

Republic of Mozambique: 2002 Article IV Consultation, Fourth Review Under the Poverty Reduction and Growth Facility and Request for an Extension of the Poverty Reduction and Growth Facility Arrangement—Staff Report; Public Information Notice and News Brief on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Mozambique

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with the Republic of Mozambique, Fourth Review under the Poverty Reduction and Growth Facility Arrangement and Request for an extension of the Poverty Reduction and Growth Facility Arrangement, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, Fourth Review Under the Poverty Reduction and Growth Facility and Request for an Extension of the Poverty Reduction and Growth Facility Arrangement prepared by a staff team of the IMF, following discussions that ended on **April 25, 2002** with the officials of the Republic of Mozambique on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 3, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- the Public Information Notice (PIN) and a News Brief summarizing the **views of the Executive Board as expressed during the June 17, 2002 Board meeting, Executive Board discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Mozambique.

The document(s) listed below have been or will be separately released:

Letter of Intent*	Report on the Observance of Standards and Codes
Memorandum of Economic and Financial Policies*	Statistical Appendix
	Technical Memorandum of Understanding*

*May also be included in Staff Report.

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Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

REPUBLIC OF MOZAMBIQUE

**Staff Report for the 2002 Article IV Consultation,
Fourth Review Under the Poverty Reduction and Growth Facility and
Request for an Extension of the Poverty Reduction
and Growth Facility Arrangement**

Prepared by the African Department

(In consultation with the Fiscal Affairs, Legal, Monetary and Exchange Affairs,
Policy Development and Review, Statistics, and Treasurer's Departments)

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June 3, 2002

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EXECUTIVE SUMMARY

Growth recovered from the floods in 2000 to reach almost 14 percent in 2001, led by agriculture and construction. The first year of operations at the MOZAL aluminum smelter also contributed to a narrowing in the external current account deficit (including grants) to under 11 percent of GDP. In 2002, growth is expected to be close to the average of 8½ percent recorded since the mid-1990s.

Inflation surged to over 22 percent at end 2001. Steps taken to tighten monetary policy in mid-year were slow to take effect and the depreciation of the metical prompted unexpectedly large increases in administered prices. Improved monetary control and the metical's stability helped limit cumulative inflation to under 1 percent in the first four months of 2002.

All quantitative and structural performance criteria and benchmarks were observed except for the benchmarks on reserve money. Revenue collections were ½ of 1 percent of GDP higher than programmed in 2001. Despite a shortfall in external assistance, priority social expenditures were in line with the poverty reduction strategy paper (PARPA), and the domestic primary deficit was also ½ percent of GDP smaller than programmed. The new public financial management law has been approved and the new income tax law is being considered by parliament.

Banco Austral was successfully re-privatized in December in line with program understandings. The authorities and the new owners have begun to implement a strategy for the recovery of nonperforming loans and steps are being taken to establish accountability. Resolution of an additional recapitalization need in Banco Comercial de Moçambique (BCM), which merged with Banco Internacional de Moçambique (BIM) in late 2001, was a key issue in the discussions. The need to ascertain the reasons for the capital shortfall and put in place safeguards to minimize the use of public funds led to some delay in completing the review.

The PARPA's medium-term framework remains valid, although modifications are needed to take account of HIV/AIDS. The government has established processes for monitoring of the PARPA's implementation with the involvement of the parliament. **Updated medium-term projections reaffirm that Mozambique is well placed to maintain long-term debt sustainability**; the recent global economic slowdown has not led to any deterioration in external debt indicators.

The program aims to reduce inflation to 8 percent by the end of 2002 through fiscal consolidation and improved monetary control. Structural reforms focus on bank supervision, tax reforms and public expenditure management.

The staff recommends that the Executive Board completes the fourth review of the current PRGF arrangement and approves the authorities' request to extend the arrangement for one year.

I. INTRODUCTION

1. **A staff team visited Maputo during the period February 20 to March 9 to hold discussions for the fourth review under the Poverty Reduction and Growth Facility (PRGF) arrangement and the 2002 Article IV consultation.**¹ The mission met with Ministers of Planning and Finance (Ms. Diogo), Industry and Commerce (Mr. Morgado) and State Administration (Mr. Chichava), the Governor of the Bank of Mozambique (Mr. Maleiane), and with senior officials. Discussions on the program for 2002, including the strategy for additional recapitalization of Banco Internacional de Moçambique (BIM), the largest commercial bank, were concluded in Washington at the time of the spring meetings.

2. **In addition to requesting completion of the fourth review under the PRGF arrangement, the authorities are seeking a one-year extension of the current PRGF arrangement** to allow full disbursement of the committed amount in support of the reform program (Table 1). The government's letter of intent and memorandum of economic and financial policies (MEFP), as well as a supporting memorandum of technical understanding (TMU), are presented in Appendix I. Other appendices summarize Mozambique's relations with the Fund and the World Bank Group, discuss statistical issues, and present selected social and demographic indicators.

3. **On the occasions of the last Article IV consultation and attainment of the completion point under the enhanced HIPC Initiative, Directors commended the authorities for their strong record of program implementation and for their efforts to combat poverty.**² Directors noted the progress on fiscal management and structural reforms under the PRGF-supported program and the authorities' commitment to, and strong ownership of, the program. They urged the authorities to address lingering problems in the financial system and to continue efforts to improve execution and tracking of poverty-related expenditures.

¹ The staff team consisted of Mr. Andrews (Head), Messrs. Lopes and Engelke (both AFR), Mr. Manoel (FAD), Ms. Aylward (PDR), and Mr. Schwidrowski (Resident Representative). The mission collaborated closely with World Bank staff, including financial sector experts and an overlapping technical assistance mission from FAD (headed by Mr. Manoel), to advise on the implementation of reforms in public expenditure management. Ms. Patel, Advisor to the Executive Director for Mozambique, participated in the discussions.

² Republic of Mozambique—Staff Report for the 2000 Article IV Consultation and Second Review Under the Poverty Reduction and Growth Facility (EBS/00/62; 3/30/00) and Republic of Mozambique—Enhanced Initiative for Heavily Indebted Poor Countries—Completion Point Document (EBS/01/156; 9/6/01).

II. RECENT ECONOMIC DEVELOPMENTS

4. **Economic activity has recovered strongly from the devastating floods that reduced growth in 2000 to less than 2 percent.** Aided by a rebound in agricultural output, post-flood reconstruction activity, and the first full year of production by the MOZAL aluminum smelter, growth reached almost 14 percent in 2001, bringing average growth for the last two years close to the annual average of 8½ percent recorded in the second half of the 1990s (Table 2). Initial indications point to a continuation of growth at close to 9 percent in 2002. Prospects have not been significantly affected by the temporary slowdown in world growth, given the strong domestic orientation of agriculture and the continued demand for MOZAL's output (para.16). In addition, initial reports indicate that the severe drought affecting southern Africa has had only localized effects in some parts of the central and southern regions of the country. However, a fuller assessment that is underway may indicate that the drought is leaving a more widespread impact in Mozambique.

5. **Inflation, which had subsided in early 2001 to less than 1 percent, rose to 22 percent at year's end, reflecting an overly expansionary monetary stance** that went hand in hand with a depreciation of the metical. In nominal effective terms, the metical depreciated by 13 percent in the first half of 2001 after having depreciated by 11 percent in 2000 (Figure 1). The impact on domestic prices of the resulting increase in import prices began to be felt in mid-2001 and was sharply accentuated in the fourth quarter by unexpectedly large increases in administered prices, particularly an increase of one-third in private bus fares. As a result, inflation averaged over 3 percent per month during the last quarter of 2001.

6. **The central bank began to tighten monetary policy in mid-2001** by raising reserve requirements and interest rates (MEFP para. 4, Table 3, and Figure 2). Although pressure on the exchange rate abated, broad money growth remained in excess of 40 percent through October. The central bank responded by tightening the enforcement of reserve requirements, introducing automatic and escalating penalties for noncompliance, and establishing a minimum daily reserve requirement (of 10 percent of applicable deposits). In addition, the central bank stepped up its open market operations, leading to a 30 percent increase in treasury bills outstanding between June 2001 and March 2002, and increased sales of foreign exchange to ensure adequate sterilization of aid-financed government spending. The 12-month rate of broad money growth declined to 30 percent by March 2002, underpinning continued stability in the metical and reinforcing the normal seasonal decline in inflation; in the first four months of 2002 the cumulative increase in consumer prices was less than 1 percent.

7. **Revenue collections were ½ of 1 percent of GDP higher than programmed in 2001** as a result of buoyant income tax collections and the favorable impact of the depreciation on customs collections. This outturn was reflected in the domestic primary deficit (excluding expenditures for bank restructuring), which, at 5.6 percent of GDP, was also ½ of 1 percent of GDP lower than programmed (Table 4). Capital expenditures were sharply lower than programmed as a result of a shortfall in external project financing (MEFP

para. 3). Other expenditures (excluding expenditures for bank restructuring) were in aggregate close to programmed levels. Within this total, priority spending amounted to 18.8 percent of GDP, an increase of ½ of 1 percent of GDP over 2000 (Table 5). Expenditures on bank recapitalization (2.3 percent of GDP) were 1 percent of GDP lower than programmed because the bonds to recapitalize Banco Austral (BA) were issued in two tranches (in December 2001 and March 2002), rather than one, as programmed.

8. **External developments in 2001 were more favorable than envisaged under the program.** The current account deficit (including grants) narrowed slightly in 2001 to 10.5 percent of GDP from 11.8 percent in 2000, as aluminum exports from MOZAL and a decline in imports contributed to a further narrowing of the trade deficit, which has been more than halved since 1999 (Table 6). Aided by this strong performance, net international reserves increased by US\$7 million despite a shortfall of US\$120 million in external assistance.

9. **Difficulties in the banking sector in 2001 brought to the fore issues of financial sector soundness, accountability, and the role of banking supervision.** In April, the last-minute withdrawal of the private shareholder from the recapitalization of BA resulted in a government takeover of the bank. In line with the strategy presented at the time of the last review, the BA was successfully resold in December to Amalgamated Banks of South Africa (ABSA) (MEFP para. 7). Safeguards put in place during the period of interim management helped to minimize the need for further liquidity support. Steps were also taken to strengthen banking supervision, including the tightening of regulations on connected lending to shareholders and bank employees. However, the emergence of a capital deficiency in another bank (BIM), underscored the need for further action in the 2002 program (MEFP para. 8).

10. **Important progress was made in key fiscal reforms** with the passage of a new public financial management law and parliamentary consideration of a new income tax law. A large taxpayer unit was launched in Maputo in December 2001. However there were further delays in developing the strategic plan for the justice system, in part resulting from the complexity of a consultation process involving autonomous institutions in the sector. A draft was circulated in February 2002, and the authorities expect to finalize detailed plans for the four branches of the system during the year.

11. **All quantitative and structural performance criteria for end-December 2001 were observed** (MEFP, Tables 1 and 2). Despite the sizable shortfall in external program support, the unadjusted end-December target for international reserves was even exceeded. Other quantitative performance criteria and benchmarks for end-September and end-December 2001 were also observed by comfortable margins, with the exception of the benchmark on reserve money. The program's structural benchmarks were all observed.

12. **The implementation of Mozambique's first full poverty reduction strategy paper (PARPA under its Portuguese acronym), which was submitted to the Executive Board in September 2001, has been at the center of the government's efforts to combat poverty.** The elaboration of the PARPA has brought a sharper focus on social welfare issues,

which has been enhanced by improvements in tracking of social public expenditures. Although updated social indicators for 2001 are not available, the combination of higher social spending and broad-based economic growth has been generally conducive to improvements in social conditions during 2001 and early 2002.

III. MEDIUM-TERM FRAMEWORK AND BALANCE OF PAYMENTS PROSPECTS

13. **The medium-term strategy in the PARPA aims to reduce the incidence of poverty from 70 percent in 1997 to 50 percent by 2010.** The strategy relies on growth at an average rate of 8 percent through 2010 and increased social spending in priority areas, including education, health, agriculture and rural development, and basic infrastructure. Aided by the maintenance of macroeconomic stability and the continuation of reforms to create an enabling environment for the private sector, the main sources of growth are expected to be agriculture and industry, with growth of the latter accelerating as four “megaprojects” go on stream by 2005. Investment is projected to average more than 40 percent of GDP through 2005, with roughly two-thirds covered by FDI and related private foreign borrowing.

14. **The PARPA’s medium term framework calls for a significant fiscal adjustment and a reduction in aid dependence.** Ensuring the delivery of government services in priority areas will require concerted efforts to mobilize domestic resources and enhance the efficiency of spending. Tax reforms, including the new income tax, and continuing efforts to strengthen tax administration are geared to raising revenues to 15 percent of GDP by 2005. Expenditures are expected to fall from current high levels as bank restructuring operations and post-flood reconstruction come to an end. In addition, expenditure rationalization will be supported by improvements in public expenditure management (PEM) and, over the longer term, civil service reform. In line with these immediate priorities, tax reform and improvements in PEM are key elements for the program in 2002.

15. **The PARPA strategy remains valid, although some modifications to the framework are required to take account of additional factors.** The joint staff assessment (JSA) of the PARPA noted the need to more fully incorporate the impact of HIV/AIDS into the PARPA.³ While work is continuing on the quantification of the likely macroeconomic consequences of HIV/AIDS in Mozambique, the authorities have, as an interim step toward a full revision of the framework later this year, lowered the projected growth rate through 2010 by 1 percent per annum (Box 1). Revisions have also been made to the macroeconomic framework to incorporate the costs of servicing bonds issued to recapitalize banks which would peak at just over 1 percent of GDP in 2002 and average ½ of 1 percent of GDP annually through 2010. These costs will be accommodated without additional recourse to domestic borrowing.

³ Mozambique—Joint Staff Assessment of the Poverty Reduction Strategy Paper (EBD/01/73; 8/29/01).

Box 1. HIV/AIDS

Latest estimates indicate **HIV prevalence in Mozambique in 2000 at about 12 percent of the adult population, with the incidence ranging from 20 percent in the central region to 6 percent in the north.** It is estimated that, without concerted efforts to stem the spread of the disease, population growth would decline from 2.5 percent to 1.6 percent, so that by 2010 the population would be 10 percent lower than in the absence of AIDS. By then, 15 percent of the population would be orphaned, and life expectancy at birth would have declined from 50 to 36 years.

The **impact of HIV/AIDS** differs according to country circumstances, but the main macroeconomic consequences stem from:

- households suffering losses in income and savings because of a gradual loss of capacity to work and the costs of treatment and care;
- firms experiencing higher labor costs owing to lower productivity, higher absenteeism, and increases in training and insurance costs; and
- the government suffering similar losses and increased costs as a main employer and provider in health and education, while losing tax revenues.

The overall macroeconomic loss arises from lower productivity growth, mainly owing to lower returns on human capital and slower technical progress. Based on other countries' experience, it is estimated that growth would be lowered by up to 2 percent per annum.

Preliminary results from an analysis being carried out by the authorities and supported by the World Bank indicate that the **overall impact of HIV/AIDS on the growth rate, if the government does not react to the pandemic, increases over time, ranging from about 1 percent in 2004 to about 4 percent difference in 2010, compared with the no-aids scenario.** The study suggests that awareness campaigns (preventive) are highly important for limiting the scope and duration of the AIDS pandemic. Maintaining high school enrollments and expanding the supply of educational services to compensate for the loss in productivity growth is key policy advice for mitigating the negative medium-term effects of the pandemic. The emphasis of the National Action Plan for the Reduction of Absolute Poverty (PARPA) on educational investment should, therefore, be strengthened in the medium term.

16. **Mozambique's current account deficit is expected to widen sharply in 2002 and remain large in 2003**, reflecting imports for megaprojects, before narrowing over the medium term. In 2004, the net contribution of large projects to the current account becomes positive, reaching about US\$400 million in 2008, with MOZAL continuing to account for about half of total exports over the medium term. Given MOZAL's very low production costs and the movement of prices of imported ore in line with the price of its output, the prospects for MOZAL are relatively robust to world economic and aluminum cycles.

17. **Updated medium-term projections reaffirm that Mozambique is well placed to maintain long-term debt sustainability.** The recent global economic slowdown and decline in commodity prices have not adversely affected external debt indicators. In comparison with the completion point, the ratios of the net present value (NPV) of debt (after enhanced HIPC Initiative debt relief) to exports, GDP, and revenue are either unchanged or slightly improved over the medium term,⁴ reflecting somewhat lower debt service and strong economic performance. Projected debt relief over the medium term is about US\$12 million higher per annum than anticipated at the time of the completion point (see para. 32 below).

18. **There are, however, some risks over the medium term.** The Maputo Iron and Steel Project (MISP), which was to begin this year, has been suspended following the bankruptcy of Enron, a key participant in the project. While the impact will largely be mitigated by a new titanium ore project in Nampula, which is expected to begin exports in 2003, the suspension underscores the risk that such large-scale projects may not materialize. In the initial years, the impact of the cancellation of a typical megaproject would be moderate, as lower FDI and private borrowing would be offset by lower imports of investment goods. Over the longer-term, export growth would be cut by about 1 percent per annum from the baseline projection, resulting in higher current account deficits and some additional borrowing. In such a scenario, after some initial decline, the debt service ratio would by 2010 revert to its current level, although at under 5 percent of exports of goods and services, it would still afford a significant margin of safety in the event of additional adverse shocks.

19. **Net aid inflows, which increased to 16 percent of GDP in 2001 partly as a result of exceptional assistance after the 2000 floods, are projected to decline** in dollar terms and by over 5 percent of GDP through 2005 to somewhat below the levels before the floods. By incorporating such prudent assumptions, the scenario underscores the need for revenue mobilization and the efficient management of public resources. A change in the composition of external support, with grants declining to US\$300 million in 2005 instead of averaging US\$380 million over the medium term, would give rise to higher debt service costs. However, under this scenario, the debt service would still decline to less than 3 percent of exports by 2010. Despite these risks, Mozambique's external vulnerability is moderated by the government's policies of only contracting or guaranteeing concessional debt and of targeting reserve coverage at above six months of nonmegaproject imports.

⁴ For example, the ratio of the NPV of debt to exports for 2002 appearing in the completion point document was 115 percent, while, based on current data, it is 114 percent. For 2010, the relevant ratios of the NPV of debt to exports are 56 percent (completion point) versus 55 percent (current data), and this ratio is lower when additional bilateral debt relief beyond the HIPC Initiative is considered.

IV. MAIN ISSUES IN THE DISCUSSIONS

20. **The authorities reaffirmed the macroeconomic framework set out in the PARPA**, which calls for fiscal adjustment over the medium term to safeguard fiscal and external sustainability while reducing aid dependence. Against this background, the discussions focused on bringing end-period inflation back down to 8 percent in 2002; ensuring that expenditures meet the priorities set out in the PARPA; resolving recent banking sector difficulties and strengthening banking supervision; implementing the new income tax law; and strengthening public expenditure management.

A. Fiscal Policy

21. **The authorities agreed that, in support of the objectives set out in the PARPA, of fiscal consolidation, and of the tightening of monetary policy, the program for 2002 should aim to reduce the primary deficit and avoid recourse to domestic borrowing** (both defined to exclude bank restructuring operations), as already reflected in the budget. They recognized, however, that it was necessary to reassess fiscal targets in the budget in light of the strong revenue performance in 2001 and the surge in inflation in late 2001.

22. **On the basis of existing policies and the application of the new fiscal incentives code, revenues are projected to amount to 13.0 percent of GDP in 2002**, matching last year's performance. The staff argued for an increase in the specific duty on petroleum, which, in real terms, has been significantly eroded since 1997. The authorities agreed that such a measure would support the medium-term objective of increased revenue mobilization, but they argued that it should be timed to avoid further rises in pump prices, which could affect sensitive transport prices. Recognizing these concerns and the role that this measure could play over the medium term in financing higher social spending, the staff supported the authorities' intention to make this the subject of an ex ante Poverty and Social Impact Assessment (PSIA), to be conducted in mid-2002 with donor assistance. The latter would also serve an important role in helping to build capacity to undertake PSIA's and provide greater experience in using the results to further policy debate within and outside government.

23. **The program targets a reduction in the domestic primary deficit (excluding bank-restructuring operations) from 5.6 percent of GDP in 2001 to 3.4 percent in 2002.** Despite higher-than-expected inflation, the authorities intend to hold the nominal wage bill at its budgeted level (MEFP para. 17). This position was reaffirmed following the conclusion of annual tri-partite wage negotiations in May. This resulted in a 22 percent increase in the minimum wage, which restored its dollar value to the level prevailing since April 1999. Although the authorities were reluctant to revisit nominal spending levels in the budget, they agreed that some revisions to spending on goods and services and domestic capital were needed to preserve the real values of budgeted priority spending. While rapid growth with the return to low inflation is seen as key to poverty reduction, high levels of social spending envisaged in the PARPA provide a direct means of tackling poverty. In this vein and following these adjustments, priority expenditure would account for 67 percent of noninterest

spending (excluding bank restructuring costs) in 2002, compared with 66.2 percent in 2001. In line with the expected reduction in total spending following the end of postflood reconstruction, total priority expenditure will fall to 17.2 percent of GDP in 2002 from 18.8 percent in 2001. As envisaged in the PARPA, education spending will decline from the temporary peak in 2001, which included large capital expenditures, with spending on post-primary education also declining in line with PARPA priorities in 2002. In total, the decline in education spending accounts for all of the net decline in PARPA expenditures as a percent of GDP.

24. **The authorities agreed that structural reforms in the 2002 program would focus on the key challenges of implementing the new corporate and personal income tax and reforms of public expenditure management.** FAD is already taking a lead role in coordinating the income tax reform and has approved a request to provide similar support to public expenditure management (Boxes 2 and 3).

B. Monetary and Financial Sector Policy

25. **The authorities shared the staff's concern over the upturn in inflation in 2001.** While noting that special factors had contributed to the surge in prices, the authorities agreed that monetary policy had been too accommodating, and that the initial steps taken in mid-2001 to tighten liquidity had not been effective. The staff concurred on the importance of ensuring full compliance with reserve requirements as sought under the second package of measures taken at end-2001 that contributed to the subsequent deceleration in money growth. In this regard, the staff noted that the sale of the BA had removed an obstacle to effective liquidity management. The staff also advised that a closer coordination of fiscal and monetary policies was essential. In this regard, it stressed the importance of coordinating the pace of expenditures financed with external budget support and the sales of foreign exchange to ensure adequate sterilization, noting that during the first half of 2001 foreign exchange sales had fallen short of programmed, as well as actual, aid disbursements.

26. **As announced by the Bank of Mozambique in its annual policy statement in December, monetary policy in 2002 will be geared to limiting the growth in broad money to 19 percent by year's end.** The staff suggested that implementation should be monitored through a performance criterion on reserve money rather than on net domestic assets. The central bank agreed that it would closely monitor changes in its reserve money, as a leading indicator of the expansion of broad money and of liquidity conditions in the system. However, in view of the uncertainty surrounding the demand for money and need for further refinement of the monetary policy framework, especially the sterilization of externally financed expenditures, it was agreed that the performance criterion under the 2002 program would continue to apply to net domestic assets of the central bank, and that a benchmark on reserve money would be retained.

Box 2. Income Tax Reform

Following the overhaul of customs tariffs and the introduction of a modern value-added tax (VAT) in 1999, the income tax is now the focus of reform. The current system includes a business profits tax; a labor income tax; a complementary tax, which, in practice, is applied only to some capital income; a tax on rental income, a national reconstruction tax; and taxes on the production of petroleum and other minerals. The complexities of the system and generous exemptions and deductions have eroded its yield, with revenues from the income and profits tax receipts falling to only 2 percent of GDP in 2000. In addition, administrative costs are high, particularly for the complementary tax, which has a negligible yield.

A **new income tax law** was submitted to the parliament in December 2001, and preparations are under way, with Fund technical assistance, for its full application to 2003 incomes. **The new law is intended to raise the tax yield by broadening the tax base and simplifying both the tax structure and procedures for assessment and collection.** At the same time, the reform aims to foster economic growth by removing distortions and providing for a more equitable treatment of different sources of income. The main elements of the reform, as reflected in the law and the tax codes now under development, are as follows:

- A corporate tax and an individual income tax will replace the current five taxes on income.
- Administration will be simplified by eliminating filing requirements for small taxpayers, the majority of whom only have employment income, and fostering withholding at source on other forms of income, including interest paid by financial institutions and rental income from properties.
- Large taxpayers, especially legal entities, will be subject to self-assessment, supported by ex post audits as needed. As well as simplifying administration, this will facilitate a move to prepayments during the tax year and thus smooth government tax receipts.
- Income earned abroad will be included in the tax base, and a tax credit (not exceeding the rate at which profits are taxed in Mozambique) would be granted for tax paid abroad. This will bring the system into line with the principle of taxation on worldwide income that South Africa and other important commercial partners have adopted or are to adopt.
- Technical improvements, such as updating the provisions for depreciation business assets, inventory valuation, and the treatment of doubtful loans, and allowing losses recorded in one fiscal year to be carried forward for deduction from profits in the five subsequent fiscal years, instead of the current three, will be made.

In tandem with the income tax reform, a **new fiscal incentives code**, to be adopted in 2002, limits the type and scale of tax exemptions that can be granted to investors, thereby creating conditions for their effective control and tracking. The new code also includes more transparent rules for tax incentives for investors in large projects.

The government is also **consolidating indirect taxation and adjusting other taxes:**

- **VAT consolidation** will be achieved by providing systematic support, particularly in drafting the needed supplementary legislation, for the processing of refunds, collection, supervision, and training for persons working in the tax sector.
- **Other taxes** need substantial adjustments: (a) the stamp tax will be eliminated on actions subject to the VAT; (b) a new annual property tax on vehicles, based on engine size, will be implemented; and (c) SISA, a tax on the transfer of property, and in particular of real estate, will be revised, since the privatization of property was initiated only recently in Mozambique and is still getting off the ground.

Box 3. Public Expenditure Management Reform

The 2001 fiscal transparency Report on Observance of Standards and Codes (ROSC) for Mozambique and the 2001 World Bank public expenditure review recommended several **measures to improve public expenditure management (PEM) that are now being implemented**: (a) public availability of fiscal information has been enhanced by publishing a quarterly budget execution report; (b) budget execution reports in 2002 will include extrabudgetary activities, especially donor-financed programs, and the 2003 budget will include self-generated revenues of ministries and their related expenditures; (c) budget preparation and execution has been improved by using a more detailed functional expenditure classification; and (d) a modern and more comprehensive public finance law covering all aspects affecting the PEM area was approved in 2001.

Prominent among these measures is the promulgation in 2002 of **Law No. 9/2002, which establishes the government financial management system (SISTAFE)**, intended to create an integrated financial information system encompassing all stages of the federal budget process. As such, the SISTAFE would mark a fundamental change from an archaic manual system, of limited scope and of little help for decision making, to a modern financial management system that through the timely production of more comprehensive and analytically useful data, supports effective decision making and helps to improve the transparency of government activities. A technical coordination unit, UTRAFE, was set up in the Ministry of Planning and Finance (MPF) to coordinate all ongoing reforms related to the implementation of SISTAFE. The SISTAFE would:

- integrate complementary subsystems or processes, such as budget preparation, financial management, asset management, public accounting, and internal control; and
- be supported by information technology that permits standardized treatment of budget and financial information (unified data bank), the respective accounting entries, consolidation, and, finally, follow-up and control.

A recent FAD technical assistance mission developed an **action plan** for implementing the SISTAFE, covering a number of sequenced phases, and donors have indicated their desire to support this process. Implementation of the following recommendations is seen as crucial to the success of the action plan:

- **Strengthen UTRAFE and improve the coordination of TA** in the area of public finance by (a) providing an advisor on long-term assignment to assist the MPF; (b) establishing a steering committee, coordinated by the UTRAFE, with the participation of all deputy directors of MPF; (c) fostering the involvement of line ministries (especially Education and Health) and the provincial directors of the MPF in developing the SISTAFE; (d) unifying under the UTRAFE coordination of the ongoing technical assistance being provided by different external donors in the area of PEM; and (e) halting other initiatives to introduce similar budget and financial control systems at the sectoral level of other budgetary institutions.
- **Augment MPF senior management's involvement** in the work of the SISTAFE to include the participation of the minister and vice-ministers in the tasks and the definition of the implementation strategy.
- **Adjust the organizational structure and redefine the role of the institutions** in the budgetary execution process.

Disseminate the information on SISTAFE implementation and further enhance the transparency of the project by (a) preparing periodic, routine reports describing the progress made and problems encountered in the implementation of the SISTAFE; and (b) executing the SISTAFE financial expenditures entirely through the budget.

27. **The staff welcomed the sale of the BA to ABSA, noting that this was an important step toward promoting the integrity and efficiency of the domestic financial system.** However, the authorities agreed that unfinished business remained regarding loan recovery, accountability for the bank's difficulties, and lessons for banking supervision. Understandings were reached on a strategy for the recovery of the BA's nonperforming loans (MEFP para. 20) and the government agreed that it would include the results of loan recovery efforts in published quarterly budget execution reports. Steps to establish accountability for the losses in the BA will be monitored by the World Bank under its prospective Economic Management and Private Sector Operation (EMPSO) (Box 4).

28. **It was recognized from the outset that the cost of the required recapitalization of BIM would be a fraction of those previously undertaken for the Banco Comercial de Moçambique (BCM) and BA.** Nevertheless, the government's role in another bank recapitalization was a major issue in the discussions, in view of the systemic and governance implications. As a first step to expediting the recapitalization, the budget for 2002 included an appropriation of Mt 500 billion (½ percent of GDP). In the interim, the central bank placed restrictions on BIM's new lending. While pressing BIM's management to call upon shareholders to recapitalize the bank, the government also announced its intention to divest from the bank as soon as feasible. Accordingly, at a shareholders' meeting at end-April, it was decided to proceed with an initial capital injection equivalent to Mt 240 billion to restore compliance with the Basel capital adequacy ratio, with the government contributing in proportion to its 23 percent stake in BIM. To underscore its intention of divesting from BIM, the government's contribution to the recapitalization was in the form of nonvoting shares rather than equity. However, an additional capital injection might be needed, depending on the results of independent audits of BIM's accounts and its pension fund. In line with conditionality under the proposed EMPSO credit, the central bank has instructed BIM to produce a business plan, including provisions for bad loan recovery, aimed at improving financial performance.

29. **Financial sector soundness has become increasingly tied to the health of the two now largest banks (BIM and BA) that jointly account for about two-thirds of the assets of the system.** Aware of the special challenges that such concentration poses for bank supervision, the central bank has focused its efforts on restoring rigorous compliance with prudential ratios by the system's major institutions. Given the majority foreign ownership of BIM and BA, the central bank is also stepping up contacts with home country supervisory authorities to enhance cross-border supervision. The authorities also look forward to further advice on strengthening supervision in the context of an FSAP to be conducted later this year.

30. **To improve the monitoring of prudential ratios the central bank issued a circular in April 2002 changing the frequency of the commercial banks' reporting on compliance with capital adequacy requirements from semiannual to monthly.** In addition, it will rigorously apply existing penalties for providing incomplete or erroneous information to the supervision department and, building upon Fund technical assistance, is

Box 4. Structural Conditionality

Coverage of structural conditionality in the current program

Structural conditionality under the 2002 program focuses on implementing tax reform, improving public expenditure management (PEM), and strengthening bank supervision. Implementation of the new income tax law and the fiscal incentives code are central to the medium-term strategy, while improvements in PEM—drawing on the 2001 fiscal transparency Report on Observance of Standards and Codes (ROSC)—are key to ensuring the efficient use of resources, including donor assistance. In the financial sector, further safeguards are needed in light of the recent costly and disruptive problems with commercial banks.

Status of structural conditionality included in earlier programs

- In partial observance of a performance criterion for end-March 2001, the Banco Comercial de Moçambique (BCM) was recapitalized as envisaged at the time. However, in the process of merging BCM with the Banco Internacional de Moçambique (BIM), it became apparent that the bank was not observing capital adequacy requirements. Given the importance of compliance with prudential ratios by the system's largest bank, and the earlier large bank recapitalization operations, resolution of BIM's capital deficiency, including an assessment of the sources of the losses and remedial actions, became a focus of discussions for this review.
- While progress in dealing with BA has been in line with previous understandings, the staff and the authorities concurred that further actions are needed; these are being supported under a prospective World Bank operation (see below).
- Separately, an end-May 2001 benchmark on the drafting of a new fiscal incentives code was observed but, in view of subsequent revisions and delays in implementation, adoption of the new code is proposed as a performance criterion for June 2002.

Structural areas covered by World Bank and other donor lending and conditionality

Under an Economic Management and Private Sector Operation (EMPSO), the World Bank is taking the lead in supporting reforms to the judicial and regulatory systems, privatization, and strengthening the financial system. Under the EMPSO, the World Bank staff has reviewed the overall strategic plan for the justice system and will monitor its progress; and has agreed on conditionality for BA's loan recovery and establishment of accountability for its losses, in line with the leading advisory role that the World Bank has played in BA's resolution. Other multilateral and bilateral donors have support programs for Mozambique with conditionality that draws upon the PRGF-supported programs or requires its continued implementation.

Other relevant structural actions not included in current program

Consideration was given to including conditionality on the enforcement of reserve requirements. However, under the system now in force, penalties for noncompliance are immediately deducted from banks' balances. The implementation of a new computerized information system will strengthen this process by including the automatic calculation and deduction of penalties. Consideration was also given to the establishment of an escrow account for external debt-service payments, pending conclusion of bilateral agreements on HIPC Initiative debt.

introducing a comprehensive reporting format, to be used in all bank inspections (MEFP para. 22).

C. Program Financing and External Sector Issues

31. **Mozambique's total external financing needs will rise by over 70 percent in 2002 to US\$1.7 billion.** This increase reflects a very sharp widening in the current account deficit, before grants, to almost 40 percent of GDP as a result of further large-scale foreign investment, including MOZAL II, which will double the smelting capacity. Taking into account a small programmed accumulation of net international reserves, the total external financing requirement is expected to be covered by a mix of grants, concessional loans and private investment flows, and debt relief (Table 7).

32. **Total disbursements of official loans and grants (excluding HIPC Initiative debt relief provided by multilaterals in the form of grants) are projected to decline by about 11 percent in 2002, as exceptional assistance after the 2000 floods comes to an end.** Within this total, grants are expected to be more than US\$100 million lower than in 2001, while borrowing rises with the disbursement of the first tranche of the EMPSO credit from IDA. Private sector capital flows, in the form of private borrowing and FDI, are projected to rise to US\$ 1.1 billion, in line with the sharp increase in imports of goods and services related to the megaprojects. The total debt relief of US\$416 million in 2002 includes the outcome of the Paris Club meeting in November 2001, which resulted in higher debt relief than expected at the enhanced completion point because of a greater-than-expected concentration of remaining claims in the hands of creditors who have agreed to go beyond HIPC Initiative terms.

33. **Mozambique is negotiating bilateral agreements with Paris Club creditors** and has contacted non-Paris Club official bilateral and commercial creditors, requesting that they reach agreements in line with the terms of the enhanced HIPC Initiative debt relief. The staff suggested the establishment of an escrow account, in which estimated payments to official non-Paris Club and commercial creditors due after HIPC Initiative debt relief would be set aside.⁵ This procedure would ensure that resources were available to meet debt-service payments and provide an incentive for non-Paris Club and commercial creditors to reach agreements with Mozambique. While the authorities did not agree to establish such an account, they will give further consideration to this issue. In this context, Mozambique is also expected to benefit by using IDA's Debt Reduction Facility to buy back at a discount "sovereign debt of a commercial nature." The authorities are working with a donor on updating and enhancing its debt-management system to ensure the timely payment of debt service.

⁵ Another member country that has passed its enhanced HIPC Initiative completion point, Tanzania, intends to establish such an escrow account (see "Tanzania—Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion," EBS/02/56; 3/29/02).

34. **Following its large depreciation in the first half of 2001, the metical has appreciated by 5 percent in real terms, reflecting the surge in inflation and the weakness of the rand.** This still left the metical's value at some 10 percent below its average in real effective terms in the previous three years. Over the same period, Mozambique's terms of trade have improved by some 6 percent and are projected to improve further over the medium term. Strong growth in non-megaproject exports, including agricultural products, does not suggest a shift away from the production of tradables. These developments also suggest that the real value of the metical is not posing difficulties for Mozambique's competitiveness. Accordingly, despite the currently high levels of external assistance, there is also no clear evidence that Mozambique is suffering from aid-induced Dutch disease. While inadequate sterilization of aid-financed expenditures has, at times, complicated monetary management, aid inflows appear to have been within the country's absorptive capacity, as evidenced by the strong domestic supply response, which underlies the continued strong growth performance. In addition, the large import component of recent high levels of assistance for reconstruction has moderated pressures on domestic demand. While this issue needs to be kept under review, reducing aid dependence in line with the PARPA will help to guard against the development of aid-induced Dutch disease while supporting fiscal sustainability.

35. **Mozambique will continue to pursue a flexible exchange rate policy under the program.**⁶ The authorities are committed to abstaining from intervention in the foreign exchange market for the purpose of influencing the exchange rate. They are improving the management of foreign exchange inflows, with a view to ensuring that the amount and timing of central bank sales of foreign exchange are sufficient to sterilize the liquidity expansion that would otherwise result from externally financed government domestic expenditure.

36. **Mozambique continues to conduct a relatively liberal trade regime, with average import tariffs of 13.8 percent, low tariff dispersion, and no significant nontariff barriers,** although both sugar production and cashew processing benefit from protective surcharges (Box 5). The authorities reiterated their commitment to trade liberalization, notably in the regional context of the Southern African Development Community (SADC) Trade Protocol. As part of the protocol, which aims to eventually eliminate tariffs on intra-SADC trade, the government will adhere to its intention to reduce the top tariff rate from 30 percent to 25 percent, with the reduction becoming effective in January 2003 (MEFP, para. 26). The authorities reiterated their intention to accept the obligations under Article VIII, Sections 2, 3, and 4. The outstanding issues with regard to Mozambique's

⁶ The Bank of Mozambique publishes a representative exchange rate that is an average of all licensed operations (commercial banks and exchange bureaus). This rate has stayed within 2 percent of the official rate at which the BM transacts in the interbank market, although sporadically a somewhat larger margin arises between the representative rate and the rate on cash transactions, or "parallel market rate," as designated by the BM.

Box 5. Sugar and Cashews

Since 1999, the government has supported the sugar sector through an import surcharge. The rationale for this—which was upheld by an analysis undertaken for the Food and Agriculture Organization—is akin to an “infant industry” argument in that the government advocates protection to allow output at rehabilitated sugar mills to rise to full capacity, with a corresponding decline in costs. However, no “sunset” clause or phase-out period has been established; instead, the policy is reviewed annually in the light of domestic and international sugar market developments. Employment in the sector is expected to rise from the current level of 20,000 during the peak season toward the pre-independence level of over 40,000

Aided by this protection, foreign direct investment in four sugar estates raised output to 67,000 tons in 2001, and production is expected to rise to 200,000 tons this year and 400,000 tons in 2005—when the mills will be operating at full capacity—or almost one-third higher than the peak of 30 years ago. Although current production is less than domestic consumption Mozambique exports limited amounts under preferential access to the highly protected markets of the United States and the European Union (EU). The EU’s decision to allow such imports for the first time in 2001 under the Everything But Arms Initiative and grant progressively higher access until the EU sugar regime is dismantled in 2009 has improved the prospects for long-term viability of the sugar sector in Mozambique without the prop of the import surcharge. Nevertheless, sugar producers continue to suffer large losses, as imports, in particular from Zimbabwe, have circumvented the import surcharge. In response to this, the government has temporarily suspended the value-added tax on sugar.

In the wake of the liberalization of the domestic **cashew nut industry** in the mid-1990s, the government decided to replace an administered price system favoring the domestic processing industry by an export tax on unprocessed nuts. Since 1999, the export tax has been 18 percent; it is estimated to have generated the equivalent of about US\$2 million in 2001. Nevertheless, domestic processing has continued to decline, partly owing to the un-competitiveness of the industry. The government wishes to maintain the export tax and use the proceeds to support a gradual regeneration of the cashew tree stock, aimed at doubling production to 100,000 tons by 2005, as stipulated in the National Action Plan for the Reduction of Absolute Poverty (PARPA). However, the sector, which now accounts for less than 2 percent of export earnings, is suffering largely as a consequence of a sharp fall in world prices, which in 2001 were about half the average recorded in 1995-2000.

acceptance of Article VIII include controls on the use of domestic currency and on nonresidents' accounts; domiciliation requirements for the release of foreign exchange for imports; repatriation requirements on export proceeds; and controls on payments for and proceeds from invisible transactions and current transfers.

D. Other Structural Policies

37. **In line with the PARPA, other structural reforms continue to be geared to providing an enabling environment for private sector growth.** Reforms to be supported under the prospective EMPSO credit include further liberalization of the mobile and fixed-

line telecommunications markets through new tenders and a pro-competition telecommunications law; and privatization of the government's holdings in the national telecommunications company (TDM) and the national airline (LAM), complemented by new regulations to remove barriers to the free licensing of carriers. Restructuring of the national oil company (PETROMOC) is envisaged in 2003 to increase efficiency in the energy sector and alleviate budget costs.

38. **Reforms to build a more responsive and reliable judicial system that addresses governance and equity issues are key to the long-term success of the government's strategy.** The staff, therefore, expressed concerns over further delays in the completion of the integrated plan for judicial reform, while recognizing the complex consultation process that has involved all branches of the judicial sector and civil society. The government now intends to present a final integrated plan, including the operational plans of the four judicial branches, by September 2002. In addition, other actions have been taken: a money-laundering law has been approved; a new commercial code has been submitted to parliament; and the legal requirement that contracts be written in long hand has been ended.

39. **A comprehensive public sector reform continues to be an aim of the government.** It has established a technical unit (UTRESP) that is supporting the development of plans for a civil service that is more decentralized, efficient, better-qualified, and responsive to the society's needs. These plans interlink with and complement other existing reform programs, including the judicial reform project.

V. PROGRAM MONITORING, TECHNICAL ASSISTANCE, AND STATISTICAL ISSUES⁷

40. **Implementation of the program will be monitored by reference to quantitative and structural performance criteria and benchmarks,** as specified in Tables 3 and 4 of the MEFP (Appendix I, Attachment I), with supporting definitions and elaborations contained in the TMU (Appendix I, Attachment II). Provided the one-year extension of the arrangement is granted as requested, the fifth review under the PRGF arrangement is expected to be completed by the end of November 2002, at which time the conditions for the sixth and final disbursements would be specified.

41. **The government continues to attach priority to improving the accuracy, timeliness, and coverage of national statistics.** To this end, the government has requested participation in a data dissemination Report on Observance of Standards and Codes (ROSC) that is expected to be completed later this year. As laid out in Appendix IV, the government is addressing on several fronts multiple shortcomings in Mozambique's economic and social databases. With technical assistance from STA, the central bank began in 2001 the transition of its balance of payments statistics to the fifth edition of the *Balance of Payments Manual*

⁷ Mozambique is subject to the transitional procedures governing safeguards assessments (Box 6).

Box 6. Safeguards Assessment

Under its current arrangement with the Fund, Mozambique is subject to the transitional procedures governing safeguards assessments. These procedures require the Bank of Mozambique (BM) to demonstrate, by providing certain documentation to Fund staff, that it publishes annual financial statements that are independently audited in accordance with internationally accepted standards.

The staff reviewed the documentation provided and noted that the BM published annual financial statements were independently audited in accordance with internationally accepted auditing standards. The staff did, however, note certain vulnerabilities in the BM's external audit mechanism that should be resolved. In particular, the BM should improve its follow-up of auditor recommendations and should establish an audit committee to provide additional support for responsible financial disclosures, and for active oversight and monitoring of the internal and external audit mechanisms.

In addition, the staff identified certain weaknesses in other safeguards areas that raise concern about the control environment, especially in the areas of internal controls and financial reporting. The staff therefore also recommends that the BM submit to the Fund audited financial statements, related audit reports, management letters, and any special purpose reports that become available during 2002.

During the Article IV consultation discussions, the authorities indicated that they had made progress in establishing a detailed plan to implement the external auditor's recommendations. Moreover, the functions of the existing audit board are being broadened to cover the responsibilities of an audit committee that would conduct oversight of the internal and external audit mechanisms, as recommended in the safeguards assessment.

presentation, and this work is to be concluded during 2002. Mozambique has not yet completed the reserves template, though it has undertaken an exercise toward this objective in consultation with staff (see Appendix IV). A new household survey is to be completed in 2003 that will be the basis for a more representative consumer price index and a fuller analysis of recent trends in poverty.

42. **The authorities expressed their satisfaction with Fund technical assistance, which has been provided in most areas of Fund expertise,** often in close coordination with donors and other international agencies. They highlighted the importance of technical assistance in the key area of tax policy and administration, in particular as regards the successful implementation of the value-added tax (VAT). In the financial system, Fund technical assistance supported the successful introduction in 2001 of an automated check-clearing system and the resolution of problems with commercial banks; in previous years, moreover, it supported the update of prudential norms, training in off-site and on-site supervision, and the preparation of a new plan of accounts for commercial banks. The authorities stressed that they would like to continue this collaboration, as underscored by recent requests for advice on foreign exchange management, commercial bank restructuring,

banking supervision, public expenditure management, tax reform, and balance of payments statistics.

VI. MONITORING IMPLEMENTATION OF THE PRSP

43. To enhance monitoring of the implementation of the PARPA, the government is establishing with civil society participation a PARPA and poverty observatory. Building on existing procedures, the government has prepared reporting plans, with the first annual reports on the attainment of PARPA objectives to be presented to parliament in August 2002.⁸ Monitoring will primarily be done through quarterly, semiannual and annual reporting under the government's Social and Economic Plan (PES) at the national, provincial, and sectoral levels, and with wider public participation. Quarterly and annual budget execution reports using the new budget classifier will allow more comprehensive reporting on expenditures in the PARPA priority areas. Annual household inquiries will continue to measure changes in basic social and economic indicators. Looking further ahead, the results of a second full household survey, designed for comparability with the initial 1997 survey, are expected to be available in early 2003; these results should facilitate analysis of the links between the recent rapid growth and poverty reduction.

VII. STAFF APPRAISAL

44. **In 2001, Mozambique recovered from the effects of the 2000 floods and resumed the rapid growth that is essential to achieving the government's ambitious poverty reduction goals.** At the same time, the continued strong implementation of a broad-based reform agenda was underscored by observance of all performance criteria and all but one of the benchmarks under the 2001 Fund-supported program.

45. **However, it is essential to bring inflation under control to support sustained and equitable growth.** The pickup in prices reflected excessive money growth in late 2000 and early 2001, as well as the lagged effect of the resulting currency depreciation. The tightening of monetary policies in the second half of 2001 was, therefore, overdue, and, although there are welcome signs that inflationary pressure is abating, the authorities should persevere with the current policy to ensure a return to single-digit inflation this year. Improved coordination of fiscal and monetary policies will be essential and, in this regard, the staff urges the central bank to link its foreign exchange sales to the pace of externally financed budgetary spending. Such sterilization would help to contain inflationary pressures and, in the context of the central bank's flexible exchange rate policy, maintain external competitiveness.

46. **The strategy set out in the PARPA remains valid, although some adjustments have been required to the macroeconomic framework.** The inclusion of the costs of redeeming bonds issued for bank recapitalizations and the outlook for external assistance

⁸ The authorities intend this report to constitute also the first annual poverty reduction strategy paper (PRSP) progress report.

both underscore the need to ensure improved revenue mobilization. The staff encourages the authorities to continue working, with the help of a World Bank study, to incorporate the effects of HIV/AIDS into the framework.

47. **A number of the key issues in the banking system that dominated the policy debate in 2001 have now been resolved.** The sale of the BA to a reputable international bank has removed a major threat to the financial system and a serious obstacle to liquidity management. A strategy has been put in place for the efficient recovery of the BA loans that combines commercial banking procedures and the use of the government's strong executive powers. The authorities' commitment to include the results of the loan recovery effort in published quarterly budget execution reports is a welcome step toward ensuring transparency and accountability in this area. The envisaged launch of an investigation into the causes of the bank's difficulties will also help to provide important lessons and send a strong signal to avoid a recurrence of similar problems.

48. **With regard to the BCM, which merged with BIM in late 2001, some further recapitalization needs emerged.** These additional needs were significantly smaller than the recapitalization requirements that were met in 2000 and 2001. In light of the systemic importance of restoring compliance with the prudential ratios by the country's largest bank, the government has agreed to participate in the recapitalization in line with its minority shareholdings in the merged entity, and to sell those shareholdings as soon as feasible. The staff agrees on the strategy to give priority to the restoration of prudential requirements while minimizing the budgetary impact of the needed recapitalization. In any event, it will be important to design and implement the envisaged divestment of government's banking sector holdings as soon as possible.

49. **The emergence of an additional capital shortfall in BIM and the delays in ascertaining the banks' financial situation underscore the need to strengthen banking supervision.** In this regard, the staff welcomes the shift to the more frequent monthly reporting of data on compliance with prudential ratios; it also welcomes the authorities' commitment to rigorously apply penalties for the submission of incomplete or incorrect information and to follow through on technical assistance recommendations to start producing regular, standardized reports on all banks. The challenge ahead is to ensure that the powers of the supervision department are used to the fullest extent to guard against a recurrence of problems in the banking system. In this context, the staff urges the Bank of Mozambique to ensure that any instances of noncompliance with new regulations on connected lending are addressed without delay.

50. **The major reforms in tax policy and public expenditure management launched in 2001 are now well under way.** It is essential to ensure that the new tax regime enters fully into force at the beginning of 2003. Given the uncertainties inherent in the introduction of a new tax regime, the government should resist calls for lower income tax rates until and unless the intended increase of collections has firmly been established. Although considerably delayed, the recent approval of a new fiscal incentives code, stipulating more

transparent and equitable tax incentives, is also a welcome step to help bolster revenue collections over the medium-term.

51. **The publication of a new financial management law in early 2002 created the basis for greater transparency, efficiency, and accountability in all stages of the budgetary process.** Such improvements are particularly important with regard to allocating and tracking priority spending under the PARPA. Following the approval of the law, the government has embarked on the challenging task of designing and implementing a modern financial management system. The staff encourages the Ministry of Planning and Finance to assume a leading role in this process, while close involvement of other public institutions should help ensure broad support for the envisaged reforms.

52. **The government has recently approved a monitoring strategy for the PARPA that envisages the integration of progress reports on implementation into the budget process.** The staff considers this strategy to provide a good balance between relying on existing instruments, focusing on key indicators, and the need to enhance monitoring through greater participation. In this latter respect, the formal involvement of parliament through its request for periodic reports on implementation is particularly welcome. The staff encourages the authorities to include in this reporting the results of the forthcoming Poverty and Social Impact Assessment.

53. **The integrated strategic plan for judicial reform** is now expected to be completed only by September 2002. While the staff recognizes the difficulties involved in coordinating actions of independent institutions, the authorities should avoid further delays. Failure to move forcefully on justice reform could ultimately become a serious obstacle to the continued expansion of private investment and growth on which medium-term poverty reduction depends.

54. **The staff welcomes the priority given by the authorities to comprehensive public sector reform** and agrees that it will take many years to accomplish this complex task. However, the staff cautions that more attention should be paid to the potential pitfalls that may arise from an inappropriate sequencing of the many areas of reform that are currently envisaged. In particular, the staff recommends that the intended role of central government—and, thus, the implied human resource needs—be more clearly defined at an early stage of the reform process and as a precursor to salary reform.

55. **Following the attainment of the completion point under the enhanced HIPC Initiative, debt-management capacity needs to be strengthened** to ensure that existing external obligations are met and that the contraction of new debt is monitored and remains within the country's payments capacity. This strengthening will require improved coordination between the Ministry of Planning and Finance and the Bank of Mozambique, and the development of a debt strategy, including private external debt, in line with the country's medium-term financing requirements. The authorities should also continue to press for agreements with non-Paris Club and commercial creditors. In this regard, the staff urges the authorities to give further consideration to the establishment of an escrow account into

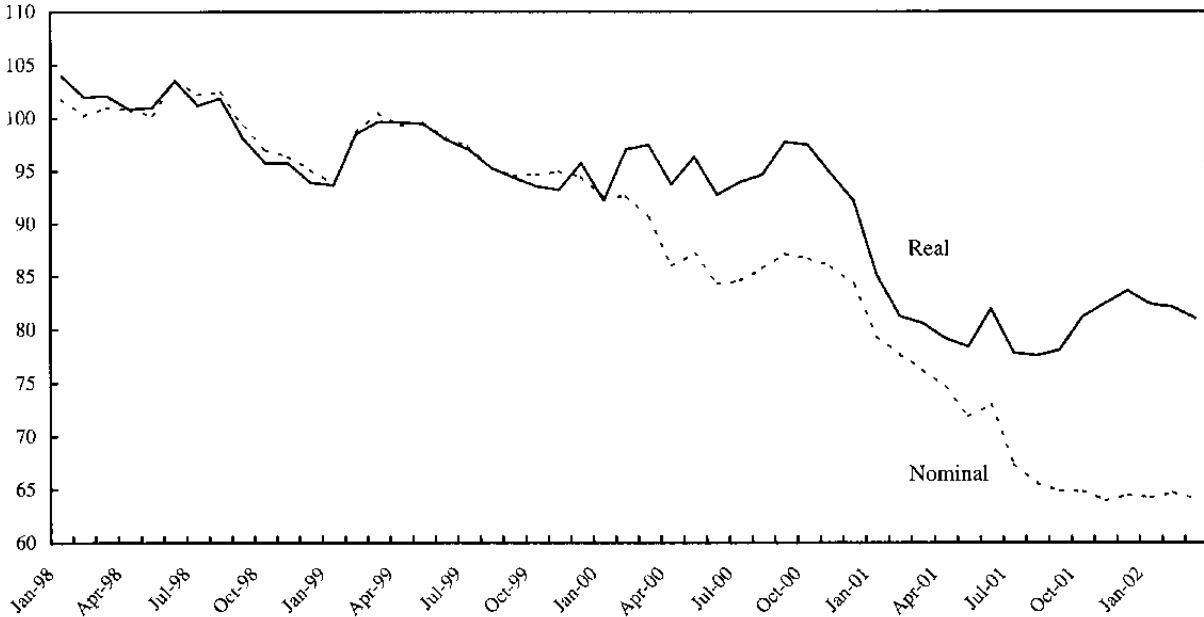
which post-HIPC Initiative debt-service payments would be made, pending agreements with these creditors.

56. **Improvements are needed in the quality and timeliness of Mozambique's statistical data.** The government's request to participate in a data dissemination ROSC is welcome, particularly as this should help to mobilize technical assistance to build capacity in the most critical areas.

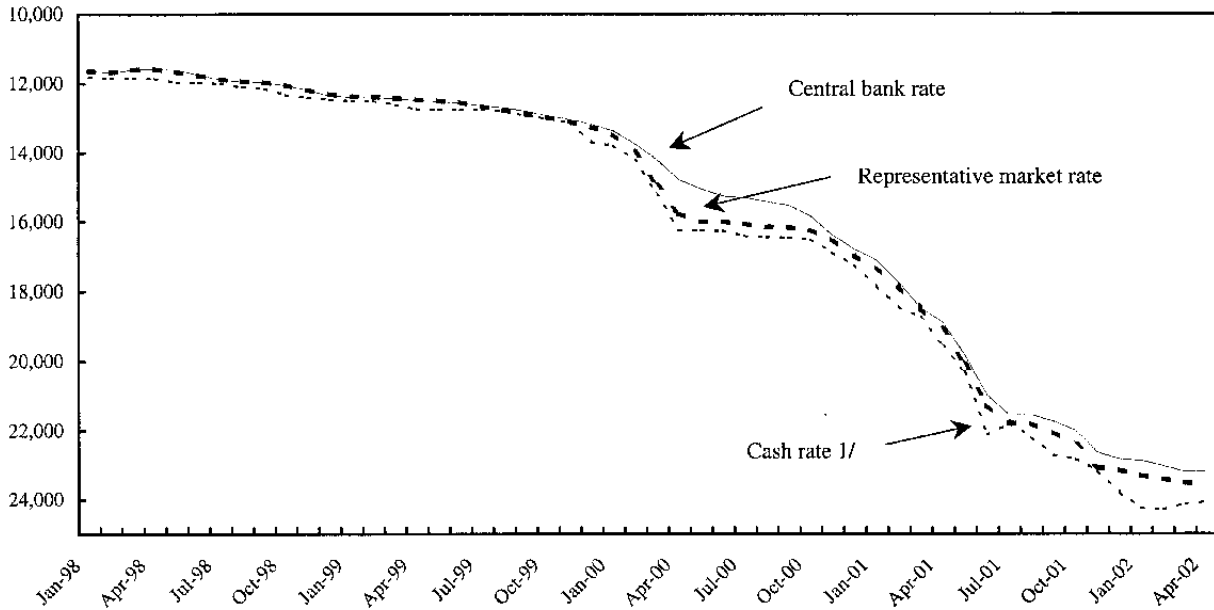
57. **The staff recommends the extension of the arrangement as requested by the authorities, and the completion of the fourth review.** It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Mozambique: Exchange Rates

Effective Exchange Rate, January 1998 - March 2002
(Index, 1998 = 100)



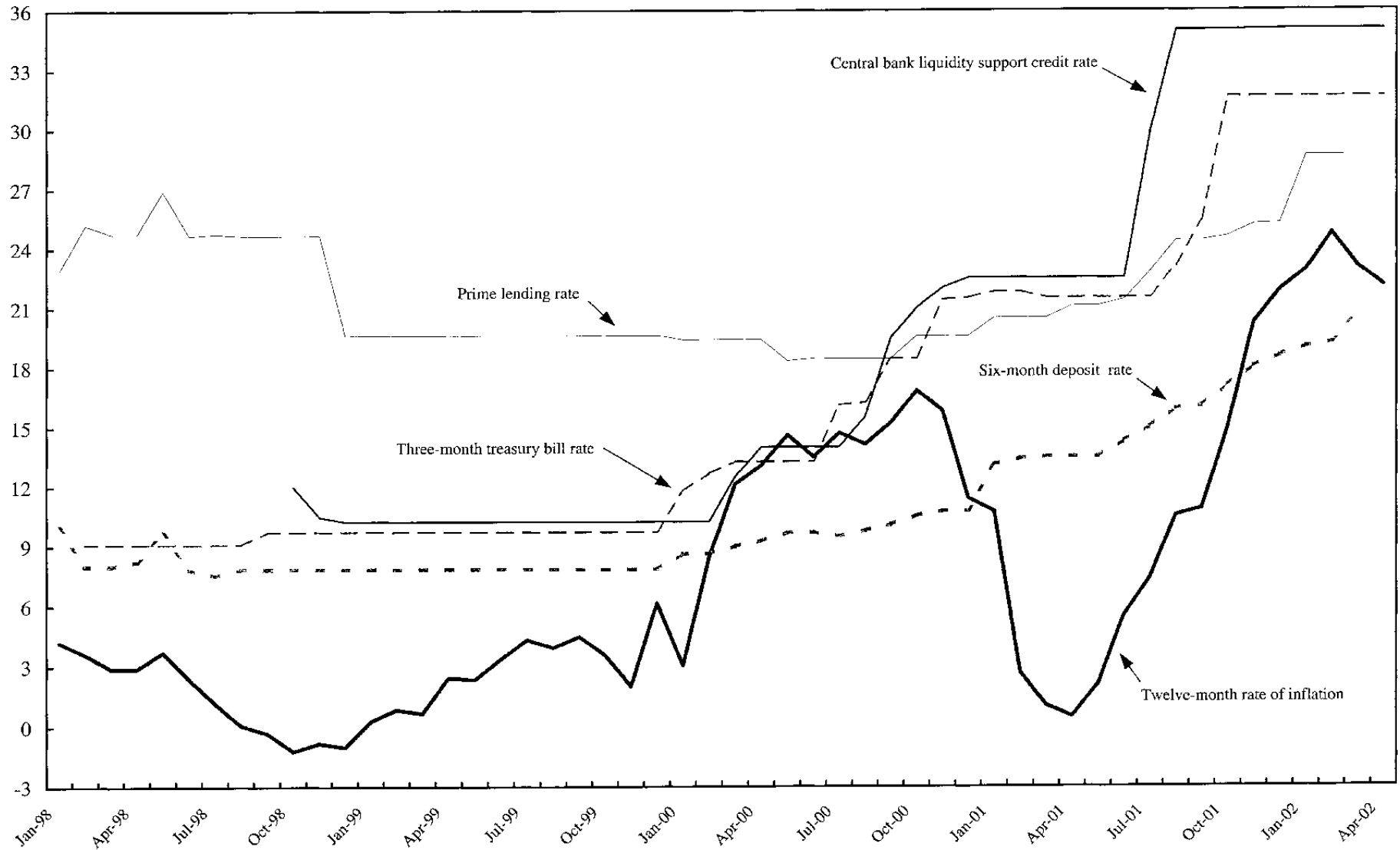
Parallel and Market Exchange Rates, January 1998 - April 2002
(Meticais per U.S. dollar; period average)



1/ A more depreciated rate for the metical is usually offered on cash denominations transacted without record by informal operators and some foreign exchange bureaus.

Sources: Mozambican authorities; and IMF, Information Notice System.

Figure 2. Mozambique: Inflation and Interest Rates, January 1998 - April 2002
(In percent)



Source: Mozambican authorities.

Table 1. Mozambique: Revised Phasing of Performance Criteria, Reviews, and Disbursements Under the PRGF Arrangement, 1999-2003

Date	Disbursements		Events
	Millions of SDRs	Percent of quota	
June 1999	8.4 (Disbursed)	7.4	Board approval of Poverty Reduction Growth Facility (PRGF) arrangement
September 1999	n.a.	n.a.	Test date for quantitative performance criteria ¹
March 2000	28.4 8.4 (Disbursed)	25.0 7.4	Approved augmentation of access Completion of first review
June 2000	n.a	n.a	Test date for quantitative performance criteria for third disbursement ¹
December 2000	8.4 (Disbursed)	7.4	Completion of second review and endorsement of annual program
December 2000	n.a	n.a	Test date for quantitative performance criteria for fourth disbursement ¹
September 2001	8.4 (Disbursed)	7.4	Completion of third review
December 2001	n.a	n.a	Test date for quantitative performance criteria for fifth disbursement ¹
June 2002	8.4	7.4	Completion of fourth review, endorsement of annual program, and request for extension of PRGF arrangement through June 2003.
<u>Upon extension of arrangement</u>			
June 2002	n.a	n.a	Test date for quantitative performance criteria for sixth disbursement ¹
November 2002	8.4	7.4	Completion of fifth review
December 2002	n.a	n.a	Test date for quantitative performance criteria for seventh disbursement ¹
May 2003	8.4	7.4	Completion of final review
Total	87.2	76.8	

¹ Structural performance criteria had or will have test dates at or near the same date as quantitative performance criteria.

Table 2. Mozambique: Selected Economic and Financial Indicators, 1999-2005

	1999	2000	2001		2002	2003	2004	2005
			Prog.	Outturn				
(Annual percentage change, unless otherwise specified)								
National income and prices								
Nominal GDP (in billions of meticaís)	51,915	58,905	70,178	74,675	95,151	106,447	125,167	144,422
Nominal GDP (in billions of U.S. dollars)	4.09	3.75	3.31	3.61	3.88	4.02	4.57	5.10
Real GDP	7.5	1.6	9.6	13.9	9.0	5.6	11.9	9.8
GDP deflator	2.9	11.7	6.6	11.3	16.9	6.5	5.0	5.0
Consumer price index (annual average)	2.9	12.7	5.1	9.0	16.6	6.5	5.0	5.0
Consumer price index (end of period)	6.2	11.4	7.0	21.9	8.0	5.0	5.0	5.0
External sector								
Merchandise exports (in U.S. dollars)	16.0	28.3	104.4	93.3	1.1	6.8	114.7	27.1
Merchandise imports (in U.S. dollars)	46.8	-3.1	16.8	-3.9	58.3	-1.7	-5.4	12.7
Terms of trade (in U.S. dollars)	-14.3	-2.8	0.9	5.8	3.5	2.1	1.0	0.7
Nominal effective exchange rate (end of period) 1/	-0.7	-10.8	...	-23.4	...	...	...	...
Real effective exchange rate (end of period) 1/	2.0	-3.7	...	-9.3	...	...	...	...
(Annual change in percent of beginning-period broad money, unless otherwise specified)								
Money and credit								
Net domestic assets	23.9	11.6	7.4	9.1	12.0	9.3	17.6	22.4
<i>Of which</i> : net credit to the government	0.0	4.1	2.4	5.3	7.0	-1.5	-1.2	-0.5
credit to the economy (in percent)	22.9	22.3	19.7	22.9	14.1	7.8	11.5	10.1
Broad money (M2)	35.1	42.4	19.0	29.7	19.2	11.9	17.6	15.4
Velocity (GDP/ average M2)	5.2	4.1	3.8	3.9	4.0	4.2	6.0	4.3
Prime rate (in percent; end of period)	19.6	19.6	...	25.3	...	...	...	...
(In percent of GDP)								
Investment and saving								
Gross domestic investment	36.9	39.6	31.6	41.6	57.7	54.1	33.3	29.9
Government	11.6	13.3	16.0	14.0	12.6	12.5	11.7	11.0
Other sectors	25.3	26.3	15.6	27.7	45.1	41.6	21.6	18.9
Gross national savings	19.3	26.9	15.3	31.1	28.8	30.9	27.3	27.0
Government	11.5	11.0	11.3	11.7	8.9	9.4	9.0	8.5
Other sectors	7.8	15.9	4.0	19.4	19.8	21.5	18.4	18.6
Current account, after grants	-17.5	-12.7	-16.3	-10.5	-28.9	-23.2	-6.0	-2.9
Government budget								
Total revenue	12.0	12.7	12.4	12.9	13.0	13.6	14.7	15.0
Total expenditure and net lending (incl. residual)	25.1	28.8	35.3	30.7	29.9	27.1	26.2	25.4
Overall balance, before grants	-13.2	-16.1	-23.0	-17.8	-16.9	-13.5	-11.4	-10.4
Total grants	11.7	11.6	14.1	12.9	10.1	10.0	8.3	7.5
Overall balance, after grants	-1.5	-4.5	-8.9	-4.9	-6.7	-3.4	-3.1	-2.9
Domestic primary balance	-3.4	-6.7	-10.1	-7.7	-6.1	-3.4	-2.8	-2.6
Excluding bank restructuring	-0.8	-5.0	-6.2	-5.6	-3.4	-3.4	-2.8	-2.6
External financing (incl. debt relief)	1.8	3.7	7.5	3.0	4.6	3.8	3.4	3.0
Domestic financing	-0.3	0.8	1.4	1.8	2.1	-0.4	-0.3	-0.1
(In percent of exports of goods and nonfactor services)								
Net present value of total external debt outstanding 2/	212.0	194.4	113.8	116.1	100.3	96.5	80.4	64.8
External debt service (nonfinancial public sector)								
Scheduled, after original HIPC Initiative assistance	15.3	5.5	4.4	5.8	8.1	8.0	6.2	5.0
Scheduled, after enhanced HIPC Initiative assistance	...	2.5	2.8	3.6	5.2	5.4	4.1	3.4
Scheduled, after additional bilateral assistance	...	...	2.7	3.5	4.1	4.3	3.4	2.9
(In millions of U.S. dollars, unless otherwise specified)								
External current account, after grants	-718	-478	-538	-380	-1,120	-934	-273	-146
Overall balance of payments	-236	-351	-425	-419	26	63	111	63
Gross international reserves (end of period)	669	746	729	727	733	788	880	917
In months of imports of goods and nonfactor services	5.5	5.8	5.5	6.4	4.4	4.8	5.6	5.2
In percent of broad money	75.5	76.2	83.9	77.9	73.5	73.1	71.8	67.2
Exchange rate (meticaís per U.S. dollar; end of period)	13,300	17,140	23,000	23,320	...	...	...	...
Use of Fund resources (in millions of SDRs)								
Purchases/disbursements	21.0	45.2	8.4	8.4	16.8	8.4	0.0	0.0
Repurchases/repayments, before HIPC Initiative assis	22.8	23.0	21.0	21.0	17.7	15.4	15.9	20.5
Credit outstanding	145.4	167.6	155.0	155.0	154.1	147.1	131.1	110.6

Sources: Mozambican authorities; and staff estimates and projections.

1/ A minus sign indicates depreciation.

2/ Public and publicly guaranteed, in percent of the three-year average of exports. The data for 1999-2000 include the impact of total debt relief grant original HIPC Initiative. Data for 2001-05 include the impact of total debt relief under the enhanced HIPC initiative, additional bilateral assistance, borrowing.

Table 3. Mozambique: Monetary Survey, December 1998 - December 2002

(In billions of meticaís, unless otherwise specified)

	1998 Dec.	1999 Dec.	2000 Dec.	2001				2002				
				June	September		December		Mar. Prel.	June Prog.	Sep. Prog.	Dec. Prog.
					Prog.	Outturn	Prog.	Outturn				
Central bank												
Net foreign assets	-1,973	-1,384	-99	1,451	-115	803	-115	1,764	2,234	2,186	2,352	2,137
(in millions of U.S. dollars)	-160	-104	-6	66	-5	36	-5	76	95	88	92	82
Net international reserves	5,214	6,242	9,015	11,517	12,166	11,000	12,096	12,440	13,033	13,538	14,034	14,040
(in millions of U.S. dollars)	422	469	526	525	526	496	526	533	552	546	550	540
Medium- and long-term foreign liabilities	-7,338	-7,819	-9,357	-10,390	-12,607	-10,527	-12,535	-10,964	-11,091	-11,768	-12,111	-12,224
Other	151	193	243	324	326	330	324	344	291	416	429	321
Net domestic assets	4,665	4,501	4,039	3,246	5,133	4,715	5,412	4,293	3,563	4,225	4,579	5,313
Credit to government (net)	-4,898	-5,175	-5,433	-5,645	-4,805	-5,121	-4,189	-4,581	-5,504	-4,886	-4,684	-4,482
Of which: Banco Austral related	...	...	...	...	...	...	...	678	1,078	1,078	1,078	1,078
Credit to banks (net)	454	408	483	1,604	650	1,096	300	476	575	575	575	575
Credit to the economy	75	74	1	1	1	1	1	0	1	1	1	1
Other items (net; assets +)	9,033	9,194	8,989	7,286	9,288	8,739	9,300	8,397	8,491	8,536	8,687	9,220
Reserve money	2,692	3,117	3,940	4,697	5,018	5,518	5,297	6,056	5,797	6,412	6,931	7,450
Currency outside banks	1,650	2,174	2,425	2,621	2,528	2,909	2,668	2,970	2,698	2,975	3,299	3,624
Bank reserves	1,042	943	1,515	2,076	2,489	2,609	2,629	3,086	3,098	3,437	3,632	3,826
Currency in banks	269	391	428	343	280	322	340	610	340	505	609	714
Deposits in meticaís	639	237	845	1,614	2,064	2,093	2,145	2,211	2,586	2,759	2,831	2,904
Required reserves (calculated)	530	710	1,246	1,456	2,054	2,285	2,135	2,386	2,540	2,734	2,806	2,879
Free reserves (calculated)	109	-473	-401	158	10	-192	10	-175	46	25	25	25
Deposits in foreign currencies	134	315	242	119	145	194	144	265	173	174	191	208
(in millions of U.S. dollars)	11	24	14	5	6	9	6	11	7	7	8	8
Deposit money banks (DMBs)												
Net foreign assets	1,721	2,109	4,449	5,815	5,633	6,077	6,405	6,046	6,320	6,722	7,009	7,235
(in millions of U.S. dollars)	139	159	260	265	243	274	278	259	268	271	275	278
Net domestic assets	5,350	7,502	9,904	11,111	10,966	12,118	10,893	12,747	13,851	14,165	14,594	15,084
Banks' reserves	1,310	1,013	1,545	2,245	2,489	2,783	2,629	3,307	3,137	3,437	3,632	3,826
Liabilities to central bank (net)	-337	-307	-959	-1,901	-904	-1,460	-554	-628	-534	-655	-655	-655
Credit to government (net)	-714	-441	296	1,281	1,236	677	-544	334	2,185	1,769	1,769	1,769
Of which: bank recapit. bonds (from Dec. 2001)	...	...	...	...	...	...	...	466	1,659	2,159	2,159	2,159
Credit to the economy	6,649	8,645	11,343	12,950	12,319	13,604	13,578	13,943	14,568	15,382	16,196	17,011
Of which: in foreign currency	1,918	2,934	4,350	4,823	5,248	5,133	5,206	5,405	5,382	5,915	6,361	6,760
(in millions of U.S. dollars)	155	221	254	220	227	231	226	232	228	239	249	260
Other items (net; assets +)	-1,559	-1,408	-2,321	-3,465	-4,174	-3,486	-4,216	-4,210	-5,505	-5,768	-6,349	-6,867
Of which: improvements in banks' capital	...	...	...	...	...	...	...	-1,123	-2,737	-3,237	-3,237	-3,237
Deposits	7,070	9,611	14,353	16,926	16,599	18,195	17,299	18,793	20,170	20,886	21,602	22,319
Demand and savings deposits	5,370	7,293	10,775	12,090	11,985	13,216	12,490	14,034	14,784	15,849	15,597	16,667
Time deposits	1,701	2,318	3,579	4,835	4,615	4,979	4,809	4,759	5,387	5,037	6,006	5,652
Monetary survey												
Net foreign assets	-253	725	4,350	7,266	5,517	6,880	6,291	7,810	8,553	8,908	9,361	9,372
Net domestic assets	8,973	11,059	12,429	12,281	13,610	14,224	13,676	13,954	14,315	14,953	15,540	16,571
Domestic credit	1,112	3,104	6,207	8,587	8,751	9,161	8,845	9,697	11,249	12,265	13,281	14,298
Credit to government (net)	-5,612	-5,616	-5,137	-4,364	-3,569	-4,444	-4,733	-4,246	-3,319	-3,117	-2,915	-2,713
Excluding bank recapitalization costs	...	...	...	...	...	...	...	...	-5,755	-6,332	-5,716	-5,099
Credit to the economy	6,725	8,720	11,344	12,951	12,319	13,605	13,578	13,944	-4,512	-5,503	-5,301	-5,099
Other items (net; asset +)	7,860	7,956	6,222	3,694	4,860	5,063	4,831	4,256	3,066	2,688	2,260	2,273
Of which: discrepancy in BoM/DMBs net claims	386	170	-446	-128	-254	-191	-254	79	80	80	80	80
Money and quasi money (M2)	8,720	11,785	16,779	19,547	19,128	21,104	19,967	21,763	22,868	23,861	24,901	25,942
Currency outside banks	1,650	2,174	2,425	2,621	2,528	2,909	2,668	2,970	2,698	2,975	3,299	3,624
Deposits	7,070	9,611	14,353	16,926	16,599	18,195	17,299	18,793	20,170	20,886	21,602	22,319
Of which: foreign currency deposits	3,045	4,151	7,107	9,361	9,650	9,799	9,614	9,897	9,853	10,567	11,107	11,554
(in millions of U.S. dollars)	246	312	415	427	417	442	418	424	417	426	435	444
Memorandum items:												
M2 growth (12-month percent change)	17.6	35.1	42.4	43.5	34.1	45.2	19.0	29.7	29.7	22.1	18.0	19.2
M2 growth at constant end-per. ex. rates (in percent)	14.8	31.7	29.3	25.0	12.0	26.1	3.9	12.5	16.6	14.9	10.3	13.3
Credit to the economy (12-month percent change)	24.4	29.7	30.1	29.5	26.9	30.8	19.7	22.9	21.9	18.8	19.0	22.0
Currency/M2 (in percent)	18.9	18.4	14.5	13.4	13.2	13.8	13.4	13.6	11.8	12.5	13.2	14.0
Velocity (GDP/average M2)	5.81	5.06	4.12	...	...	...	3.82	3.87	...	...	...	3.99
Market exchange rate (meticaís per U.S. dollar)	12,366	13,300	17,131	21,933	23,133	22,182	23,000	23,320	23,367	24,794	25,517	26,000

Sources: Bank of Mozambique (BoM); and Fund staff estimates and projections.

Table 4. Mozambique: Government Finances, 1999-2002

	1999	2000	2001 Prog.	2001 Prel.	2002					
					Budget	Prog. Q1	Actual Q1	Prog. Q2	Prog. Q3	Prog. Year
(In billions of meticaais)										
Total revenue	6,207	7,463	8,670	9,616	11,184	2,642	2,445	5,383	8,409	12,406
Tax revenue	5,733	6,857	7,824	8,589	10,110	2,335	2,281	4,853	7,612	11,208
Taxes on income and profits	867	1,008	1,190	1,498	1,665	337	366	717	1,142	1,969
Taxes on goods and services	3,638	4,331	5,126	5,379	6,092	1,510	1,438	3,133	4,898	6,888
<i>Of which : on petroleum products</i>	759				1,027	244	155	490	766	1,027
Taxes on international trade	1,046	1,297	1,212	1,477	2,112	423	405	854	1,357	2,011
Other taxes	183	221	296	235	240	65	72	149	216	340
Nontax revenue	474	606	846	1,027	1,074	307	164	530	797	1,198
Total expenditure and net lending	12,815	16,735	24,780	23,221	27,404	8,518	8,134	14,041	20,868	28,460
Current expenditure	6,332	7,836	10,699	10,489	13,051	3,359	2,861	6,197	9,936	13,581
Compensation to employees	2,995	3,844	5,002	4,898	6,032	1,097	1,098	2,462	4,074	6,042
Goods and services	1,928	1,976	3,129	2,883	3,151	1,446	1,146	2,104	3,196	3,333
Interest on public debt	324	118	538	478	1,133	267	95	510	810	1,430
Domestic	6	14	270	328	737	208	0	342	555	924
External	318	104	268	150	396	59	0	168	255	506
Transfer payments	1,085	1,664	2,030	2,230	2,734	549	522	1,121	1,856	2,776
Capital expenditure	6,001	7,826	11,210	10,428	11,557	2,509	3,525	5,141	8,099	11,984
<i>Of which : locally financed</i>	1,765	2,532	2,919	3,411	3,060	684	903	1,608	2,716	3,313
Net lending	482	1,073	2,871	2,304	2,797	2,650	1,748	2,704	2,834	2,895
<i>Of which : locally financed</i>	-6	914	2,686	2,304	2,627	2,607	1,748	2,619	2,706	2,725
Unallocated revenue (+)/expenditure (-) 1/	-220	-221	0	326	0	0	-197	0	0	0
Overall balance, before grants	-6,828	-9,493	-16,109	-13,279	-16,221	-5,876	-5,886	-8,658	-12,459	-16,054
Grants received	6,073	6,855	9,893	9,637	8,858	2,175	3,721	4,384	7,165	9,656
Project	2,787	3,810	5,653	5,985	6,112	1,102	1,938	2,513	4,169	6,463
Nonproject	3,287	3,045	4,239	3,652	2,746	1,073	1,783	1,871	2,996	3,193
Overall balance, after grants	-754	-2,638	-6,216	-3,642	-7,362	-3,700	-2,165	-4,274	-5,295	-6,398
Central bank transfer of HIPC assist. by the IMF	0	485	664	513	463	107	131	218	344	453
Net external borrowing	910	1,674	4,587	1,750	4,619	620	576	1,610	2,993	3,912
Disbursements	1,394	1,956	5,241	2,203	5,584	723	684	1,820	3,278	4,271
Project	1,394	1,484	2,637	1,032	2,385	723	531	1,020	1,214	2,208
Nonproject	0	472	2,604	1,171	3,198	0	153	800	2,063	2,063
Cash amortization	-483	-282	-655	-453	-965	-103	-108	-210	-284	-359
Net domestic financing	-156	479	965	1,379	2,281	2,973	952	2,446	1,957	2,032
Net bonds issued for bank restructuring	0	745	1,945	700	2,390	2,190		2,190	2,190	2,030
Other	-156	-266	-980	679	-109	783		256	-233	2
Memorandum items:										
Domestic primary balance, before grants 2/	-1,780	-3,923	-7,096	-5,785	-6,420	-3,742	-3,169	-4,531	-6,139	-5,784
Excluding bank restructuring net lending	-1,780	-2,969	-4,351	-4,200	-3,869	-1,186	-1,578	-1,971	-3,579	-3,224
Bank restructuring net lending	0	954	2,745	1,585	2,551	2,556	1,591	2,560	2,560	2,560

Table 4. Mozambique: Government Finances, 1999-2002 (concluded)

	1999	2000	2001 Prog.	2001 Prel.	2002 Budget	2002 Prog.
(In percent of GDP, unless otherwise indicated)						
Total revenue	12.0	12.7	12.4	12.9	12.8	13.0
Tax revenue	11.0	11.6	11.1	11.5	11.6	11.8
Taxes on income and profits	1.7	1.7	1.7	2.0	1.9	2.1
Taxes on goods and services	7.0	7.4	7.3	7.2	7.0	7.2
Taxes on international trade	2.0	2.2	1.7	2.0	2.4	2.1
Other taxes	0.4	0.4	0.4	0.3	0.3	0.4
Nontax revenue	0.9	1.0	1.2	1.4	1.2	1.3
Total expenditure and net lending	24.7	28.4	35.3	31.1	31.4	29.9
Current expenditure	12.2	13.3	15.2	14.0	14.9	14.3
Compensation to employees	5.8	6.5	7.1	6.6	6.9	6.3
Goods and services	3.7	3.4	4.5	3.9	3.6	3.5
Interest on public debt	0.6	0.2	0.8	0.6	1.3	1.5
Domestic	0.0	0.0	0.4	0.4	0.8	1.0
External	0.6	0.2	0.4	0.2	0.5	0.5
Transfer payments	2.1	2.8	2.9	3.0	3.1	2.9
Capital expenditure	11.6	13.3	16.0	14.0	13.2	12.6
<i>Of which</i> : locally financed	3.4	4.3	4.2	4.6	3.5	3.5
Net lending	0.9	1.8	4.1	3.1	3.2	3.0
<i>Of which</i> : locally financed	0.0	1.6	3.8	3.1	3.0	2.9
Unallocated revenue (+)/expenditure (-) 1/	-0.4	-0.4	0.0	0.4	0.0	0.0
Overall balance, before grants	-13.2	-16.1	-23.0	-17.8	-18.6	-16.9
Grants received	11.7	11.6	14.1	12.9	10.1	10.1
Project	5.4	6.5	8.1	8.0	7.0	6.8
Nonproject	6.3	5.2	6.0	4.9	3.1	3.4
Overall balance, after grants	-1.5	-4.5	-8.9	-4.9	-8.4	-6.7
Central Bank transfer of HIPC assistance by the IMI	0.0	0.8	0.9	0.7	0.5	0.5
Net external borrowing	1.8	2.8	6.5	2.3	5.3	4.1
Disbursements	2.7	3.3	7.5	2.9	6.4	4.5
Project	2.7	2.5	3.8	1.4	2.7	2.3
Nonproject	0.0	0.8	3.7	1.6	3.7	2.2
Cash amortization	-0.9	-0.5	-0.9	-0.6	-1.1	-0.4
Net domestic financing	-0.3	0.8	1.4	1.8	2.6	2.1
Net bonds issued for bank restructuring	0.0	1.3	2.8	0.9	2.7	2.1
Other	-0.3	-0.5	-1.4	0.9	-0.1	0.0
Memorandum items:						
Domestic primary balance, before grants 2/	-3.4	-6.7	-10.1	-7.7	-7.4	-6.1
Excluding bank restructuring net lending	-3.4	-5.0	-6.2	-5.6	-4.4	-3.4
Total expenditure in education	3.5	5.4	6.0	6.5	5.1	4.9
Total expenditure in health	2.9	3.5	3.2	3.0	3.9	3.7
Current expend. on defense and security	2.4	2.4	2.6	2.3	2.4	2.2
Nominal GDP (in billions of meticaís)	51,915	58,905	70,178	74,675	87,308	95,151

Sources: Mozambican authorities; and Fund staff estimates and projections.

1/ Residual discrepancy between identified sources and uses of funds.

2/ Revenue minus noninterest current expenditure minus locally financed capital expenditure and locally financed net lending. Unallocated revenue and expenditure are included in the primary balance.

Table 5. Mozambique: Expenditure in PARPA Priority Sectors, 1999-2002 1/
(In billions of meticaís, unless otherwise indicated)

	1999	2000	2001	2002 Prog.
Total expenditure, excluding bank restructuring costs	12,815	15,781	21,636	25,900
Interest payments on public debt	324	118	478	1,430
Total expenditure (excluding bank restruct. costs + interest payments)	12,491	15,663	21,158	24,470
Total actual/budgeted expenditure in PARPA priority sectors (1)	6,895	10,798	14,006	16,397
(in percent of GDP)	13.3	18.3	18.8	17.2
(in percent of total expenditure, excluding bank restruct. costs + interest payments)	55.2	68.9	66.2	67.0
Education	1,795	3,157	4,890	4,689
Primary	1,410	2,744	3,891	4,050
Postsecondary	384	414	999	639
Health	1,493	2,038	2,235	3,491
HIV/AIDS	0	6	132	212
Infrastructure development	1,481	2,490	3,621	4,444
Roads	...	...	1,845	2,293
Sanitation and public works	...	...	1,776	2,151
Agriculture and rural development	583	994	730	832
Governance and judicial system	991	1,244	1,704	1,921
Security and public order	722	843	1,095	1,246
Governance	60	142	249	212
Judicial system	209	258	359	463
Other priority areas 2/	552	869	694	807
Social actions	69	180	160	199
Labor and employment	55	56	79	144
Mineral resources and energy	428	634	455	465
Assumed baseline expenditure in PARPA priority sectors (2) 3/	6,895	7,823	9,918	12,637
(in percent of GDP)	13.3	13.3	13.3	13.3
Education	1,795	2,036	2,581	3,289
Primary	1,410	1,600	2,029	2,585
Postsecondary	384	436	553	704
Health	1,493	1,694	2,148	2,737
HIV/AIDS	0	0	0	0
Infrastructure development	1,481	1,680	2,130	2,714
Agriculture and rural development	583	662	839	1,069
Governance and judicial system	991	1,124	1,425	1,816
Security and public order	722	819	1,038	1,323
Governance	60	68	86	110
Judicial system	209	237	301	383
Other priority areas 2/	552	626	794	1,012
Social actions	69	78	99	126
Labor and employment	55	63	79	101
Mineral resources and energy	428	485	615	784
Additional expenditure in PARPA priority sectors (3) = (1)- (2)	...	2,975	4,089	3,760
(in percent of GDP)	...	5.1	5.5	4.0
Education	...	1,121	2,309	1,400
Primary	...	1,143	1,862	1,465
Postsecondary	...	-22	446	-65
Health	...	344	87	755
HIV/AIDS	...	6	132	212
Infrastructure development	...	809	1,491	1,730
Agriculture and rural development	...	332	-109	-237
Governance and judicial system	...	120	279	105
Security and public order	...	24	57	-77
Governance	...	74	163	103
Judicial system	...	21	59	80
Other priority areas 2/	...	243	-100	-204
Social actions	...	102	60	73
Labor and employment	...	-7	0	42
Mineral resources and energy	...	148	-160	-319

1/ PARPA stands for National Action Plan for the Reduction of Absolute Poverty, which is the Portuguese acronym for the Poverty Reduction Strategy Paper (PRSP).

2/ Relates to expenditures viewed complementary to PARPA priority areas and which contribute to income generation and employment opportunities.

3/ Maintaining constant share in GDP from 1999 base.

Table 6. Mozambique: Balance of Payments, 1999-2007
(In millions of U.S. dollars, unless otherwise specified)

	1999	2000	2001		2002	2003	2004	2005	2006	2007
			Program	Estimate						
Trade balance	-916	-798	-608	-414	-1,058	-979	-13	220	191	141
Exports, f.o.b.	284	364	744	704	711	759	1,630	2,072	2,234	2,285
Large projects	76	127	487	441	424	446	1,286	1,692	1,818	1,829
Other exports	208	237	257	263	287	313	345	380	416	457
Imports, c.i.f.	-1,200	-1,162	-1,352	-1,117	-1,769	-1,738	-1,644	-1,852	-2,044	-2,144
Large projects	-514	-118	-391	-200	-781	-684	-467	-564	-671	-703
Other imports	-685	-1,044	-961	-918	-987	-1,054	-1,176	-1,288	-1,373	-1,441
Services (net)	-236	-243	-376	-436	-502	-405	-687	-798	-971	-1,021
Receipts	356	405	374	348	360	379	391	406	423	441
Expenditures	-592	-648	-750	-784	-862	-783	-1,078	-1,203	-1,393	-1,462
<i>Of which</i> : interest on public debt	-162	-161	-146	-147	-32	-17	-18	-19	-20	-20
Current account, before grants	-1,152	-1,042	-984	-850	-1,560	-1,384	-701	-578	-780	-880
Unrequited official transfers	434	564	446	469	440	450	428	432	421	418
<i>Of which</i> : multilaterals' HIPC assistance grants	...	...	...	...	48	46	47	51	50	47
Current account, after grants	-718	-478	-538	-380	-1,120	-934	-273	-146	-359	-462
Capital account	613	279	131	0	1,188	997	384	209	402	493
Foreign borrowing	472	484	374	210	664	684	341	291	435	507
Public	112	162	239	104	171	160	160	160	160	160
Private 1/	360	322	135	106	493	524	181	131	275	347
Amortization	-240	-344	-396	-392	-120	-161	-163	-199	-210	-223
Public	-201	-306	-306	-306	-32	-40	-42	-45	-46	-49
Private	-40	-38	-90	-86	-87	-121	-121	-155	-164	-173
Direct investment (net)	382	139	153	183	644	475	206	118	178	209
Short-term capital and errors and omissions (net)	-131	-153	-18	-38	-61	0	0	0	0	0
Overall balance	-236	-351	-424	-419	7	63	111	63	44	31
Financing	-808	-98	0	-7	-7	-63	-111	-63	-44	-31
<i>Of which</i> : Bank of Mozambique net international reserves (increase -)	-47	-98	0	-7	-7	-63	-111	-63	-44	-31
Financing gap before debt relief	1,044	449	425	425	0	0	0	0	0	0
Memorandum items:										
Debt relief 2/	1,044	449	425	425	416	404	351	292	166	149
Current account deficit (percent of GDP)										
Before grants	28.2	26.8	29.8	23.6	39.0	34.4	15.3	11.3	14.1	14.9
After grants	17.5	11.8	16.3	10.5	28.9	23.2	6.0	2.9	6.5	7.8
After grants, excluding large projects	4.2	8.2	10.3	7.9	6.1	5.3	7.3	8.0	8.4	8.3
Gross international reserves	669	746	729	727	733	788	880	917	930	932
In months of imports	5.5	6.1	5.5	6.4	4.4	4.8	5.6	5.2	4.8	4.6
In months of imports, excl. large projects	8.5	6.9	7.4	7.5	7.2	7.3	7.4	7.1	6.8	6.5
Debt Indicators										
NPV debt/GDP	19.8	24.6	27.7	25.3	24.1	25.3	24.2	23.5	23.3	23.1
NPV debt/exports	212.0	194.4	113.8	116.1	100.3	96.5	80.4	64.8	54.7	52.8
NPV debt/revenue	165.4	193.9	224.0	196.2	184.9	185.7	164.4	156.6	152.9	149.3
Debt service due/exports	15.3	9.1	2.7	3.5	4.1	4.3	3.4	2.9	2.6	2.5
Debt service due/revenue	17.5	9.4	7.2	5.8	7.5	8.4	6.9	7.0	7.2	7.1

Sources: Mozambican authorities; and staff estimates and projections.

1/ Private borrowing, not guaranteed by the government or the Bank of Mozambique.

2/ The BOP presentation changes in 2002: debt relief is incorporated above the line so that debt service to official bilateral and commercial creditors reflects what is owed after relief. Debt service to multilaterals is still shown before debt relief, but with HIPC assistance grants a new entry under

Table 7. Mozambique: External Financing Requirements and Sources, 1999-2007
(In millions of U.S. dollars)

	1999	2000	2001 Estimate	2002 Program	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
External financing requirements	2,360	1,696	1,297	1,768	1,619	975	840	1,034	1,134
Current account, excluding grants	1,152	1,042	850	1,560	1,384	701	578	780	880
Amortization 1/	272	373	420	141	180	183	225	242	251
Changes in arrears (increase -)	762	0	0	0	0	0	0	0	0
Changes in reserves (increase +) 2/	44	129	-10	6	55	92	37	13	2
Short-term capital and E&O (net; outflow +) 3/	131	153	37	61	0	0	0	0	0
Total identified financing	1,317	1,247	872	1,768	1,619	975	840	1,034	1,134
Disbursements from existing and new commitments	935	1,108	690	1,124	1,144	769	723	856	925
Grants 4/	434	564	469	440	450	428	432	421	418
Loans	501	544	220	685	695	341	291	435	507
Bilateral	0	0	0	0	0	0	0	0	0
Multilateral 1/	140	222	115	192	170	160	160	160	160
IDA	79	125	33	110	158	135	141	115	106
IMF	29	60	11	21	11	0	0	0	0
Other	33	37	71	61	2	25	19	45	54
Private sector	360	322	106	493	524	181	131	275	347
Direct foreign investment	382	139	183	644	475	206	118	178	209
Debt relief 5/	1,044	449	425	0	0	0	0	0	0
Memorandum items									
Total Reduction in Debt Service Due (Debt Relief) 6/	1,044	449	425	416	404	351	292	166	149
Assistance on traditional mechanisms	972	299	282	286	270	216	156	35	19
Assistance under the original HIPC Initiative	51	104	99	93	95	96	96	91	89
Assistance under the enhanced HIPC Initiative	0	10	17	27	27	28	30	31	32
Assistance under additional bilateral	0	0	1	10	11	10	10	10	9
Paris Club deferral (flood relief)	21	37	26	0	0	0	0	0	0
Remaining gap	0	0	0	0	0	0	0	0	0

Sources: Mozambican authorities; and staff estimates and projections.

1/ Including the Fund.

2/ Excluding the Fund.

3/ Including commercial banks accumulation of net foreign assets.

4/ Includes IDA interim assistance under the original HIPC Initiative in 1999 (US\$150 million).

5/ Includes the 1996 Paris Club flow rescheduling on Naples terms; the rescheduling of the debt to Russia after an up-front discount of 80 percent; the 1997 commercial debt rescheduling with the Bank of Brazil; total assistance under the HIPC Initiative; the Paris Club deferral; and the application of traditional rescheduling mechanisms by non-Paris Club creditors.

6/ Since debt relief is no longer shown as a below-the-line item once a country passes its completion point, the memorandum items provide the data on debt relief after 2001.

June 3, 2002

Dear Mr. Köhler:

1. The Executive Board of the Fund approved a three-year Poverty Reduction and Growth Facility (PRGF) arrangement for Mozambique on June 28, 1999. The attached memorandum of economic and financial policies describes progress under the government's reform program for the year 2001 and sets out the objectives and policies that it intends to pursue during 2002. On this basis, the government requests that the fifth loan under the PRGF arrangement in an amount equivalent to SDR 8.4 million be disbursed following the completion of the fourth review under the arrangement, and further requests that the period of the PRGF arrangement be extended for 12 months to allow time for the completion of the remaining reviews and related disbursements envisaged under the arrangement.
2. The Government of Mozambique will provide such information as the Fund requests in connection with the progress made in implementing the economic and financial policies and achieving the objectives of the program.
3. The Government of Mozambique believes that the policies and measures set out in the attached memorandum are adequate to achieve the objectives of its program and will take any further measures that may become appropriate for this purpose. During the remaining period of the arrangement, including the period of the requested extension, Mozambique will continue to consult with the Managing Director on the adoption of any measures that may be appropriate, at the initiative of the government or whenever the Managing Director requests such a consultation. Moreover, after the period of the PRGF arrangement and while Mozambique has outstanding financial obligations to the Fund arising from loans under the arrangement, the government will consult with the Fund from time to time, at the initiative of the government or whenever the Managing Director requests consultation on Mozambique's economic and financial policies.
4. The Government of Mozambique will conduct with the Fund the fifth review of the three-year PRGF arrangement not later than end-November 2002, based on quantitative and structural performance criteria for end-June 2002 and end-July 2002, respectively.

Sincerely yours,

/s/

Luisa Dias Diogo
Minister of Planning and Finance

/s/

Adriano Afonso Maleiane
Governor
Bank of Mozambique

Attachment

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

**Memorandum of Economic and Financial Policies
of the Government of Mozambique for 2002**

I. RECENT DEVELOPMENTS AND PROGRAM IMPLEMENTATION

1. The Government of Mozambique presents this memorandum in support of its request for the fifth loan disbursement under the Poverty Reduction and Growth Facility (PRGF) arrangement for Mozambique approved by the Executive Board of the Fund on June 28, 1999. The economic and financial policies and related structural reforms here described are intended to secure the stable macroeconomic framework that is critical to sustained growth and poverty reduction, as underscored in the government's National Action Plan for the Reduction of Absolute Poverty (PARPA) which was presented in 2001 as Mozambique's poverty reduction strategy paper (PRSP) in the context of the PRGF-supported program.

2. The Mozambican economy has recovered strongly from the devastating 2000 floods, which limited growth to under 2 percent. Aided by the first full year of production of the MOZAL aluminum smelter, and buoyant agricultural production and construction activity, growth is estimated to have reached 13.9 percent in 2001. The current account of the balance of payments narrowed from 11.8 percent of GDP in 2000 (excluding grants and large projects) to 10.7 percent of GDP in 2001, and gross international reserves of the Bank of Mozambique (BM) increased to US\$727 million, or the equivalent of six months of imports of goods and services. However, price developments were less favorable; after declining early in 2001, the 12-month rate of inflation increased very sharply in the last quarter of the year, reaching 22 percent in December.

3. Implementation of the economic policies set out in the PARPA was supported by the observance of all of the quantitative performance criteria through December 2001 established under the PRGF arrangement (Table 1). The fiscal outturn for 2001 was stronger than programmed as regards both revenue (0.5 percentage point of GDP higher) and expenditure (4.2 percentage points lower). The revenue gains were generated by income and international trade taxes, reflecting continued improvements in coverage of taxable transactions. Expenditure shortfalls were recorded mainly in capital investment 2.0 percent of GDP, owing to lower-than-envisaged external project assistance. In response to large and unexpected delays in disbursements of external budget support in the latter part of 2001, the government resorted to cash control of current expenditure. As a result, wage payments and expenditure in goods and services were 0.5 percent and 0.6 percent of GDP lower than programmed respectively. The domestic primary balance deficit (excluding bank restructuring net lending) was 5.6 percent of GDP, compared with the program target of 6.2 percent, and in nominal terms it remained well below the performance criterion for end-2001.

4. The performance criteria on the net domestic assets and net international reserves of the BM were observed—the latter by a large margin. However, reserve money continued to exceed the program benchmark. Following a period of sustained pressure on the metical, the BM acted to tighten liquidity conditions. Reserve requirements calculated over each two-

week period were increased by 3.5 percentage points to 11.5 percent with effect from July 2001, and the interest rate on liquidity support operations (*facilidade permanente de cedência*) was increased to 35 percent and maintained above the treasury bill rate. Although pressure on the exchange rate rapidly abated, the 12-month rate of broad money growth remained in excess of 40 percent through October. The impact of larger reserve requirements was partially offset by incomplete compliance with reserve requirements, especially by Banco Austral (BA), and by a shift in government deposits from the central bank to commercial banks. In response to these difficulties, the BM has tightened the enforcement of reserve requirements, issued new regulations to increase penalties for noncompliance, and introduced a daily minimum requirement of 10 percent. In addition, the BM placed higher volumes of treasury bills in the market and gradually increased its sales of foreign exchange to sterilize the liquidity impact of government expenditures financed with external budget support. These measures have begun to improve monetary control, with the 12-month rate of broad money growth declining from 43 percent in June 2001 to 30 percent in March 2002.

5. After averaging over 3 percent per month in the final quarter of 2001, the monthly increase in the consumer price index slowed to an average of under 0.2 percent per month in the first four months of 2002. However, the 12-month rate of inflation stood at 22 percent in April 2002. The metical has remained broadly stable vis-à-vis the U.S. dollar since October 2001. As a result of this stability, the recent sharp depreciation in the South African rand, and the higher rates of inflation in Mozambique, the 12 percent depreciation of the trade-weighted real effective exchange rate during the first half of 2001 has been largely reversed.

6. Further progress was made in the implementation of structural reforms in tax policy and public expenditure management (Table 2). The new income tax law (*lei de bases do sistema tributário*), which rationalizes corporate and personal income taxes and broadens the tax base, was submitted to the parliament in December (a performance criterion), and preparations are under way, with external assistance, for its implementation in time for its full application to 2003 incomes. Adoption of a new code of fiscal incentives, which establishes standard concessions for foreign investors (including transparent rules for investors in large projects) was delayed, pending the approval of the new income tax law. Although a draft was completed in May 2001, further rounds of consultations were held and the code will come into force in June 2002 (a performance criterion). Steps to improve tax administration included the launching of a large taxpayer unit in Maputo in December 2001 (a structural benchmark). The budget for 2002 was prepared using the new expenditure classification that will, inter alia, allow for a more detailed reporting of priority social spending. A new public financial management law, which, building on the results of the fiscal transparency assessment (ROSC) establishes the basis for fundamental improvements in public expenditure management (PEM), was approved by the parliament in October 2001. Work has now begun on the long and challenging process of implementing these reforms in PEM throughout government.

7. Difficulties in the financial sector came to the fore in 2001 after private shareholders in the insolvent BA refused to participate in its recapitalization. The government purchased

the BA for US\$1 and the central bank took control of the bank in April, appointing interim management to prepare the bank for reprivatization. At the end of December 2001, the BA was successfully sold to Amalgamated Banks of South Africa (ABSA). The final costs of recapitalizing the bank will depend on a further review of the bank's assets, to be completed by July. The net cost to the government of the BA sale is currently estimated at US\$107 million, which corresponds to the sale price of US\$10 million, net of the costs of recapitalization. In addition, the government is assuming the cost of pension obligations, which, subject to an actuarial review, are estimated at Mt 497 billion. Since the central bank's intervention in the BA in April 2001, delinquent loans in the amount of Mt 102 billion have been recovered as of end-December 2001.

8. Banco Comercial de Moçambique (BCM) was recapitalized in late 2000 and March 2001, on the basis of the bank's 1999 accounts. The size of this capital injection, including government's participation pro rata to its 49 percent shareholding, was in line with the amounts established in the program. However, a further capital deficiency later became apparent and the audited accounts for December 2000, which were received by the BM in August 2001, indicated that the recapitalization had not been large enough to cover losses incurred in 2000. Resolution of this capital deficiency was delayed by the merger of BCM with Banco Internacional de Moçambique (BIM), which took place in November 2001. The BM initially established a deadline of end-March 2002 for the recapitalization, which was subsequently extended to end-April to allow additional time to ascertain the reasons for the capital shortfall and establish safeguards to limit the potential for further losses.

9. With assistance from the Fund and the World Bank, steps have been taken to strengthen banking supervision. In line with program benchmarks, regulations were issued in October 2001 to commence consolidated supervision of related financial institutions, and, in October, regulations on connected lending were tightened by lowering limits on bank lending to shareholders and board members. In line with priorities identified in the context of discussions with World Bank staff on a new Economic Management and Public Sector Operation (EMPSO), the BM also tightened in March 2002 licensing requirements for financial institutions by significantly raising the minimum own capital requirements (in the case of banks, from the equivalent of US\$800,000 to US\$2.7 million); at the same time, it issued guidelines on the role of its banking supervision department, reiterating the central bank's regulatory powers and referencing the relevant legislation.

10. Progress has been made towards the development of a strategic plan for the reform of the whole justice system, although the government regrets that this was not completed as had been expected by end-2001. A draft of the strategic plan was provided to the staff of the World Bank in February 2002; adoption of the final plan will form a condition for the release of the second tranche of the proposed EMPSO credit from IDA. A draft of the operational plan for the reform of the Ministry of Justice, consistent with the integrated plan for the entire system, was also completed in February 2002. The corresponding operational plans for the other three branches of the system—the Supreme Court, the Administrative Court and the Attorney-General—will be drafted by end-June 2002 and finalized by end-September 2002. The Commercial Code, which was drafted during 2001, and which subsequently went

through a consultation process with civil society and the private sector, has been submitted to parliament where it will be debated shortly.

II. THE MEDIUM-TERM CONTEXT

11. As established in the PARPA, the government's key medium-term objectives are (i) the reduction of absolute poverty; (ii) the attainment of high and sustainable growth through the creation of an enabling environment for the private sector; (iii) the reduction of regional inequalities; and (iv) the consolidation of peace, national unity, and democracy. Achievement of these objectives will be supported, *inter alia*, by the maintenance of a stable macroeconomic environment. As described below, the government is drawing upon processes already in place to ensure comprehensive monitoring of the implementation of the PARPA with the participation of interested parties, including parliament.

12. The medium-term strategy elaborated in the PARPA calls for fiscal consolidation, including a widening of the tax base, to facilitate a reduction in foreign aid dependency and safeguard fiscal and debt sustainability. At the same time, this strategy will help to ensure that inflows of external assistance remain within the country's absorptive capacity and do not generate adverse macroeconomic consequences. While this broad strategy remains appropriate, some revisions to the macroeconomic framework will be required to take account of new developments. In particular, one of the envisaged large foreign private investments (or megaprojects), the Maputo Iron and Steel Project, which was due to begin construction in 2002, has been put on hold in the wake of the bankruptcy of its largest participant, Enron. As was recognized in the PARPA, further work is needed to assess the macroeconomic impacts of HIV/AIDS; this is continuing with the assistance of the World Bank and will be incorporated into revisions of the medium-term expenditure framework later this year.

13. In line with the strategy in the PARPA, the medium-term framework envisages a continuation of rapid growth at an average annual rate of 8 percent through 2010, with inflation declining to a range of 5 to 7 percent. In support of these objectives, and taking into account an expected gradual decline in external assistance over the medium term, the primary fiscal deficit (excluding bank restructuring costs) would be reduced from 5.6 percent in 2001 to 2.5 percent in 2005. As a result, the government would be able to avoid recourse to domestic borrowing while at the same time meeting the cost of the redemption of bonds issued for bank recapitalization. Improvements in domestic resource mobilization, especially through the new income tax regime, increased revenues from megaprojects, and more effective use of government spending, will be key to ensuring that these objectives can be maintained while meeting the expenditure priorities set out in the PARPA. Improvements in public savings are also expected to contribute to a gradual reduction in the current account deficit from under 24 percent of GDP in 2001 to about 11 percent in 2005 (excluding grants). At the same time, the net present value (NPV) of Mozambique's external debt, which is estimated to have declined to about 116 percent of exports in 2001 as a result of debt relief granted under the enhanced Initiative for Heavily Indebted Poor Countries (HIPC) is expected to continue to fall over the medium term. Partly as a result of strong import growth

in connection with megaprojects, the import coverage of gross international reserves is expected to decline from the current high level of 6.4 months of imports in 2001 to about 4 months over the medium term.

III. PROGRAM FOR THE REMAINDER OF 2002

14. The program for 2002 is designed to foster rapid growth and further improvements in priority spending, both of which support the attainment of the poverty reduction goals. To safeguard macroeconomic stability, protect those vulnerable to inflation, and return to the path set out in the PARPA, policies will be geared to reducing inflation from 22 percent at end-2001 to 8 percent at end-2002. Although growth is expected to slow after the strong recovery in 2001, buoyant agricultural production and large foreign investments are expected to contribute to growth of 9 percent in 2002.

15. Against the background of strong private sector activity, fiscal policy will support the moderation of demand pressures to contain inflation while protecting social spending. In line with the budgetary framework of the PARPA, the government envisages a reduction in its primary deficit (excluding bank restructuring costs) to 3.4 percent of GDP in 2002. Revenues are expected to amount to 13.0 percent of GDP in 2002. The government is also considering an increase in the petroleum excise tax to restore the real value eroded since its last increase in October 1997, but is concerned that such an increase should be timed to avoid further increases in pump prices. To ascertain better the implications of raising the petroleum tax, including the consequences for key transport prices, the government intends to make this issue the subject of a poverty and social impact assessment to be conducted in mid-2002. In addition, small gains in collections are expected from the operations of the large taxpayer units in Maputo and Beira.

16. Public expenditure will continue to be channeled toward the PARPA priorities, which are expected to account for 67 percent of noninterest expenditure in 2002 (excluding expenditures for bank restructuring), up from 66.2 percent in 2001. The government is committed to the PARPA medium-term objectives and will use its quarterly and semi-annual budget implementation reports to closely monitor expenditures for PARPA priority areas to ensure meeting of PARPA objectives. Within this total, spending on education will decline from the peak levels reached in 2001 as envisaged in the PARPA, while spending on health will increase.

17. The budget for 2002 envisages a wage bill of Mt 6.0 trillion to accommodate (i) a general wage increase of 11.7 percent; (ii) automatic promotions under the new career system (corresponding to a 3.5 percent increase in the wage bill); and (iii) the hiring of about 4,000 teachers and 800 health workers as contemplated in the PARPA. Despite the sharp increase in inflation that became apparent after the budget was submitted to parliament, and an increase of 22 percent in the minimum wage that was agreed in May, the government intends to limit the wage bill in 2002 to this budgeted amount. In this regard, the unexpected shortfall in wage payments from the budgeted amount in 2001 provides additional room for the higher general wage increase of 18 percent that was granted after the decision was reached

on the minimum wage; nevertheless, the wage bill would fall back from 6.6 percent of GDP in 2001 to 6.3 percent in 2002. Current spending on goods and services would decline to 3.5 percent of GDP with savings expected in nonpriority areas. Capital expenditure is expected to decline to 12.6 percent of GDP, as reconstruction after the flood damage in 2000 draws to a close. However, both domestic and external interest payments are expected to rise on account, respectively, of the servicing of the new bank recapitalization bonds and the end of the deferral of payments to the Paris Club that was granted to provide additional support in the aftermath of the floods. Expenditures on bank recapitalization, which are classified as net lending and largely take the form of interest-earning bonds, are estimated to total Mt 2,390 billion in 2002. Excluding the issuance of these bonds, the government would not need to resort to domestic financing in 2002.

18. The reduction in the 12-month rate of inflation to about 8 percent by end-2002 will be supported by a prudent monetary stance that aims at reducing the growth in broad money just under 20 percent by end-2002 from the rate of almost 30 percent in March 2002. With net international reserves of the BM roughly unchanged, the monetary program would accommodate growth in credit to the private sector of 22 percent to meet the needs of the expanding economy.

19. Monetary control will be assisted by strict enforcement of reserve requirements, which until January 2002 had been undermined by the BA's persistent noncompliance and the adverse signal that this noncompliance sent to the system. With the recapitalization of the BA and the imposition of stronger and accelerating penalties for noncompliance in early January, full observance of reserve requirements has since been recorded for the banking system as a whole. To improve control of liquidity management, the BM will continue to work closely with the treasury in coordinating government spending and the absorption of any excess liquidity through sales of foreign exchange and treasury bills. While the envisaged deceleration in inflation should generate some room for reducing interest rates during 2002, interest rate rates will continue to be determined by liquidity conditions.

20. In line with its commitment to an efficient, equitable, and transparent process for recovery of the BA's nonperforming loans that are reflected in the sales contract, the government has decided on the following course of action. First, as provided for in the sales contract, the new management of the BA is seeking to collect on nonperforming loans. In this regard, the contract provides attractive incentives for the BA to pursue these loans. Second, all nonperforming loans that are fully provided for and considered unrecoverable by the BA are being transferred to the government on payment of a nominal sum of one metical. The purchase by the government took place in May, immediately after the completion of a review of the BA's loan portfolio. This constituted a crucial first step toward using all available means to swiftly pursue the most delinquent debtors. Subsequently, the government will use its powers of *execução fiscal* to pursue collection of these nonperforming loans, where necessary. In line with understandings reached with World Bank staff, the government will include reporting on the progress of debt collection efforts in the budget execution reports that are published on a quarterly basis.

21. In light of the further capital shortfall in BIM in which, following the merger with BCM, government is now a 23 percent shareholder, the authorities developed a strategy to ensure that the recapitalization take place without undue delay while at the same time putting in place safeguards to minimize the use of government funds and limit the potential for future losses in the bank. In line with this strategy, shareholders approved an initial capital injection of US\$10 million; this took place on May 29 with government contributing 23 percent. BM has also required, and issued tenders for, an independent opinion to clarify the scale of, and reasons for, the bank's losses and the reported sharp increase in the liabilities of the bank's pension fund. Depending on the outcome of these studies, which are expected to be completed by September 2002, an additional capital need may emerge; on the basis of available information, this is not expected to exceed US\$33 million, of which government would contribute no more than 23 percent. The BM has also required that BIM produce a business plan, including a plan to recover nonperforming loans, to show how the bank's performance can be improved. Finally, the government has reiterated, at the special shareholders meeting on April 29, its intention to divest its shareholding in BIM. In line with the government's policy of withdrawing from banking operations, the government's contribution to the recapitalization is in the form of preference shares that can be converted to voting shares when the government divests from BIM.

22. In light of the problems recently experienced in the banking sector, the central bank has enhanced its regulations and tightened enforcement. These efforts are to continue during 2002. The BM has strengthened the enforcement of capital adequacy ratios by strictly applying the penalties envisaged in the law to noncompliant banks and is now prepared to withdraw the banking license of any bank that remains in prolonged noncompliance. To improve the monitoring of prudential ratios, the BM issued a circular on March 30, 2002 requesting banks to provide all the information needed to assess compliance with capital adequacy requirements on a monthly basis. This amended the earlier requirement of semiannual reporting on capital adequacy. To ensure the accuracy and timeliness of data provided to the supervision department, existing penalties for providing late or incomplete data will be rigorously applied, and the supervision department intends to insist on external audits to clarify data inconsistencies, as provided for in the regulations. The BM will follow up rigorously on the implementation of new regulations, including through on-site inspections, and will ensure that, for banks that are not in compliance with the regulations, timetables will be agreed with the supervision department for unwinding connected lending that exceeds the stipulated limits. To improve the operations of banking supervision, the BM intends to complete installation of the new information system in the supervision department by end-September 2002. The government has also requested Mozambique's participation in the Financial Sector Assessment Program.

23. Following the promulgation of the public financial management law in February 2002, the government has begun to implement reforms in public expenditure management that are designed to yield major improvements in the transparency and accountability of the budgetary process. First, the government has implemented in the 2002 budget the more detailed new functional expenditure classifier, which facilitates monitoring of priority expenditures. The budget execution report for the first quarter of 2002, issued in

mid-May, reported for the first time on expenditure incurred while using the functional classification as recommended by the IMF's *Government Finance Statistics Manual*. Second, new procedures are being followed to broaden the coverage of budget execution reports to incorporate all externally financed public projects and programs; this information was included in the report on the first quarter. Third, to support the implementation of the new financial administration system (SISTAFE), the Ministry of Planning and Finance issued in March a ministerial circular (*despacho ministerial*) to strengthen the coordination unit (UTRAFE) and establish a steering committee of deputy directors in the ministry. A decree establishing regulations under the financial management law will be issued in June 2002. The government has also requested the Fund to provide a long-term fiscal consultant to assist UTRAFE in the implementation of the SISTAFE.

24. Tax reform has been a priority of the government's reform endeavors under successive IMF-supported programs and will remain so in 2002 with the implementation of the new income tax law. The government attaches high priority to ensuring that the new tax law is fully applicable to incomes generated from January 1, 2003 onward. To this end, the tax codes for corporate and individual income taxes will be approved by the Council of Ministers in July (a performance criterion). The rates to be included in these codes, after a process of consultation with the private sector, will be geared to ensuring that the tax reform supports the revenue objectives for the medium term set out in the PARPA. Passage of new income tax law will also facilitate the approval, in June 2002, of the new fiscal incentives code to establish standard concessions for foreign investors, including transparent rules for investors in large projects (performance criterion). In addition, to improve the efficiency of the tax system, the Council of Ministers will approve in July regulations for a new annual property tax on vehicles based on engine size, and it will approve in June regulations eliminating the stamp duty on transactions subject to the value-added tax (VAT).

25. The government recognizes the importance of public sector reform and has begun to develop a strategy in this area, focusing on decentralizing government activities, addressing corruption and improving the effectiveness of the civil service through training and salary reforms. At the same time, work is under way to define more precisely the role of government, recognizing that decisions on this issue will be a crucial first step toward determining the course of public sector reform.

26. The government will adhere to its intention to reduce the top tariff rate from 30 percent to 25 percent. The rate reduction will now become effective in January 2003 as part of Mozambique's participation in the Southern African Development Community (SADC) Trade Protocol, at which point the government will apply the reduction in the top tariff rate to all of Mozambique's trading partners.

27. In the cashew sector, government policy is focused on assisting in the replanting and rehabilitation of trees, in line with the objective of increasing productivity and restoring cashew production to 100,000 tons by 2005. In accordance with the government's existing policy, the export tax on raw cashews is to be maintained at 18 percent in 2002, and the proceeds of the tax be used to finance improvements in the sector's productivity. The sugar

sector has attracted sizable foreign direct investment in recent years, and the rehabilitation of four sugar mills is expected to be completed by 2005, when annual production is projected to reach 400,000 tons. In the interim, while production is running well below the capacity of the mills and costs are correspondingly high, the import surcharge on sugar imports imposed in 1999 will remain in place. This policy will continue to be subject to annual reviews, taking into account developments in the domestic and the highly distorted international sugar markets. To alleviate pressure from imports of sugar from Zimbabwe that evade the import surcharge, in April 2002 the government granted a temporary VAT exemption for sugar. The sector is benefiting from limited preferential access to regional markets under the SADC Trade Protocol, to the United States, and, since 2001, to the European Union.

28. The government recognizes the crucial importance of timely debt-service payments in view of Mozambique having reached its enhanced HIPC Initiative completion point in September 2001 and agreement with the Paris Club in November 2001. The government aims to reach bilateral agreements with individual Paris Club creditors by the deadline of end-June 2002 and is continuing to seek agreements on comparable terms with non-Paris Club creditors. The government realizes that for Mozambique to fully benefit from its new post-HIPC Initiative status and avoid the risk of a recurrence of debt problems, it must strengthen its debt management capacity in order to ensure timely debt service payments. It intends to continue to improve its external debt database; prepare detailed monthly debt service projections; and extend its monitoring of debt data and assessment of debt-related vulnerabilities to private sector debt.

29. The government has prepared detailed plans for monitoring implementation of the PARPA. Based on existing procedures, the government will report annually on the attainment of PARPA objectives. A first such progress report on PARPA implementation, as requested by parliament, is expected to be available by mid-August 2002. In addition, quarterly budget execution reports will continue to be provided. The government is preparing its second full household survey, which has been designed for comparability with the initial 1997 survey. The results of the survey, which should facilitate analysis of the links between the recent rapid growth and poverty reduction, should be available in 2003.

30. The government is aware that, despite progress in recent years in improving Mozambique's statistical databases, significant shortcomings remain. To address these issues, the government has requested participation in a data Report on the Observance of Standards and Codes (ROSC) in the second half of 2002. In the meantime, the government will proceed with ongoing efforts to revise Mozambique's balance of payments in accordance with of the IMF's *Balance of Payments Manual* (fifth edition).

31. During the period of the PRGF-supported program, the government will not impose or intensify restrictions on payments and transfers for current international transactions; will not introduce multiple currency practices; will not conclude bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement; and will not impose or intensify import restrictions for balance of payments reasons. Furthermore, the

government will not incur any new external payments arrears, except in cases where despite good faith efforts by the government, debt-restructuring agreements remain pending.

IV. PROGRAM MONITORING

32. The quantitative performance criteria and benchmarks that will be used to evaluate the implementation of the program are shown in Table 3 of this memorandum, with further definitions and explanations contained in a technical memorandum of understanding annexed to this memorandum. The first five quantitative targets represent key financial objectives of the program. As in the past, the program's floor on net international reserves (NIR) and the ceiling on net domestic assets (NDA) will be adjusted for higher or lower disbursements of external budget support than envisaged in the program. In addition, a similar adjustor has been added for external debt-service payments. Thus, if debt-service payments arising from final agreements with creditors are higher than programmed, the NIR floor will be lowered, and the NDA ceiling raised to account for this; conversely, if debt-service payments are lower than programmed, the NIR floor will be raised. The other quantitative targets will help to maintain a sustainable external debt position. A number of structural performance criteria and benchmarks, drawn from this memorandum, are shown in Table 4. The government understands that its ability to request disbursement of the sixth loan under the extended PRGF arrangement will be contingent upon the observance of the quantitative performance criteria for end-June 2002 set out in Table 3, the structural performance criteria set out in Table 4, and upon the completion of the fifth review of the program, which is expected to take place, at the latest, by the end of November 2002, subject to approval of the requested extension of the PRGF arrangement.

Table 1. Mozambique: Quantitative Performance Criteria and Benchmarks Under the PRGF Arrangement, December 2000-December 2001
(End of period)

	Dec. 2000 Actual	June 2001 Actual	September 2001		Actual	December 2001		Actual
			Benchmarks			Performance criteria		
			Program	Adjusted		Program	Adjusted	
(In billions of meticaís)								
Central government domestic primary deficit, excluding bank recapitalization costs (ceiling) 1/ 2/	2,969	1,711	3,771	3,771	3,589	4,340	4,340	4,207
Central government revenue (floor; benchmark only) 2/	7,463	4,140	6,039	6,039	6,186	8,670	8,670	9,616
Stock of net domestic assets of the Bank of Mozambique (BoM) (ceiling) 3/ 4/ 5/	4,039	3,246	5,133	5,162	4,715	5,412	6,215	4,293
Stock of reserve money (ceiling; benchmark only) 5/	3,940	4,697	5,018	4,826	5,518	5,297	5,122	6,056
(In millions of U.S. dollars)								
Stock of net international reserves of the BoM (floor) 6/	526	525	526	451	496	526	439	533
New nonconcessional borrowing contracted or guaranteed by the government or the BoM with maturity of more than one year (ceiling) 2/	0	0	0	0	0	0	0	0
Stock of short-term external public debt outstanding (ceiling) 7/	0	0	0	0	0	0	0	0
External payments arrears (ceiling) 2/ 8/	0	0	0	0	0	0	0	0
(In billions of meticaís, unless otherwise indicated)								
Memorandum items:								
Foreign program assistance (grants and loans; in millions of U.S. dollars) 2/	217	80	215	...	140	322	...	202
Exchange rate (meticaís per U.S. dollar; end of period)	17,140	21,788	23,133	...	22,182	23,000	...	23,320
Required reserves shortfall	-401	0	0	...	-192	0	...	-175
Adjustment to BoM's net domestic assets at program exchange rates	...	...	0	...	43	0	...	-28
Adjustment to reserve money	...	...	0	...	8	0	...	-4
Adjustment to NFA	...	...	0	...	34	0	...	-24
Stock adjustments in medium- and long-term liabilities	...	...	0	...	-1,562	0	...	-1,745
Medium- and long-term liabilities (in millions of U.S. dollars)	546	477	545	...	475	545	...	470

1/ Defined as revenue minus noninterest current expenditure minus locally financed capital expenditure and locally financed net lending.

2/ Cumulative from the beginning of the calendar year.

3/ Defined as reserve money minus net foreign assets (NFA) of the Bank of Mozambique. The foreign currency component of reserve money and NFA are valued at program exchange rates; NFA are defined to exclude the effect of any stock adjustments in medium- and long-term liabilities.

4/ To be adjusted upward/downward to the extent of any shortfall/excess of foreign program assistance valued at program exchange rates.

5/ To be adjusted downward to the extent that eligible bank reserves fall short of 11.51 percent of deposits in commercial banks at the end of each quarter.

6/ To be adjusted downward/upward to the extent of any shortfall/excess of foreign program assistance relative to the amounts shown in the memorandum item.

7/ Loans of 0-1 year's maturity, excluding normal import-related credit. Non-U.S. dollar debt converted to U.S. dollars at actual exchange rates.

8/ Continuous performance criterion; excluding arrears arising from debt-service payments that become due pending the conclusion of debt-rescheduling agreements.

Table 2. Mozambique: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement, October 2001-December 2001

Actions	Date of Implementation (End of period)	Outcome
Tax policy and administration		
Submit to the National Assembly a new income tax law(<i>lei de bases do sistema tributário</i>) to overhaul corporate, personal and complementary taxes and increase their yields by simplifying procedures for calculation and payment and increasing the bases for these taxes. 1/	December 2001	Submitted in December 2001
Launch operations of the large taxpayer unit in Maputo.	December 2001	Launched in December 2001
Financial sector		
Issue regulations to commence consolidated supervision of related financial institutions.	October 2001	Issued in October 2001
Tighten the regulations on connected lending by lowering limits on commercial bank lending to shareholders.	October 2001	Issued in September 2001

1/ Performance criterion.

Table 3. Mozambique: Quantitative Performance Criteria and Benchmarks Under the PRGP Arrangement, December 2001-December 2002
(End of period)

	Dec. 2001 Actual	March 2002 Actual Est. (in italics)	2002 Program		
			June	September	December
			Performance criteria (unless otherwise noted)	Benchmarks	
(In billions of meticaís)					
Central government domestic primary deficit excluding bank recapitalization costs (ceiling) 1/ 2/	4,207	<i>1,186</i>	1,971	3,579	3,224
Central government revenue (floor; benchmark only) 2/	9,616	<i>2,642</i>	5,383	8,409	12,406
Stock of net domestic assets of the Bank of Mozambique (BoM) (ceiling) 3/ 4/ 5/	4,293	3,563	4,225	4,579	5,313
Stock of reserve money (ceiling; benchmark only) 5/	6,056	5,797	6,412	6,931	7,450
(In millions of U.S. dollars)					
Stock of net international reserves of the BoM (floor) 6/	533	552	546	550	540
New nonconcessional borrowing contracted or guaranteed by the government or the BoM with maturity of more than one year (ceiling) 2/	0	0	0	0	0
Stock of short-term external public debt outstanding (ceiling) 7/	0	0	0	0	0
External payments arrears (ceiling) 2/ 8/	0	0	0	0	0
(In billions of meticaís, unless otherwise indicated)					
Memorandum items:					
Foreign program assistance (grants and loans; in millions of U.S. dollars) 2/	202	73	117	173	215
Actual external debt service payments (in millions of U.S. dollars) 2/	27	10	19	29	39
Exchange rate (Meticais per U.S. dollar; end of period)	23,320	23,367	24,549	25,264	26,000
Required reserves shortfall	-175	0	0	0	0
Adjustment to BoM's net domestic assets at program exchange rates	-28	0	0	0	0
Adjustment to reserve money	-4	0	0	0	0
Adjustment to NFA	-24	0	0	0	0
Stock adjustments in medium- and long-term liabilities	-1,745	0	0	0	0
Medium- and long-term liabilities (in millions of U.S. dollars)	470	475	475	475	475

1/ Defined as revenue minus noninterest current expenditure minus locally financed capital expenditure and locally financed net lending.

2/ Cumulative from the beginning of the calendar year. Foreign program assistance includes special programs. Debt service includes debt service to the IMF and on new debt.

3/ Defined as reserve money minus net foreign assets (NFA) of the Bank of Mozambique. The foreign currency component of reserve money and NFA are valued at program exchange rates; NFA are defined to exclude the effect of any stock adjustments in medium- and long-term liabilities.

4/ To be adjusted upward/downward to the extent of any shortfall/excess of foreign program assistance valued at program exchange rates and to be adjusted downward/upward to the extent that actual payments of external debt service exceed/fall short of programmed amounts.

5/ To be adjusted downward to the extent that eligible bank reserves fall short of 11.51 percent of deposits in commercial banks at the end of each quarter.

6/ To be adjusted downward/upward to the extent of any shortfall/excess of foreign program assistance relative to the programmed amount and to be adjusted upward/downward for the extent that actual payments of external debt service fall short of/exceed programmed amounts.

7/ Loans of 0-1 year's maturity, excluding normal import-related credit. Non-U.S. dollar debt converted to U.S. dollars at actual exchange rates.

8/ Continuous performance criterion; excluding arrears arising from debt-service payments that become due pending the conclusion of debt-rescheduling agreements.

Table 4. Mozambique: Structural Performance Criteria, and Benchmarks
Under the PRGF Arrangement, March-December 2002

Actions	Date of Implementation (End of period)
Structural performance criteria	
Approval by the Council of Ministers of the new code of fiscal incentives	June 2002
Approval by the Council of Ministers of the new codes for the corporate and personal income taxes	July 2002
Structural benchmarks	
Approval by the Council of Ministers of the regulations eliminating the stamp tax on transactions subject to the value-added tax (VAT)	June 2002
Approval of regulations on new vehicle tax	July 2002
Adoption of a standardized and comprehensive reporting format for all inspections conducted by the banking supervision department, so as to facilitate the identification of corrective measures as needed.	June 2002
Production, for the use of the banking supervision department, of quarterly reports on each financial institution, covering all aspects of banking soundness identified in the new reporting format.	September 2002
Publication of a decree establishing regulations under the Financial Management Law	June 2002

**Technical Memorandum of Understanding
on Selected Concepts, Definitions, and Data Reporting
Under Mozambique's Third-Year PRGF-Supported Program**

June 3, 2002

The purpose of this technical memorandum of understanding (TMU) is to describe concepts and definitions that are being used in the monitoring of the third year of the Poverty Reduction and Growth Facility (PRGF)-supported program, including the following:

- central government domestic primary deficit;
- central government revenue;
- net domestic assets, net international reserves, and reserve money of the Bank of Mozambique;
- new nonconcessional borrowing contracted or guaranteed by the government or the Bank of Mozambique with a maturity of more than one year;
- short-term external public debt outstanding;
- external payments arrears; and
- foreign program assistance.

This memorandum also describes the adjusters that will be applied to certain quantitative targets of the program.

Central government domestic primary deficit

The central government domestic primary deficit is defined as central government revenue, **less** noninterest current expenditure, **less** locally financed capital expenditure, **less** locally financed net lending, and excluding the cost of bank restructuring/recapitalization. Net lending is derived as gross lending to enterprises through *acordos de retrocessão* (excluding *acordos de retrocessão* that were required by donors), **plus** food aid disbursed but not collected in the period, **minus** repayments by enterprises of loans obtained through *acordos de retrocessão* and through refinancing agreements with the Bank of Mozambique, **minus** food aid collected but not disbursed in the period. The cost of bank recapitalization/restructuring is, for the purpose of the program, defined as the government's contributions during 2002 to the costs of recapitalizing Banco Internacional de Moçambique (BIM) and Banco Austral (BA), including the respective pension funds, in the form of cash payments, securities issued, or loans extended.

The central government encompasses all institutions whose revenue and expenditure are included in the state budget (orçamento do Estado): central government ministries, agencies, and the administration of 11 provinces. Although local governments (33 municipalities, or *autarquias*) are not included because they are independent, the bulk of their revenue is registered in the state budget as transfers to local government.

Central government revenue, expenditure, and financing

Revenue is defined to include all receipts of the National Directorate of Taxes and Audit (Direcção Nacional de Impostos e Auditoria, DNIA), the National Directorate of Customs (Direcção Nacional de Alfândegas, DNA), and the net receipts from privatization received by the National Directorate of State Assets (Direcção Nacional do Património do Estado).

For the purposes of program monitoring, revenue is considered as collected at the time when revenue is received by the DNIA from private agents or other government-collecting agencies in cash or checks, or through transfer into a DNIA bank account.

Expenditure is defined as government outlays transferred from treasury accounts to other government accounts or private sector accounts and includes spending reported to the National Directorate of Public Accounting (*despesas liquidadas*) and any further treasury advances (*operações de Tesouraria*) that have been transferred out of treasury accounts but whose use has not yet been reported to the National Directorate of Public Accounting. Any expenditure arrears will be treated like expenditure for the purpose of monitoring the ceiling on the domestic primary deficit.

For program-monitoring purposes, expenditure carried out in the current budget year but accounted for as expenditure under the previous budget (*período complementar*) is treated as spending during the current budget year.

The **financing** of the budget deficit is measured as transfers into treasury accounts and from these accounts to accounts of the institutions included in the central government, as defined above, as well as transfers from private sector accounts. All treasury accounts held at the central bank are being monitored for purposes of measuring the financing of the budget deficit. There are no treasury accounts outside the central bank.

Any discrepancy between the overall deficit (revenue less expenditure, as defined above) and its financing will be included as “unallocated revenue/expenditure” in the budget balance.

Net domestic assets

Net domestic assets of the Bank of Mozambique are defined as reserve money **minus** net foreign assets of the Bank of Mozambique. The foreign currency component of reserve money and the net foreign assets is valued at program exchange rates; net foreign assets are defined to exclude the effect of any stock adjustments in medium- and long-term liabilities.

The central bank’s foreign currency-denominated assets and liabilities are converted in its balance sheet to meticaís at actual exchange rates. For purposes of program monitoring, these amounts are converted into U.S. dollars at the agreed program exchange rate.

Stock adjustments in the central bank's medium- and long-term liabilities are understood to mean any changes that are not the result of foreign exchange flows, such as write-offs, interest capitalization, etc.

Net international reserves

Net international reserves are defined as reserve assets **minus** reserve liabilities. The Bank of Mozambique's reserve assets include (a) monetary gold; (b) holdings of SDRs; (c) reserve position at the IMF; (d) holdings of foreign exchange; and (e) claims on nonresidents, such as deposits abroad. Reserve assets exclude assets pledged or otherwise encumbered, including but not limited to assets used as collateral or guarantee for a third-party external liability (assets not readily available.) The Bank of Mozambique's reserve liabilities include (a) all short-term foreign exchange liabilities to nonresidents with original maturity of up to and including one year; and (b) all liabilities to the IMF.

New nonconcessional debt contracted or guaranteed by the government or the Bank of Mozambique with maturity of more than one year

The term "debt" will have the meaning set forth in Point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000. Government debt is outstanding debt owed or guaranteed by the Republic of Mozambique or the Bank of Mozambique (but does not include debt of any political subdivision or government-owned entity with a separate legal personality that is not otherwise owed or guaranteed by the Republic of Mozambique).

The government will not contract or guarantee external debt with original maturity of one year or more with a grant element of less than 35 percent, calculated using a discount rate based on Organization for Economic Cooperation and Development (OECD) commercial interest rates. This performance criterion applies not only to debt as defined in Point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received.

Stock of short-term external public debt outstanding

The government will not contract or guarantee external debt with original maturity of less than one year. This performance criterion applies not only to debt as defined in Point 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are short-term, import-related trade credits.

External payments arrears

The government undertakes not to accumulate payments arrears on external government debt with original maturity of one year or more owed or guaranteed by the government, with the exception of external payments arrears arising from government debt that is being renegotiated with creditors, including Paris Club creditors.

Foreign program assistance

Foreign program assistance is defined as grants and loans received by the Ministry of Planning and Finance through Bank of Mozambique accounts.

Actual external debt-service payments

Actual external debt-service payments are defined as cash payments on external debt-service obligations of the government and central bank, including obligations to Paris Club and other bilateral creditors rescheduled under enhanced HIPC Initiative completion point terms, multilateral creditors, and private creditors.

Adjusters

The quantitative targets (floors) for the central bank's net international reserves will be adjusted upward (downward) for any excess (shortfall) of foreign program assistance; and downward (upward) to the extent that actual payments of external debt service exceed (fall short of) programmed amounts.

The quantitative targets (ceilings) for the central bank's net domestic assets will be adjusted upward (downward) for any shortfall (excess) of foreign program assistance; and downward (upward) to the extent that actual payments of external debt service fall short of (exceed) programmed amounts;

The quantitative targets (ceilings) for the central bank's net domestic assets and reserve money will be adjusted downward to the extent that eligible bank reserves fall short of 11.51 percent of resident deposits in commercial banks, excluding government-earmarked funds (*fundos consignados*), at the end of each quarter.

Data reporting

In addition to providing the monthly and quarterly data needed to monitor program implementation in relation to the programs' quantitative targets and broader economic developments, the authorities will provide weekly updates of the daily data set out in Table 1 of this attachment and the weekly data set out in Table 2 of this attachment. Monthly updates will also be provided of the updates of the foreign exchange cash flow of the Bank of Mozambique as set out in Table 3.

Table 1. Mozambique: Daily Foreign Exchange Rates and Foreign Exchange Transactions, Week of [month/day-month/day]

	Exchange Rates						Transactions with BoM		
	Commercial banks		Foreign exchange bureaus		Bank of Mozambique		BoM sales	BoM purchases	Requests outstanding for BoM foreign exchange
	Buy	Sell	Buy	Sell	Buy	Sell			
Monday									
Tuesday									
Wednesday									
Thursday									
Friday									

Source: Bank of Mozambique (BoM).

Table 2. Mozambique: Weekly Financial Data

Exchange rates (In meticaïs per U.S. dollar; weekly average)
Bank of Mozambique
Buy
Sell
Secondary market
Buy
Sell
Foreign exchange bureaus
Buy
Sell
Interest rates (in percent per annum)
Permanent Access Facility (FPC)
Excess liquidity rate (FPA)
Treasury bills
28 days
63 days
1 day
162 days
364 days
Monetary authority bills (TAMs) (if any)
Open market operations (in billions of meticaïs)
Securities issues during week
Treasury bills
TAMs
Securities matured/called during week
Treasury bills
TAMs
Securities outstanding
By type
Treasury bills
TAMs
By holder
Financial institutions
Public
Amount used by the government – (Ministry of Planning and Finance)
Reserve money in (billions of meticaïs)
Currency in circulation
Bank reserves
Bank of Mozambique net foreign assets
In billion of meticaïs
In millions of U.S. dollars
Bank of Mozambique net international reserves (in millions of U.S. dollars)
External assistance disbursed (in millions U.S. dollars)
Net credit to the government (in billions of meticaïs)
Net credit to the government; flow (in billions of meticaïs)

Table 3. Mozambique: Central Bank Monthly Foreign Exchange Cash Flow
(In millions of U.S. dollars)

Beginning stock of net international reserves (NIR)

Inflows

- Program loans and grants
- Miners' remittances
- Interbank exchange market purchases
- Foreign assets income
- Provisioning of commercial banks
- Other

Outflows

- External debt service
- Interbank exchange market purchases
- Transfers to commercial banks
- Government
- Traditional circuit

Mozambique: Relations with the Fund
(As of April 30, 2002)

Membership Status

Joined 9/24/84; Article XIV

General Resources Account	SDR Million	% Quota
Quota	113.6	100.0
Fund holdings of currency	113.6	100.0
Reserve position in Fund	0.01	0.01

SDR Department	SDR Million	% Allocation
Holdings	0.05	n.a.

Outstanding purchases and loans	SDR Million	% Quota
Enhanced Structural Adjustment Facility (ESAF)		
Poverty Reduction and Growth Facility (PRGF) arrangements	154.37	135.88

Financial Arrangements

Type	Approval date	Expiration date	Amount Approved (SDR million)	Amount Drawn (SDR million)
ESAF/PRGF	6/28/99	06/27/2002	87.20	62.00
ESAF	6/21/96	06/27/1999	75.60	75.60
ESAF	6/01/90	12/31/1995	130.05	115.35

Projected Obligations to the Fund (SDR millions; based on existing use of resources and present holdings of SDRs):

	Overdue 12/31/01	Forthcoming				
		2002	2003	2004	2005	2006
Principal	0.0	15.6	14.8	15.3	20.5	24.6
Charges/interest	0.0	0.7	0.7	0.6	0.6	0.4
Total	0.0	16.3	15.5	15.9	21.0	25.0

Implementation of HIPC Initiative:

	<u>Original framework</u>	<u>Enhanced framework</u>	<u>Total</u>
Commitment of HIPC assistance			
Decision point date	4/7/98	4/7/2000	
Assistance committed (end-1998 NPV terms)			
Total assistance (US\$ million)	1,716	306	2,022
<i>Of which:</i> Fund assistance (SDR million)	93.2	13.7	106.9
Completion point date	6/29/99	25/9/01	
Delivery of Fund assistance (SDR million)			
Amount disbursed	93.2	14.8	108.0
Interim assistance	...	2.3	2.3
Completion point	93.2	12.5	105.7
Amount applied against member's obligations (cumulative)	47.6	6.0	53.6

Safeguards Assessment

Under the Fund's safeguards assessment policy, the Bank of Mozambique is subject to the transitional procedures with respect to the PRGF arrangement approved on June 28, 1999, which is scheduled to expire on June 27, 2002. The transitional procedures require a review of only the Bank of Mozambique's external audit mechanism. This assessment determines whether the bank publishes annual financial statements that are independently audited in accordance with internationally accepted standards.

The external audit assessment was completed on October 11, 2001. The assessment concluded that the Bank of Mozambique's current external audit mechanism may not be adequate in certain respects, and appropriate recommendations have been made to the authorities, as reported in Box 6 of this staff report.

Exchange arrangements

The exchange rate for Mozambique's currency, the metical (plural: meticais) is market determined. Commercial banks may buy foreign exchange from, and sell to, individual customers on a freely negotiable basis. The Bank of Mozambique publishes daily a representative exchange rate in the form of the weighted average of all licensed operators' transactions with the public of the previous day. As of end-December 2001, this rate was Mt 23.097 per U.S. dollar. Mozambique has expressed the intention to accept the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement in the near future. In this regard, a detailed examination of the exchange system is being conducted in collaboration with the Fund staff. It is expected that

Mozambique will formally accept the obligations of Article VIII, Sections 2, 3, and 4 following resolution of a few outstanding issues.

Article IV consultation

Mozambique is on the standard 12-month cycle for Article IV consultations. The 2000 Article IV consultation was completed by the Executive Board on December 18, 2000 (EBS/00/62; 3/30/00).

In considering the staff report, Executive Directors commended the Mozambican authorities for their program implementation record and for their plans to improve fiscal management and banking sector soundness. They noted the authorities' commitment to meet the conditions for the enhanced HIPC Initiative completion point by end-March 2001, but expressed concern about the realism of this timetable and emphasized the importance of quality over process. Directors also urged the authorities to improve tracking of poverty-related expenditures, particularly with regard to the use of resources freed up as a result of HIPC Initiative debt relief.

FSAP Participation, ROSCs, and OFC Assessments

Mozambique has not been subject to Financial Sector Assessment Program (FSAP) or offshore financial center (OFC) assessments. A Report on Observance of Standards and Codes (ROSC) on fiscal transparency was issued on February 22, 2001 (doc. #1155178). A FSAP and a data ROSC are to be conducted in fiscal year 2003.

Technical Assistance (over the last two years)

Departments	Timing	Form	Purpose	Counterparts
Fiscal Affairs	February 2002	Mission	Public expenditure management	Ministry of Finance
	September 2001	Mission	Tax policy and administration project formulation	Ministry of Finance
	Aug.-Sep. 2001	Short-term consultant	Income tax reform	Ministry of Finance
	Jan.-Feb. 2001	Mission	Income tax reform	Ministry of Finance
	September 2000	Mission	Review of value added tax (VAT) implementation	Ministry of Finance
	June 2000	Mission	Code of Good Practices on Fiscal Transparency	Ministry of Finance
	June 2000	Mission	Rationalization of tax incentives	Ministry of Finance
Legal Affairs	Aug.-Sep. 2001	Mission	Income tax law	Ministry of Finance
Monetary and Exchange Affairs	Sep. 2001-March 2002 (3 visits)	Short-term consultant	Banking supervision	Bank of Mozambique
	Aug.-Sep. 2001	Short-term consultant	Commercial bank restructuring	Bank of Mozambique/Banco Austral
	June 2001	Mission	Commercial bank restructuring	Bank of Mozambique
Statistics	Apr.-June 2001	Short-term consultant	Balance of payments statistics	Bank of Mozambique

Resident Representative

Mr. Schwidrowski has been Resident Representative since October 25, 1999.

Mozambique: Relations with the World Bank Group

(As of April 30, 2002)

Over the next three years (2002–04), disbursements under World Bank investment projects are expected to reach around US\$85 million on average per year. Under the Country Assistance Strategy (CAS), the World Bank support to Mozambique will focus on agriculture, education, and infrastructure. The adjustment operation, the Economic Management and Private Sector Operation (EMPSO), is expected to go to the Board in the second quarter of 2002. The first phase of a public expenditure review, a collective effort among the government of Mozambique, the World Bank, and other donors, has been completed.

World Bank Loan and Grant Operations, 1998-2002 1/

	1998	1999	2000	2001	2002
	Actuals (millions of U.S. dollars)				Projected
I. Project credit disbursements	85.1	79.4	97.5	51.6	84.9
Household Energy (6/89) 2/	4.2	0.0	0.0	0.0	0.0
Economic and Financial Management (10/89) 2/	1.0	0.0	0.0	0.0	0.0
Education II (12/90) 2/	4.2	2.5	0.0	0.0	0.0
Industrial Enterprise (12/89) 2/	10.7	7.6	2.0	0.0	0.0
Agricultural Service Rehab. Development (2/92) 2/	2.1	2.5	0.7	0.0	0.0
First Road and Coastal Shipping (6/92) 2/	5.3	12.5	4.0	0.0	0.0
Capacity Building: Human Res. Dev. (11/92)	8.2	11.3	4.5	2.8	0.0
Capacity Building: Pub. Sector & Legal Inst.Dev. (11/92)	2.9	0.9	0.7	0.0	0.0
Maputo Corridor (1/93) 2/	0.4	-0.1	0.0	0.0	0.0
Rural Rehab.(3/93) 2/	4.8	3.8	2.0	0.3	0.0
Food Security (4/93) 2/	1.3	0.1	0.0	0.0	0.0
Local Government (6/93) 2/	2.7	3.1	0.0	0.0	0.0
Second Road and Coastal Shipping (4/94)	24.5	16.9	26.5	11.4	15.0
Financial Sector Capacity Building (4/94) 2/	1.4	2.0	1.4	0.3	0.0
Gas Engineering (6/94)	1.9	1.5	1.1	1.6	3.0
Health Sector Recovery (11/95)	7.5	12.0	17.2	17.4	12.0
National Water I (2/98)	2.0	1.3	1.7	2.4	5.7
Agricultural Sec. PEP (2/99)	0.0	0.5	0.9	4.2	5.0
General Education (2/99)	0.0	1.0	0.5	1.2	5.0
Railway and Port Restructuring (10/99)	0.0	0.0	1.9	3.6	5.0
National Water II (6/99)	0.0	0.0	1.4	2.8	10.0
Enterprise Development (01/00)	0.0	0.0	2.3	3.0	4.0
Flood Emergency Recovery	0.0	0.0	28.7	-0.2	0.0
Coastal and Marine Biodiversity	0.0	0.0	0.0	0.3	1.1
NEW OPERATIONS					
Municipal Development	0.0	0.0	0.0	0.3	3.0
Roads and Bridges I	0.0	0.0	0.0	0.0	8.0
Communications	0.0	0.0	0.0	0.0	2.5
Mineral Resources Project	0.0	0.0	0.0	0.2	3.6
II. Adjustment operations	46.5	150.0	0.0	0.0	60.0
Economic Management Reform Operation (12/98) 2/ 3/	0.0	150.0	0.0	0.0	0.0
Third Economic Recovery Credit 2/	46.5	0.0	0.0	0.0	0.0
Economic Management and Private Sector Operation	0.0	0.0	0.0	0.0	60.0

1/ Date of Board approval in brackets.

2/ Closed.

3/ Grant.

Mozambique: Statistical Issues

Mozambican economic data are based on a limited number of primary statistical sources whose reliability is uneven in terms of countrywide coverage. Efforts to improve the situation have been ongoing for over a decade, including through continued technical assistance from the United Nations Development Program (UNDP); these institutions have supported Mozambique's statistical development program since 1991, under which most of the progress with nonfinancial statistics has been recorded. Following a multisector STA mission in October 1994, the Fund has also been involved in data improvement efforts on several fronts, including, more recently, monetary, balance of payments, and external debt statistics.

National accounts

Mozambique's national accounts statistics are compiled by the National Statistics Institute (INE). Revised series starting with 1991 have been compiled in accordance with the *1993 System of national Accounts* (SNA) and using a 1996 base year. The new series introduce a more detailed breakdown of the production accounts and incorporate the results of the 1996 census (household survey) on the expenditure accounts. Notwithstanding these improvements, the staff and authorities agree that the representativeness of national accounts remains hampered by the lack of coverage of remote national areas and of many largely informal transactions.

Prices and labor market

As of February 2000, a new consumer price index for Maputo, based on weights revised on the basis of the 1996 household survey results, was implemented. However, the concentration of the weights on a few basic food staples with relatively volatile prices makes the consumer price index (CPI) prone to significant swings. A preliminary national index obtained by integrating the indices for Maputo, Beira, and Nampula is under preparation.

There are very little sectoral labor market and employment data, and, where available, they have limited national coverage.

Money and banking statistics

Although improvements in the Bank of Mozambique's accounting practices have contributed to better-quality accounting information, fully consistent monetary statistics have remained elusive because of significant discrepancies in cross balances between commercial banks and the Bank of Mozambique. Moreover, the "other items, net" categories in the Bank of Mozambique's accounts remain large and subject to significant monthly fluctuations.

Currently, the Bank of Mozambique publishes the monetary data on a regular basis in its quarterly statistical bulletin and uses a unified reporting system to submit data to the Fund (both AFR and STA) in an electronic format agreed with both departments. However, the data suffer

from continuous revisions due to faulty commercial banks balance sheet data, and statistical adjustments are still made to obtain international reserves data. In addition, the modified plan of accounts for the commercial banks, implemented in January 2001, lacks the degree of detail needed for the complete sectorization of the analytical accounts for the depository corporations, as recommended by the IMF's *Monetary and Financial Statistics Manual*.

Data on foreign aid flows

The absence of firm data on foreign aid flows and their uses is one of the main data problems hampering the accuracy and reliability of the balance of payments, fiscal, and national accounts statistics. The major difficulty lies in tracking disbursements made outside the domestic financial system, which is exacerbated by the weakness of customs records. In response to this situation, AFR missions have worked with the authorities and donors to set up reporting templates for periodic updates of each donor assistance disbursement. Further progress would entail the institutionalization of this procedure under a national statistical agency.

Fiscal accounts

The lack of information on external assistance undermines the accuracy and reliability of fiscal data because the foreign-financed portion of project execution is estimated on the basis of domestically financed execution data and its assumed proportion to total financing. Similarly, the monitoring of counterpart funds generation and collection is also weak. Moreover, the lack of reporting on the uses of foreign assistance prevents an accurate functional classification of donor-financed outlays. In 2001, a new classification of fiscal accounts was introduced, and, starting with the 2002 budget, the reporting of expenditure execution by functional category is expected to improve.

However, there remains much to be done on the statistical consolidation of government operations. At present, there is little reporting on accounts of government agencies, such as the Social Security Institute (INSS), and none for local and regional governments. In May 2000, the authorities started publishing quarterly budget execution reports. This action constituted an important step toward improving fiscal transparency and accountability and allowed the monitoring of poverty reduction strategy paper (PRSP) related expenditures, including those financed by HIPC Initiative debt relief, to be started. Mozambique does not report data for publication in the *Government Finance Statistics Yearbook* or *International Financial Statistics*.

External accounts

The quality of the external accounts has been hampered by the weakness of key data sources, the absence of firm foreign aid statistics, a large informal sector operating in foreign currency, and problems with the definition of residency under the Exchange Law and Regulations. Efforts to improve the situation have been undermined by a lack of funding, coordination, and clear division of responsibilities among the government agencies involved in the production of these

statistics (the Bank of Mozambique, the National Statistics Institute, the Ministry of Planning and Finance, and the Ministry of Industry, Commerce, and Tourism).

In response to this situation, STA in 2001 fielded a resident expert at the central bank to take stock of current practices and advise on improvements. The objective is to bring Mozambique's balance of payments statistics in line with the fifth edition of the *Balance of Payments Manual* through a concerted plan of action, including improved reporting practices through existing data systems, a greater use of survey data and computer technologies, additional technical support, and the commitment of additional financial and human resources by the authorities. The advisor completed the first term of this assignment and is expected to return in 2002, for the second term, to check on progress and reassess areas of further need.

Reserve template data

Mozambique has begun an exercise to complete the reserves template. The results of the preliminary exercise indicate that Mozambique reports gross international reserves data with the required periodicity and timeliness. It reports that only the category of outflows of principal and interest is relevant with regard to the template section on "foreign currency loans, securities, and deposits," and that it has no contingent short-term net drains on foreign currency assets. With regard to outflows of principal and interest, data do not meet template requirements.

Social indicators

With the advent of its Poverty Reduction and Growth Facility (PRGF) supported program, Mozambique has made a concerted effort to generate representative and timely social indicators. Accordingly, the INE started in 2000 to publish selected social indicators on the basis of its surveys; however, the coverage and frequency of such information remain insufficient to fully monitor social conditions in time for a decisive policy response.

Mozambique: Core Statistical Indicators

(As of April 30, 2002)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Overall Government Balance	GDP/ GNP
Date of latest observation	Apr. 02	Mar. 02	Mar. 02	Mar. 02	Mar. 02	Apr. 02	Mar. 02	Dec. 01	Dec. 01	Dec. 01	Dec. 01	Dec. 01
Date received	Apr. 02	Apr. 02	Apr. 02	Apr. 02	Apr. 02	Apr. 02	Apr. 02	Feb. 02	Feb. 02	Feb. 02	Feb. 02	Mar. 02
Frequency of data 1/	D	M	M	M	M	M	M	Q/V	V	Q	Q	V
Frequency of reporting 1/	W	M	M	M	M	M	M	Q/V	V	V	Q	V
Frequency of publication 1/	D	M	M	M	M	M	M	Q/V	V	V	Q	V
Source of data 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 3/	C	C	C	C	C	C	C	C/V	V	C	C	V
Confidentiality 4/	C	D	C	C	C	C	C	C	C	C	C	C

1/ D=Daily; W=weekly; M=monthly; Q=quarterly; V=collected during mission.

2/ A=Direct reporting by central bank or relevant ministry.

3/ C=cable or fax; V=staff visit.

4/ C=unrestricted use; D=embargoed for a period of time.

Mozambique: Selected Social and Demographic Development Indicators^{1/}

(In percent, unless otherwise noted)

	Mozambique	Sub-Saharan Africa
Reducing extreme poverty		
Absolute poverty head count (national estimate) (1997) ^{2/}	69	...
Poverty gap ratio (incidence times depth of poverty) (1997) ^{2/}	29	...
Education		
Adult literacy rate (1997) ^{2/}	40	61
Primary net enrollment rate (1997) ^{2/}	49	...
Primary gross enrollment rate (1997)	71	78
Health		
Life expectancy at birth (years) (1998)	47	50
Infant mortality per 1,000 live births (1998)	134	92
Mortality under 5 years per 1,000 births (1992-2000)	213	151
Prevalence of underweight children under 5 years (1995-98) ^{3/}	26	32
Total fertility rate (births per woman) (1998)	5.2	5.4
Contraceptive prevalence rate (women aged 15-49) (1990-2000) ^{3/}	6	21
Adult HIV-1 seroprevalence rate (per 100 adults) (1997)	16	7
Environment		
Access to safe water (percent of population) (1997) ^{2/}	20	43
General indicators		
GNP per capita (Atlas method; U.S. dollars) (2000)	210	500
Purchasing power parity GNP per capita (U.S. dollars) (1998)	740	1,410
Urbanization (1998)	38	33

1/ Based on World Bank, *World Development Indicators*, 2002, unless otherwise indicated.

2/ National Poverty Assessment, 1997 (published 1998).

3/ Data for most recent year available.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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DEPARTMENT

Public Information Notice (PIN) No. 02/70
FOR IMMEDIATE RELEASE
July 9, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Mozambique

On June 17, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mozambique.¹

Background

Economic activity has recovered strongly from the devastating floods that reduced growth in 2000 to less than 2 percent. Aided by a rebound in agricultural output, post flood reconstruction activity, and the first full year of production by the MOZAL aluminum smelter, growth reached almost 14 percent in 2001, bringing average growth for the last two years close to the annual average of 8½ percent recorded in the second half of the 1990s. Near-term prospects point to a continuation of this pace of growth in 2002, fueled by further large-scale private foreign investment.

However, inflation, which had subsided in early 2001 to less than 1 percent, rose to 22 percent at year's end, reflecting an overly expansionary monetary stance that went hand in hand with a depreciation of the metical. The central bank responded by tightening monetary policy from mid-2001 through higher reserve requirements, interest rates, and sales of foreign exchange and government bonds. This tightening of liquidity enabled the 12-month rate of broad money growth to decline from 45 percent in September 2001 to 30 percent in March 2002 and the metical to remain stable since October 2001. As a result, cumulative inflation in the first five months of 2002 was less than 1 percent.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The fiscal outturn for 2001 was stronger than programmed. Revenues were ½ of one percent GDP higher than programmed and the primary fiscal deficit was correspondingly lower than programmed. The government incurred significant outlays (2.3 percent of GDP) on bank restructuring, which were financed mostly by issuing bonds to the banks concerned.

External developments in 2001 were more favorable than envisaged under the program. The current account deficit (including grants) narrowed in 2001 to under 11 percent of GDP as MOZAL's aluminum exports contributed to a further narrowing of the trade deficit, which has been more than halved since 1999. Aided by this strong performance, net international reserves were increased by US\$7 million despite a shortfall of US\$120 million in external assistance.

Problems with two of Mozambique's largest banks were the focus of policy discussions. Accordingly, one of the banks (Banco Austral) was sold to a reputable international bank; the other (Banco Internacional de Moçambique) was recapitalized by the current shareholders. Steps have been taken to strengthen banking supervision and establish accountability for losses in the banking sector.

Important progress was made in key fiscal reforms with the passage of a new public financial management law and parliamentary consideration of a new income tax law. Despite further delays in developing a strategic plan for the justice system, a draft was circulated in February 2002, and detailed plans for the four branches of the system are expected to be finalized during the year.

Executive Board Assessment

Directors welcomed the strong recovery of economic activity in 2001 from the devastating effects of the floods in the previous year, and the good prospects for continued rapid growth in the period ahead. Directors commended the authorities for continuing their impressive record of broad-based reform, which formed an essential backdrop for the recent inflows of foreign direct investment and Mozambique's strong growth performance. They observed that the Mozambican economy is now reaping the rewards of sustained implementation of sound policies, in terms of macroeconomic performance and a strengthened institutional framework. They expressed concern about the impact of drought, and welcomed the authorities' action to address emerging localized food shortages.

Directors noted that inflation had abated in recent months, following its acceleration in 2001. They urged the authorities to persevere with the recent tighter stance of monetary policies to ensure that the inflation rate returns to single digits in 2002. Improved monetary control would require closer coordination of fiscal and monetary policies, Directors noted, and in this regard they recommended that the pace of foreign exchange sales by the central bank be consistent with externally financed budgetary spending and the international reserves target.

Directors agreed with the emphasis placed on fiscal adjustment over the medium term to support external and fiscal sustainability while safeguarding priority spending. They welcomed the authorities' efforts to strengthen tax collection and improve public expenditure management. They noted that further progress in both of these areas will be fundamental to safeguard expenditures in support of Mozambique's poverty reduction strategy (PARPA)

and to reduce the current high levels of aid dependence. Directors stressed the importance of ensuring that the new income tax law enters fully into force at the beginning of 2003, and that it would be prudent to delay any reduction in tax rates under the new law until the desired increase in collections had been firmly established. Directors welcomed the passage of the new financial management law, which establishes the basis for greater transparency, efficiency and accountability in the budgetary process in line with key recommendations of the fiscal transparency ROSC completed last year. The challenge now is to follow through on these legislative changes and put in place improvements in public expenditure management. In this regard, Directors urged the authorities to implement the action plan developed by a recent technical assistance mission from the Fund's Fiscal Affairs Department. At the same time, Directors pointed out the importance of an appropriate sequencing of key reforms—including the need to define more clearly the role of government and hence the size of the civil service before embarking on a salary reform.

Directors expressed disappointment about the delay in finalizing the integrated reform plan for the judicial system. While recognizing the complexity of such a project, they considered it indispensable to the government's long-term growth strategy and strongly urged the authorities to complete the plan without further delay.

Directors commended the authorities for the successful sale of Banco Austral, despite some delays relative to the authorities' own tight timetable. Nevertheless, the emergence of a capital shortfall in the largest bank, BIM, underscored the need for further actions to strengthen the financial system. They therefore urged the authorities to send a strong signal of the need for greater discipline in the financial system by pushing ahead with rigorous and transparent loan recovery and strengthening accountability for the problems in the banking sector. Directors also stressed the importance of enhancing banking supervision and strongly supported the government's stated objective of ending all government participation in commercial banks. Directors supported the government's request to participate at an early date in the Financial Sector Assessment Program. They also commended the recent approval of anti-money laundering legislation.

Directors were encouraged that Mozambique remained well placed to maintain external debt sustainability despite adverse developments in the world economy since reaching its completion point under the enhanced HIPC Initiative. They noted, though, that there remained significant risks over the medium term, and suggested that the projections embodied in the authorities' poverty reduction strategy be updated to incorporate more fully the macroeconomic implications of HIV/AIDS. Directors observed that a key challenge is to muster domestic resources and to achieve broad-based economic growth, thus maximizing the impact on employment and poverty impact. In this regard, they encouraged the authorities to give priority to creating an environment favorable for the development of medium and small-size business enterprises, and to include more detailed plans in this area in the next revision of the PARPA.

Directors agreed that the current flexible exchange rate regime has served Mozambique well and that high levels of external assistance had not so far resulted in a sustained real appreciation of the metical or other symptoms of aid-induced Dutch disease, as underscored by strong export growth. While competitiveness had not been compromised, Directors stressed the need to closely monitor aid inflows. They commended the authorities for maintaining a liberal trade regime, and welcomed their intention to reduce the top tariff rate in 2003, and to accept the obligations of Article VIII, Sections 2, 3 and 4.

Directors noted that Mozambique had made progress in completing bilateral agreements with Paris Club creditors. They also stressed the importance of strengthening debt management capacity, to ensure that obligations remaining after HIPC and other debt relief are serviced in a timely manner and that new borrowing remains within the country's payments capacity. Directors were concerned about the difficulty in reaching agreement with official non-Paris Club and commercial creditors, and urged these creditors to play their full part in debt relief for Mozambique. Some Directors also endorsed the suggestion that an escrow account could be established, into which estimated payments for these creditors would be set aside.

Directors noted that Mozambique's data are adequate for surveillance purposes, but weaknesses were still evident, especially in national accounts and balance of payments statistics. Thus, Directors welcomed Mozambique's participation in a data ROSC during 2002.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Mozambique is also available.

Table 1. Mozambique: Selected Economic and Financial Indicators, 1999-2002

	1999	2000	2001	2002 Prog.
(Annual percentage change, unless otherwise specified)				
National income and prices				
Nominal GDP (in billions of meticaís)	51,915	58,905	74,675	95,151
Nominal GDP (in billions of U.S. dollars)	4.09	3.75	3.61	3.88
Real GDP	7.5	1.6	13.9	9.0
GDP deflator	2.9	11.7	11.3	16.9
Consumer price index (annual average)	2.9	12.7	9.0	16.6
Consumer price index (end of period)	6.2	11.4	21.9	8.0
External sector				
Merchandise exports (in U.S. dollars)	16.0	28.3	93.3	1.1
Merchandise imports (in U.S. dollars)	46.8	-3.1	-3.9	58.3
Terms of trade (in U.S. dollars)	-14.3	-2.8	5.8	3.5
Nominal effective exchange rate (end of period) 1/	-0.7	-10.9	-23.5	...
Real effective exchange rate (end of period) 1/	2.0	-3.6	-9.3	...
(Annual change in percent of beginning-period broad money, unless otherwise specified)				
Money and credit				
Net domestic assets	23.9	11.6	9.1	12.0
<i>Of which:</i> net credit to the government	0.0	4.1	5.3	7.0
credit to the economy (in percent)	22.9	22.3	22.9	14.1
Broad money (M2)	35.1	42.4	29.7	19.2
Velocity (GDP/ average M2)	5.2	4.1	3.9	4.0
Prime rate (in percent; end of period)	19.6	19.6	25.3	...
(In percent of GDP)				
Investment and saving				
Gross domestic investment	36.9	39.6	41.6	57.7
Government	11.6	13.3	14.0	12.6
Other sectors	25.3	26.3	27.7	45.1
Gross national savings	19.3	26.9	31.1	28.8
Government	11.5	11.0	11.7	8.9
Other sectors	7.8	15.9	19.4	19.8
Current account, after grants	-17.5	-12.7	-10.5	-28.9
Government budget				
Total revenue	12.0	12.7	12.9	13.0
Total expenditure and net lending (incl. residual)	25.1	28.8	30.7	29.9
Overall balance, before grants	-13.2	-16.1	-17.8	-16.9
Total grants	11.7	11.6	12.9	10.1
Overall balance, after grants	-1.5	-4.5	-4.9	-6.7
Domestic primary balance	-3.4	-6.7	-7.7	-6.1
Excluding bank restructuring	-0.8	-5.0	-5.6	-3.4
External financing (incl. debt relief)	1.8	3.7	3.0	4.6
Domestic financing	-0.3	0.8	1.8	2.1
(In percent of exports of goods and nonfactor services)				
Net present value of total external debt outstanding 2/	212.0	194.4	113.2	100.3
External debt service (nonfinancial public sector)				
Scheduled, after original HIPC Initiative assistance	15.3	5.5	5.8	8.1
Scheduled, after enhanced HIPC Initiative assistance	...	2.5	3.6	5.2
Scheduled, after additional bilateral assistance	...	...	3.5	4.1

Table 1. Mozambique: Selected Economic and Financial Indicators, 1999-2002

	1999	2000	2001	2002 Prog.
(In millions of U.S. dollars, unless otherwise specified)				
External current account, after grants	-718	-478	-380	-1,120
Overall balance of payments	-236	-351	-419	26
Gross international reserves (end of period)	669	746	727	733
In months of imports of goods and nonfactor services	5.5	5.8	6.4	4.4
In percent of broad money	75.5	76.2	77.9	73.5
Exchange rate (meticaais per U.S. dollar; end of period)	13,300	17,140	23,320	...
Use of Fund resources (in millions of SDRs)				
Purchases/disbursements	21.0	45.2	8.4	16.8
Repurchases/repayments, before HIPC Initiative assistance	22.8	23.0	21.0	17.7
Credit outstanding	145.4	167.6	155.0	154.1

Sources: Mozambican authorities; and IMF staff estimates and projections.

1/ A minus sign indicates depreciation.

2/ Public and publicly guaranteed, in percent of the three-year average of exports. The data for 1999-2000 include the impact of total debt relief granted under the original HIPC Initiative. Data for 2001-02 include the impact of total debt relief under the enhanced HIPC initiative, additional bilateral assistance, and new borrowing.

NEWS  BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 02/48
FOR IMMEDIATE RELEASE
June 17, 2002

International Monetary Fund
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Washington, D. C. 20431 USA

**IMF Completes Fourth Review Under Mozambique's PRGF
Arrangement and Approves US\$11 million Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Mozambique's performance under an economic program supported by a Poverty Reduction and Growth (PRGF) arrangement and approved the disbursement of SDR 8.4 million (about US\$11 million).

Mozambique's economic program was originally supported by a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) approved on June 28, 1999 (see [Press Release 99/25](#)), for SDR 58.8 million (about US\$76 million). In March 2000, the commitment under the arrangement was increased to SDR 87.2 million (about US\$113 million). So far, Mozambique has drawn SDR 62.00 million (about US\$80 million) under the arrangement.

The PRGF, which is the IMF's concessional facility for low-income countries, is the successor arrangement to the ESAF. It is intended that PRGF-supported programs will in time all be based, as is the case of Mozambique, on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty.

PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

After the Executive Board's discussion of Mozambique, Shigemitsu Sugisaki, Deputy Managing Director, and Acting Chairman, stated:

"Following the devastating effects of the floods in 2000, Mozambique has resumed the rapid rates of economic growth that are essential to the sustained implementation of the country's ambitious poverty reduction strategy. Performance under the PRGF-supported program for 2001 extended Mozambique's successful track record of financial stabilization and structural reform over the last decade. All of the program's end-2001 quantitative and structural targets were met except for the benchmark on reserve money.

"The sharp increase in inflation in 2001 has been a cause for concern. However, the subsequent tightening of monetary policy initiated in mid-2001 has reinforced the normal easing in prices in the opening months of the year, and inflationary pressures have declined considerably. The government's program appropriately calls for continued monetary restraint aimed at bringing the inflation rate down to single digits during 2002. At the same time, fiscal policy is suitably geared to meeting priority spending consistent with the government poverty reduction strategy, while lowering the primary fiscal deficit and avoiding recourse to domestic borrowing.

"The authorities have also faced difficult challenges in the banking system, including capital shortfalls in two of Mozambique's largest banks. Steps taken to resolve these difficulties, including the sale of one of these banks, have been complex and costly. The government is committed to a rigorous and transparent process to recover nonperforming loans and to strengthening accountability for these problems. At the same time, in an effort to avoid the recurrence of these problems, the government's program includes tightening of banking regulations and strengthening of banking supervision.

"The macroeconomic framework set out in Mozambique's poverty reduction strategy paper (PARPA) appropriately calls for fiscal adjustment over the medium term to safeguard fiscal and external sustainability while reducing the country's current high dependence on external aid. This will require concerted efforts to mobilize domestic resources and enhance the efficiency of government spending. In line with these objectives,

the government's structural reform program in 2002 focuses on the implementation of a new income tax law and of the new public financial management law, which aims at improving public expenditure management.

“Despite adverse developments in the world economy since Mozambique reached its completion point under the enhanced HIPC Initiative, there has been no deterioration in debt indicators. The country appears well placed to maintain external sustainability,” Mr. Sugisaki said.

**Statement by Cyrus D.R. Rustomjee, Executive Director for the
Republic of Mozambique
June 17, 2002**

Introduction

My Mozambican authorities are grateful to the Fund for its positive cooperation and effective support and to the staff for their very constructive role during the numerous dialogues with the authorities, both of which have been invaluable for Mozambique's long-lasting adjustment and reform process, initiated in the second half of the 1980s. My authorities are also appreciative of the steady and multi-faceted assistance provided by their development partners over the years, which has greatly facilitated the materialization of the ambitious targets set under successive programs. The staff report provides a candid and balanced assessment of recent economic developments and my authorities generally concur with the thrust of policy recommendations and view the report to be a useful contribution to the current policy formulation.

The report sets out in clear terms the considerable progress that my Mozambican authorities have made in implementing sound economic and financial policies. The economy is now reaping the rewards of these policies in terms of macroeconomic stability and strengthened institutional framework. These conditions were essential for laying the foundations for a sustainable and higher level of growth of the economy and reduction of wide-spread poverty. Determined steps taken to deregulate the economy, that included the liberalization of the trade and exchange regime, the reform of the financial sector, and the aggressive program of privatization of public enterprises, were fundamental in enhancing the overall efficiency and competitiveness of the Mozambican economy and in creating an enabling environment for increased private sector participation. The rising inflow of foreign direct investment is a testimony of the growing confidence in the economy.

Despite the impressive growth performance during most of the 1990s decade, at an annual average rate of 5.7 percent, sustaining such rapid economic growth and ensuring better living standards for the entire population is an immense challenge facing my authorities. In this regard, while the megaprojects have an important role to play in this process, the major test will lie on the ability to attract flow of resources to small and medium scale labor-intensive productive activities, which will assist in guaranteeing a more balanced growth of the economy while at the same time expanding the prospects for creating employment opportunities. In this connection, my authorities are fully cognizant of the need to boost national savings not only to stimulate domestic investment but also to reduce foreign aid dependency.

Recent Economic Developments

The evolving resilience of the economy is attested by the manner in which the country has swiftly recovered from the devastating effects of the 2000 floods that has beset Mozambique. Economic activity recovered strongly in 2001, when GDP growth reached almost 14 percent,

over 4 percentage points above the program expectations, mainly on account of buoyant agricultural production and construction activity and to which the first full year of production of the aluminum smelter megaproject made also an important contribution. The fiscal outcome turned out to be much stronger than programmed, with the domestic primary deficit being 2.4 percentage points lower than projected, as a result of better than expected performance in revenue collection and a sharp reduction, predominantly, in capital spending due to a shortfall in external financing. Delays in the disbursement of pledged external budget assistance have prompted the authorities to rely on further restrictions on the wage bill and spending on goods and services. The external current account deficit has also narrowed significantly, compared to both the program target and the outturn in 2000. The international reserves position was further strengthened. Building on past achievements on structural reforms, additional actions were taken during 2001, particularly in the area of fiscal reforms.

In the pursuit of the goals clearly set in their poverty reduction strategy paper, PARPA, my authorities have continued to attach special attention to the implementation of a wide range of social policies aimed essentially at increasing investment in human capital and social and economic infrastructure. Improvements in tracking of public expenditures have been important in enhancing the quality of social sector spending.

Conversely, progress was less reassuring in relation to price developments, where performance has fallen short of expectations, with inflation reaching nearly 22 percent by end-2001 and reversing past gains. Some difficulties also emerged in the financial sector related to the recapitalization of the two largest commercial banks, Banco Internacional de Moçambique (BIM) and Banco Austral (BA). The government has provided the necessary support to these banks, for augmenting their capital base. One of the banks, the Banco Austral, was successfully reprivatized in 2001, after the last minute refusal by its private shareholder to participate in its recapitalization. In the course of the year, it also became apparent that the recapitalization of another bank, Banco Comercial de Moçambique effected in 2000, was insufficient and the issue will be addressed in the context of the 2002 budget.

As a result of these generally very positive developments, Mozambique has exceeded by comfortable margins all quantitative performance criteria and observed all structural benchmarks for end-September and end-December 2001, with the exception of the benchmark on reserve money.

The Medium-Term Strategy

To sustain the gains achieved so far, the medium-term strategy, as outlined in the PARPA, aims essentially at maintaining a stable macroeconomic environment supportive of sustainable high levels of growth that benefit all segments of the population, particularly those most affected by abject poverty. It also aims at giving continuity to the structural reforms to further strengthen the functioning of market mechanisms and boost private sector activity. The authorities are fully aware of the importance of fostering progress to place the public finances on a sustainable path. To this end, special emphasis will continue to be

devoted to strengthening domestic resource mobilization and enhancing the efficiency of spending while meeting the expenditure priorities related to poverty-reduction programs. In support of these objectives the medium-term strategy envisages a continuation of rapid growth at an average of 8 percent through 2010. Inflation is expected to be contained within a range of 5 to 7 percent. The projected reduction in the primary fiscal deficit (excluding bank restructuring costs) from 5.6 percent in 2001 to 2.5 percent in 2005 is regarded as necessary to reduce reliance on foreign assistance. The planned improvements in domestic savings will also assist in narrowing the external current account deficit to 11 percent of GDP by 2005, from 23.6 percent in 2001. While no significant changes are anticipated in this strategy, some adjustments to the macroeconomic framework are expected to occur once the full impact of the HIV/AIDS as well as of the postponement of a megaproject, are incorporated in the PARPA projections.

Policy Course in 2002

The policies envisaged in the program for 2002 have been formulated in line with the government's poverty reduction strategy described in the PARPA, which was endorsed by the Boards of the Fund and the World Bank in September of 2001. Like other countries in Southern Africa, Mozambique has been facing both the social and economic adverse effects of the severe drought that is afflicting the region. While the full assessment of the impact of this natural disaster is being carried out, the authorities have decided to adopt a less ambitious approach than would have been the case, in setting the key macroeconomic goals for 2002. The economy is projected to still grow at a robust pace of 9 percent against the 12 percent initially estimated and the 12-month inflation rate is projected to be reduced back down to 8 percent.

As **fiscal** consolidation will remain one of the major challenges facing economic policy in the medium-term, the authorities' intention is to continue to guide their fiscal policy to progressively reducing fiscal imbalances. To this end, a further reduction in the domestic primary deficit (excluding the bank restructuring costs) to 3.4 percent of GDP is envisaged for 2002, followed by additional declines in subsequent years. The authorities realize the importance of increased revenue mobilization efforts and they intend to explore additional feasible avenues that would assist in the materialization of this objective. They are ready to consider the staff's suggestion to increase the petroleum excise tax, but would first like to ascertain its impact on poverty, especially on the prices of some transportation means used by a large majority of the people, which could further erode their already meager income. Accordingly, this issue has been made the subject of a poverty and social impact assessment, which is currently being conducted. The authorities will continue with the policy of improved monitoring and controlling public spending. Resources will also continue to be channeled with priority towards social programs with direct impact on poverty alleviation envisaged in the PARPA. The fact that the wage bill will be contained to its budgeted amount despite the higher-than expected inflation and an increase of 22 percent in the minimum wage that resulted from the tri-partite negotiations in May 2002, corroborates the authorities' determination to maintain a tight lid on other expenditures. The authorities also intend to maintain the momentum of the tax reform initiated under previous programs, through the

implementation of the new income tax law. With a view to improve transparency and accountability of the budgetary process important reforms were introduced in public expenditure management. A plan is being designed to introduce reforms in the public sector aimed at improving its effectiveness.

The measures in the fiscal area are to be complemented by keeping a tight rein on **monetary** expansion so as to be consistent with the projected decline in inflation. The growth of broad money is expected to slow down to 19 percent from about 30 percent in 2001. As a result of the substantive tightening of the monetary stance adopted in mid-2001 and continued into 2002, inflationary pressures are showing signs of subsiding. According to the latest developments, inflation has been kept in line as envisaged in the program, during the first five months of 2002. In May, the accumulated inflation was of 0.9 percent, while the 12-month inflation stood at 19.5 percent. These positive developments were made possible among other factors, by the significant slow down in monetary expansion and greater stability in the exchange rate against the US dollar. In addition, the central bank will continue to work closely with the treasury to improve the coordination between the monetary and fiscal policies and linking government spending to foreign exchange sales, which will assist to better control liquidity management and hence inflationary pressures.

My authorities were particularly concerned with the problems that recently emerged in the **banking system**. As a result, the monetary authorities are paying particular attention to strengthening the role of banking supervision, improving regulations, and tightening enforcement. These include measures to strictly enforce the observance of capital adequacy ratios, mandatory adherence to International Accounting Standards, and strict regulations on connected lending. Measures are also being taken to reinforce the capabilities of the supervision department through recruitment of new staff, training of the existing ones, and installation of a new information system. Recognizing the value of the Financial Sector Assessment Program, the authorities have already requested to participate in it and hope to be able to benefit from an FSAP soon.

Having reached the completion point under the enhanced HIPC Initiative, the authorities are keenly interested in further strengthening their **debt management capacity**. To this end, they have requested the assistance of foreign consultants who on the basis of the existing capability in managing the debt will be formulating a post-HIPC debt strategy to be proposed to the authorities. In moving in this direction, it is important to my authorities to see some progress being made towards the resolution of the outstanding debt to non-Paris Club creditors. However, despite the authorities' continuous efforts to persuade these creditors to accord HIPC comparable terms in rescheduling the debt, apart from a few exceptions, there has been no progress. With no positive prospects in view to rapidly resolve these pending issues, the authorities do not see much merit in maintaining an escrow account as suggested by the staff.

Conclusion

Despite the very extensive period of time in which the economy has gone through a process of adjustment and reform, my authorities continue to believe that only through the pursuit of sound policies and reforms will the real potential of the Mozambican economy be able to be unleashed for the benefit of its people. In this effort, they hope to be able to count on the support of their development partners and the BWIs.

We are pleased to advise that my authorities, as has been the case in the past, have acceded to the publication of the staff report.