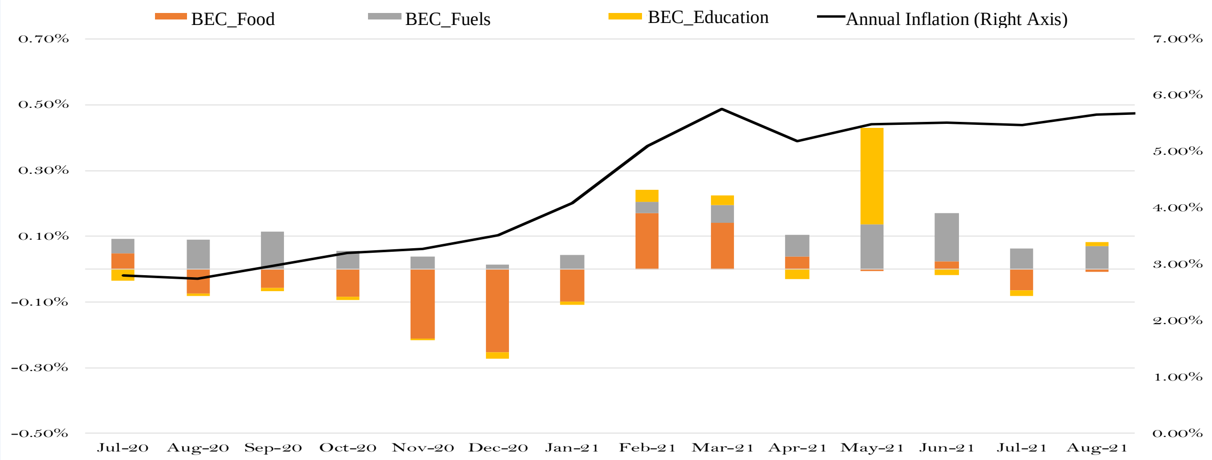
Chart 1 - Contribution of the base effect



Source: BM

Chart 2 shows the developments in base effect contributions of some CPI classes, regarded by their weight in overall inflation. The analysis suggests that the base effect of education classes and fuels drove the acceleration of inflation in the month of May 2021, reflecting the reduction of about 50% in school fees and the fall of oil prices in the international market. In June, there is a dissipation of the contribution of the education class. However, the persistence of the fuel class has stimulated a slight acceleration in annual inflation.

Chart 2 - Base effect contribution by classes



Source: BM

As per chart 1, July shows a lower contribution by the base effect on account of the combined movement between the positive contribution from the fuel class and negative from the food and education classes.

In August, the base effect again contributed significantly to overall inflation, reflecting the positive impact of the fuel and education classes.

The base effect contribution by classes is not only limited to the fuel, food and education classes. They were chosen for this reflection for the aforementioned reasons. In addition, the weight of each class on the CPI influences the respective contribution of the base effect to annual inflation. Thus, specifically regarding July 2021 (Chart 2), the net contribution of the base effect by the three classes was negative[10], which differs with the positive contribution of the total base effect in annual inflation (Chart 1).

[10] Reflecting the negative contribution, especially from the food class.

Chapter III: Medium-Term Inflation and Economic Activity Forecasts

Inflation projections for the medium term remain at a single digit. These forecasts are supported by the lower depreciation of the Metical, against a backdrop of expected inflationary pressures in the economies of major trading partners, as well as rising food and oil prices in the international market. With regard to economic activity, prospects for domestic economy recovery are consolidated, mainly driven by external demand, on account of advances in vaccination programs, the adoption of stimulus packages in advanced economies, as well as favorable developments in export commodity prices. Given this macroeconomic framework and the risks and uncertainties associated with the inflation projections, the MPC decided to maintain the MIMO rate at 13.25%.

III.1. External Assumptions for Projections[11]

Inflation projections are based on the following external assumptions:

- Lower GDP growth in South Africa and the US in 2021, followed by a faster recovery in 2022;
- Upward revision of inflation forecasts for South Africa and the US for 2021 and 2022;
- Upward revision of Brent price forecasts in the international market in the projection horizon; and
- Downward revision of food price forecasts in the international market for 2021 and upward revision for 2022.

Table 3-1: External Assumptions ()

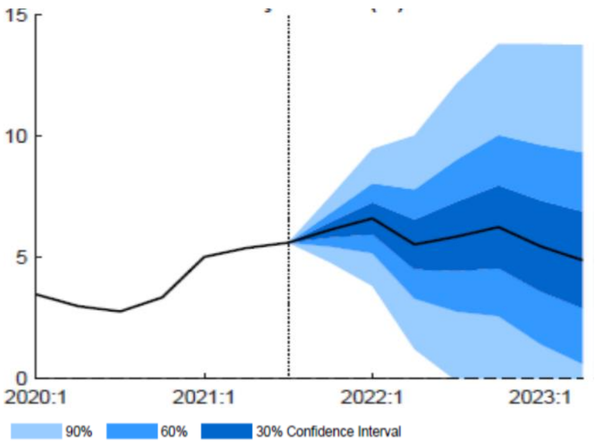
	2020	2021	2022
Us Real GDP(%)	**-3.4**	**6.1**	**3.4**
July´s MPC	-3.5	6.4	3.0
RSA Real GDP (%)	**-7.0**	**4.8**	**2.0**
July´s MPC	-7.0	5.2	2.0
US inflation (%)	**1.3**	**4.4**	**4.2**
July´s MPC	1.3	4.1	3.7
RSA Inflation (%)	**3.3**	**4.2**	**4.2**
July´s MPC	3.3	4.1	4.0
Brent price (USD)	**42.3**	**68.1**	**68.6**
July´s MPC	42.3	67.0	66.9
Food prices in the international market (%)	**3.1**	**25.4**	**-3.0**
July´s MPC	3.1	26.6	-3.8

GPMN / BM

III.2. Internal Assumptions

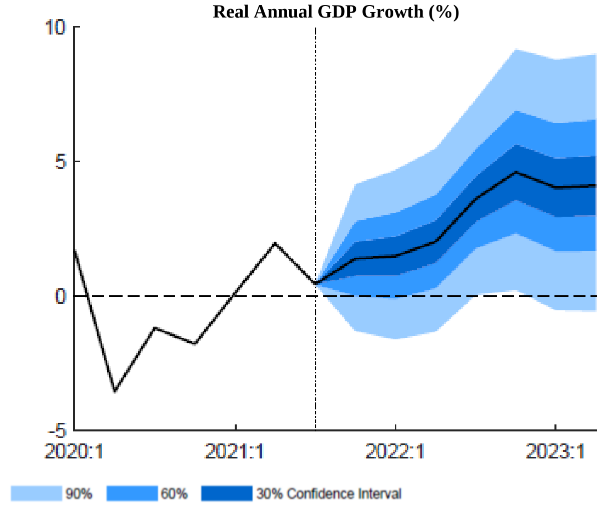
Pressure on prices of administered goods is expected to continue in the medium term. The prospects of oil price recovery in the international market may generate pressure on domestic prices, through the adjustment of the price of fuels. However, the lower depreciation of the Metical against the currencies of Mozambique's main trading partners may cushion potential impacts of this adjustment on the country's overall price index.

Chart 3-1: Mozambique Annual Inflation Projection (%)



Source: BM

Chart 3-2: Mozambique Real Annual GDP Growth Forecast



Source: BM

Prospects for lower exchange rate pressure in the medium term remain. The recent dynamics of the Metical exchange rate against the main tradable currencies, combined with the prospect of external demand recovery, resulting from the improvement of the economic forecast of the country's main trading partners, as well as the developments in the prices of main export goods, suggests a lower exchange pressure in the medium term.

Prospects for greater pressure on public spending remain. The military instability in the northern region, the population resettlement challenges, and logistics and acquisition and administration of the vaccine against COVID-19 will continue to weigh heavily on public spending in the medium term.

III.3. Result of Projections

Inflation is expected to remain at a single digit, in the short and medium term. These forecasts mainly reflect the continued lower depreciation of the Metical, which cushions the effect of the outlook for rising food and oil prices in the international market (Chart 3-1).

Prospects for gradual recovery of the economy in 2021 and 2022 are consolidated. This recovery is supported by the prospects of resumption of external demand, as a result of the gradual easing of restrictive measures imposed under COVID-19 and the adoption of monetary and fiscal stimulus packages, as well as favorable developments in export commodity prices (Chart 3-2).

[11]Source: Global Projection Model Network (GPMN)

III.4. Monetary Policy Decision

The Monetary Policy Committee (MPC) of the Banco de Moçambique has decided to keep the policy rate, MIMO, unchanged at 13.25%. The decision is based on the prospects of maintaining inflation at a single digit, despite the prevalence of high risks and uncertainties, especially those arising from the impacts of COVID-19.

The MPC has also decided to keep the interest rates for the Standing Deposit Facility (SDF) at 10.25% and the Standing Lending Facility (SLF) at 16.25%,

In addition, the MPC has decided to lower the reserve requirement ratios for liabilities in national currency from 11.50% to 10.50%, and in foreign currency from 34.50% to 11.50%, to provide more liquidity to the economy.

Risks and uncertainties associated with inflation projections have slowed, but remain high. Domestically, it is noteworthy the slowdown of military instability in the northern region of the country and the prevalence of uncertainties as to the extension and magnitude of the impact of COVID-19 on the economy, as well as the dynamics of the prices of administered goods and services. In the external environment, the pandemic's developments also remain uncertain, in addition to the risk relating to supply chain constraints, which may limit the supply of imported goods.